



An Historic Oddity – The Dow Passes The Nikkei

December 2, 2002

If you follow the markets long enough, you eventually realize that events that once looked impossible happen all the time. Investors too often try to predict the future from the recent past, and too often come to grief. In 2000, the NASDAQ Composite Index reached 5000. How many people predicted it would fall below 3000, let alone 1500? In the early 1980s, many banks' prime rate (the rate at which they make short-term loans to their best commercial customers – believe it or not, it was once the stuff of daily business news) stood above 20%. Fed Funds at 1-1/4%? A distant historical curiosity. And for those of us that learned about finance and the markets during the 1980s, one recent event really stands out. On November 14, 2002 the Dow Jones Industrial Average closed at 8542.13, higher than Japan's Nikkei 225 Index (8303.39 that day). At one time, the gap between the two indices was more than 36,000 points.

When we look back at dramatic moves in markets, whether over a year or two or over a decade or two, we sometimes feel that we should have seen them coming. But can we really plan our portfolios that way? Should we have known the NASDAQ would fall below 1200? Is it bouncing now, or will it fall back? Could we have known in 1990 that Japan's stock market would slide, and the U.S.' prosper? What will they do next? We may have opinions on all these questions, but what we know is that the markets will surprise us. The best approach to investing is to plan accordingly. We know what the engines of economic growth are – we can invest in them. We know how badly concentrations of risk can burn us – we can avoid them. We can build portfolios to create the best reward potential for the risk we are willing to take, and manage our portfolios to reduce the risks that do not earn us a reward.

Let's look at the U.S. and Japan in 1989. As mad as the market bubble of the late 1990s seems now, the 1980s were really a wild and woolly time in American business. The decade began with high inflation and high interest rates. It saw the beginnings of a long market rally that sprung from the persistent frustrations of the 1970s. The big business stories of the 80s were stories of massive restructuring of American industry. They had characters as colorful as any in recent history. *The Wall Street Journal* supplied them with suitable Homeric epithets:

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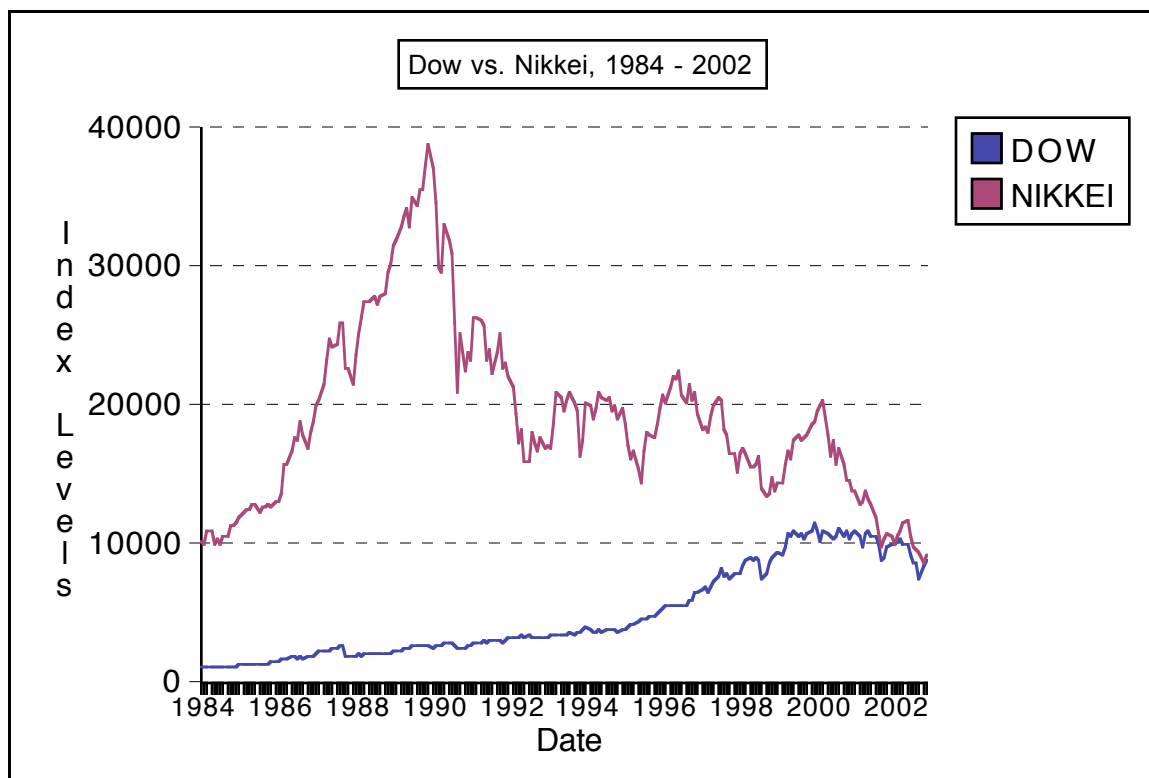
“Maverick Texas Oilman T. Boone Pickens,” “Minneapolis Investor Irwin Jacobs,” or “New York Financier Carl Icahn,” who suddenly became “TWA Chairman Carl Icahn” after one contest for corporate control. This was the era of the hostile takeover. We saw leveraged buyouts of everything from Topps Co. (makers of baseball cards and Bazooka bubble gum) to RJR Nabisco. We howled about *Barbarians at the Gate*. Bond desks were the place to be on Wall Street (remember *Liars’ Poker* and *The Bonfire of the Vanities?*) and junk bonds were the most glamorous of all (who could forget “Junk Bond King Michael Milken” and *The Predators’ Ball?*).

Many ordinary Americans found it frightening to watch corporate raiders, LBO specialists, and suspender-clad financiers wreak such havoc in corporate America during the 1980s. While American industry seemed in disarray – maybe civil war – Japan seemed a model of cool efficiency. Japanese manufacturing quality was the envy of the industrial world. So was Japanese labor productivity (sound familiar?). Japanese groups paid astronomical prices (far too high, as it turned out) to buy U.S. trophy properties from Rockefeller Center to Pebble Beach. Tokyo land prices rose to where a writer could estimate fancifully that the grounds of the Imperial Palace in Tokyo were worth more than all the land in California.

At the end of 1989, the Nikkei 225 Index, the most popular general measure of the level of the Japanese stock market, stood at 38,916. This turned out to be its peak, but no one knew that at the time. The index had been below 10,000 as recently as 1984, so it had nearly quadrupled in just over five years. Writers on both sides of the Pacific – quietly confident in Japan, hand-wringing in America – asserted that the high level of equity and real estate prices must reflect real values, arguing that Japan had discovered a kind of philosopher’s stone of business that converted the energies of ordinary workers into fabulous, and ever-increasing, wealth.

As the Nikkei ended 1989 at 38,916, the Dow Jones Industrial Average stood at 2,753. The Dow had more than doubled in five years, but that was nothing to the Nikkei’s moonshot. Worse, many Americans saw the 1980s as a decade of redundancies and restructurings – sometimes the results of those takeovers and leveraged buyouts – which seemed even more depressing against the backdrop of what looked like a growing Japanese industrial hegemony. Even though the point levels of the indices are arbitrary accidents of history, it *felt* bad to see the principal Japanese index reach a level fourteen times the Dow’s. It was just one more sign of a seemingly insurmountable gap. At the end of the 1980s, who could have blamed an American investor for concluding that the American economy was in hopeless decline at the hands of mercenary predators, and that we were on the verge of an era of Japanese industrial supremacy?

The figure below shows the denouement. We are now nearly thirteen years, and counting, into a crushing bear market in Japanese equities. As good as Japanese manufacturing was and is, apparently Japan's fearsome economic power was part of a bubble much more dramatic than the U. S. internet bubble a decade later. The Nikkei closed November 2002 at 9,215, a loss of -76%, or -10.5% per year over the period since December 1989.



U. S. stocks had a very good decade in the 1990s. Even now, after declining more than 20% from its peak, the Dow stands (11/29/02) at 8,896, a gain of +223% since the end of 1989, and an annualized return, not counting dividends, of +9.5%. One entirely reasonable explanation for the U.S. market's performance since 1989 is that those corporate raiders really did squeeze inefficiency from American business, and that the restructuring they stimulated, painful as it was, set the stage for a period of handsome growth and solid returns. Should we have known? Maybe. Should we have invested? Absolutely.

When the Dow and the Nikkei crossed during November at about 8,500, they closed a gap that had seemed impossible in 1989. And that's the point. Everyday experience tempts us to base our expectations on the events of the recent past. But in the investment world, shocking

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events occur as a matter of course. Sound investment practice recognizes that planning only for what seems likely today is a recipe for disappointment or disaster. Instead, recognize that the greatest opportunities, and the greatest risks, often lie in the places they seem least likely today. Position your portfolio to capture opportunities and mitigate the effect of risk. Investors that came into the 1990s with solid allocations to U. S. equities and only modest exposures to the hottest overseas market of the 1980s have profited handsomely in the years since.

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Source for all figures: TIA analysis, based on index data from Yahoo! Finance.

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