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Forecast: Worse Than a Perfect Storm

95 Recommendations

By Bill Barker
March 9, 2007

You're likely familiar with the concept of "the perfect storm." Ever since Sebastian Junger's excellent book of the same name came out, chronicling the convergence of three separate weather systems that met over the North Atlantic in 1991 to create one of the more violent storms on record, the phrase has become part of the cultural landscape.

And we're hearing it again these days -- in part with good reason, but for the most part without.

Like many items that have seeped into cultural consciousness, the phrase has been diluted of much of its meaning. The storm that Junger wrote about was a roughly once-in-a-century occurrence. Nowadays, there's no combination of events too trivial to possibly be accused of being a perfect storm. A 90-point drop in the Dow in one day? I've heard that called the result of a perfect storm, even though it happens many times a year.

A brief search on Google News finds that within the past 72 hours, "perfect storms" have been responsible for stagnating minority ownership of radio stations, depriving Canadian truckers from getting cheap fuel, causing 52-week highs in gold, and making legislation addressing global warming vaguely conceivable.

Oh, and there's been one causing problems in the stock market as well.

Actually, I believe we have a combination of occurrences that could get us closer to a perfect storm, though that's not ultimately what I'm worried about for investors in foreign markets.

"Perfect storms" in the market
The two market crashes of recent history that typically spark claims of perfect stormism are 1987's Black Monday and the tech crash of 2000 to 2002. The 1987 crash qualifies much more closely. The 20% drop in the Dow Jones on one day actually *is* a rare event -- certainly in the sense that it has happened only *once* this century on a standard market-trading day.

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The Nasdaq crash of 2000 to 2002 is a bit different -- a prolonged decline in the average, though it certainly carried a few individually breathtaking days. It was a pretty long-lasting storm, though.

What's the perfect storm on the horizon today?
Today, the combination of factors that could make for a perfect storm are (1) the extreme returns of a number of foreign markets last year, (2) the growing knowledge of those returns among investors, and (3) the rush of money moving toward those markets.

Consider first the returns of some select foreign markets in 2006, which were fueled by individual darlings such as **Companhia Vale de Rio Doce** (NYSE: RIO), **Vimpel-Communications** (NYSE: VIP), and **Baidu.com** (Nasdaq: BIDU).

Index	Change
China	121%
Russia	92%
Mexico	49%
India	47%
Brazil	33%

Source: Birinyi Associates.

Second, consider this data point. According to research produced by Evergreen Capital, when you have hot sectors of the market trading at historically high valuations (as some but not all of these markets now are), and there are massive inflows of cash into the mutual funds that invest in those sectors, years of underperformance result.

Third, consider this: According to *Barron's*, last year, 92% of all net mutual fund inflows went into foreign funds.

That's three things, right? Hot sectors, high valuations, and significant money inflows? Are foreign-market investors in for a perfect-storm scenario, a la 1987 or Nasdaq 2000?

Well, we could have had some evidence of that last week, when the Chinese market collapsed to the tune of 9% in one day, but I think there are other problems on the horizon.

Let's recall that the 1987 event, though it qualified as a once-in-a-century market crash, wasn't really that bad. The market had returned to September 1987 levels again by June 1989. Even those who put everything in at the top were looking at a 10% gain on their investments two years after the crash. And those who got in shortly after the crash were up 30% or more after two years.

Not so with the Nasdaq crash of 2000. Seven years later, the **Nasdaq 100 Trust Shares** (Nasdaq: QQQQ) are still less than half of their peak valuation. Major components, such as **Microsoft** (Nasdaq: MSFT), **Cisco Systems** (Nasdaq: CSCO), and **Yahoo!** (Nasdaq: YHOO) each trade at less than half of their pre-crash highs.

What really worries me is not that there could be a sudden, massive crash of historical nature in some market somewhere in the world. I can't predict such things, though I recently wrote that I don't think the conditions are present domestically for a market crash. What concerns me more than a once-in-a-decade or -century scenario is the very mundane type of squall that habitually crushes shareholder returns.

Think about it: The way the vast majority of Americans invest in the stock market is to buy a mutual fund with the help of a professional financial advisor. Day in and day out, through perfect storm or sunny skies, that's what people do.

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The Motley Poll

Are you planning any home improvements in 2007?

Yes, I'm upgrading with an eye toward selling.
I'm making improvements, but I'm staying put.

And what are the results of that?

A recent study (link opens a PDF file), titled "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry," is the most detailed work ever conducted comparing the record of financial advisors with those who make their own mutual fund purchases. It shows that this country's financial advisors truly cost investors.

Here are the results for returns for 1996 through 2002:

Financial advisors:	2.9%
Individual investors:	6.6%

*Raw returns, net of all expenses.

This is consistent, by the way, with other studies of mutual fund returns to investors. Investors using financial advisors habitually realize only a fraction of mutual fund returns in their accounts, and mutual funds themselves realize a fraction of the long-term returns that the stock market provides to buy-and-hold investors.

The real perfect storm: an everyday, not once-in-a-lifetime, occurrence. That's awful. That's a consequence of the true perfect storm: poor knowledge about the costs of investing; switching strategies; chasing the hot market; self-interested financial advisors.

We hope you do better than that over the coming decades. The costs, and rewards, are dramatic.

If you're interested in experiencing the exciting returns of foreign markets over the coming decades, join us at our *Motley Fool Global Gains* international-investing service, as we recommend individual companies --- ones that aren't going to be from the priciest, hottest markets. We think that an intelligent approach -- cost-conscious, informed, and directed by your own best interests -- will serve you incredibly well internationally over the long term. A free 30-day guest pass is yours today.

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