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Adding Up the Zeros

By Randall W. Forsyth

Who's a truly successful investor? One who's happily heading out to the golf course on a weekday afternoon -- while the market's open and down 200 points.

Those were the plans of Michael O'Higgins when his phone rang last week at the Miami office housing his eponymous investment firm of O'Higgins Asset Management. You, too, might be tempted to shoot a round during the workday if you were up 27% so far this year, one in which (if you needed to be reminded) the major averages are down anywhere from 17% for the Dow to twice that for the Nasdaq. And eschewing any false modesty, Mike also notes that his funds are up over 400% in the five years through September, a span in which the bubble and its bursting has left the S&P 500 basically flat.

When this column checked in with Mike back in May, he already was up 19% for the year, owing to a combination of shorts on the S&P 500 and the Nasdaq 100, combined with longs in gold stocks. He covered those short positions during July's nose dive because Mike says he felt that he had too much company in his bearishness. (He got that same feeling last November, when he sold his long-term Treasury zero-coupon bonds that he rode from a 15% yield in 1980 all the way down to under 5%.) By mid-summer, insider trading (the legal kind done by corporate types) had turned to the buy side after officers had been dumping four times as much as they were buying earlier in the year. The VIX -- the Chicago Board Options Exchange volatility index, popularly viewed as the market's "fear index" -- spiked higher, signaling some kind of panic blow-off. So he cashed in his winnings on that bet.

But Mike was quick to add that he could be resetting those shorts any time now. Why? "We're setting up a similar situation to what preceded the crash of '87." For those of you whose memories don't stretch back 15 years, the market plunged as much on a single Monday that October -- 22% -- as it has lost so far this doleful year.

"Basically, people are even from five years ago," Mike observes. "If the market is down from here, they're underwater." Mutual-fund investors are apt to start bailing out again, "in a mirror image to the late 'Nineties," he says.

Equity funds saw some $47 billion exit during July's downdraft, and though bottom-pickers having been back in buying funds of late, he thinks folks will start dumping their funds again once the market resumes its trip south.

Fund managers, Mike alarmingly notes, have been running down cash positions since the beginning of the year to meet redemptions. Simple math dictates that cash would be rising as a percentage of fund portfolios as the value of the stocks they hold declines. Instead, they're getting more deeply invested, which will force more liquidations if their shareholders start to redeem again.

Add to that the litany of other signs of still-excessive valuations, notably paltry dividend yields, which have crept up to only 2.2% for the DJIA. Dividends, he dryly adds, are something beyond accountants' ability to manipulate.

Besides shorting the indexes, Mike sees gold shares as a mirror image to stocks, and indeed to paper assets of all types. "Around the world, people have gotten screwed by holding paper currencies -- in Russia and Argentina, Europeans lost 35% by holding euros, not to mention if you owned Enron, WorldCom or Global Crossing." And gold's allure now isn't as an inflation hedge. Ed Hyman's ISI Group points out that gold has moved up while the TIPS spread -- the yield premium regular Treasuries pay over inflation-protected securities -- has contracted.

Mike sees gold as being where stocks were in 1982. For nearly 20 years up to that point, the Dow spent virtually all of its time between 750 and 1000, before it broke through that ceiling and never looked back. Gold, after spiking to $800 an ounce in early 1980, steadily declined, and has spent the last five years mostly between $250 and $300, conditioning people to sell at the top end of that range. This year, the metal broke through to $330, slipped back to near -- but not below -- $300 and has been consolidating around $320.

Gold shares have had a better run, with the XAU (the Philadelphia gold and silver index) soaring from 55 at the beginning of the year to 89 at mid-year, only to give almost all of it back in July's slide. Since then, however, the XAU is back up to 76, and headed to 100, says Mike. His play: all cash and 7% in call options on the XAU.

Of the sector, he says: "It's so cheap and it acts so beautifully." At gold's peak 22.5 years ago, the Dow and the metal sold at roughly the same price. Now, the DJIA fetches about 26 times the gold price. The average ratio, Mike points out, is 10-to-12 times. There are two ways to get back to that golden mean: stocks could be halved or the metal could double. You get the idea he doesn't mind how he gets there.