
Dow 36,000: Are Stocks Actually Undervalued?

James K. Glassman

James K. Glassman is a resident fellow at the American Enterprise Institute in Washington, D.C. He is the author, with Kevin Hassett, of *Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market*, published in 1999. *Dow 36,000* quickly made its way onto *Wall Street Journal* and *Business Week* best-seller lists and was named one of the top three financial books of the year by Amazon.com.

Glassman has been publisher of *New Republic*, president of the *Atlantic Monthly Company*, executive vice president of *U.S. News & World Report*, editor of *Roll Call*, and a columnist for the *Washington Post*. He has written for those publications and for the *New York Times*, the *Wall Street Journal*, the *Los Angeles Times*, and *Forbes*.

He hosted PBS's *TechnoPolitics* for four years (1995–99) and was moderator of CNN's *Capital Gang Sunday* for three years (1995–98). He has appeared on *Nightline*, *Crossfire*, and the *PBS NewsHour*.

In December 1999, Glassman spoke to an *American Experiment* audience about the principles underlying *Dow 36,000* and reactions to it.

I used to do a lot of writing about politics and economics, and I still do some. But about six years ago, I became interested again in a subject that I had been writing about twenty years ago: the stock market. And then about

three years ago, I went to the American Enterprise Institute, a think tank in Washington, and it turned out that in the office next to me was a young—or young to me, anyway—economist named Kevin Hassett. Kevin is a real

economist; I am merely a journalist. Kevin has a Ph.D. from the University of Pennsylvania and taught at Columbia; he was a senior economist at the Federal Reserve.

Kevin and I began to talk about what was going on in the stock market, which puzzled us. These discussions led to an op-ed piece in which we laid out the basics of the theory that ended up in our book. Kevin suggested that we put our ideas down on paper, after we had been talking about them and researching them for over a year. When the piece was published on March 30, 1998, the Dow was at 8781; the Wall Street Journal headline was “Are Stocks Overvalued? Not a Chance.” We got an enormous response, almost all of it negative, so we figured we were really onto something.

Then we got some book offers, and in the summer of 1998 we decided to start writing a book. At the time, the Dow was at 7500. We projected a Dow of 35,000, then did some major revision and ended up at 36,000. The book came out in September 1999, and it has turned out to be the kind of book no one can refrain from commenting on.

The Wall Street Journal called our book “dangerous.” Barron’s called it “infamous.” The St. Louis Post Dispatch called it “ridiculous.” Business Week called it “ludicrous.” And those were the good reviews.

In fact, we’ve had many good reviews, including a terrific piece by Gregory Mankiew, a professor of economics at Harvard who has written the textbook that’s replacing the Samuelson textbook—thank God—as the

main textbook that young, impressionable college students use for economics. And there was a great piece in Kiplinger’s Personal Finance by Knight Kiplinger, who said that our book should be placed on an altar next to the works of Peter Lynch and Benjamin Graham.

The Infamous Book

So what does this infamous, ridiculous, ludicrous, and dangerous book that you should place on your altar say? It says that stocks are undervalued, that stocks today are cheap, that the proper valuation for the stock market as reflected by the Dow Jones Industrial Average—which is a good proxy for the market as a whole, thirty blue chip stocks—should be, today, 36,000. The Dow currently is about 11,000.

What does this mean? It means that investors can hold stocks right now and feel comfortable. If you are worried about being in the stock market, or worried that you missed it—I’ve been hearing “I missed the market” ever since I started writing my column in 1993—you should not be worried. You have not missed it. If you are uncomfortable about being in the market today, you should not be.

It is important to own the right kinds of stocks, the right kind of portfolio, and we talk about that in the second half of the book. I’ll mention that later, but mainly I want to talk about how we came up with this seemingly very large number. In fact, it may be an understatement. In August 1982, only eighteen years ago, the Dow Jones Industrial Average stood at 777. Hard

to believe today, but it's true. Today, it's over 11,000. That is an increase of a factor of fourteen over a period of seventeen and a half years.

In 1995, 1996, 1997, and 1998, the Standard and Poor's 500 stock index, which is also a good proxy for the market as a whole—it's roughly the five hundred largest U.S. stocks—returned, in price increase plus dividends, more than 20 percent in each of those years. Four years in a row. That has never before happened in American history. In fact, the S&P had never returned more than 20 percent more than twice in a row until 1997. That year was a triple, 1998 was a quadruple, and I would not rule out—even though I am not, I emphasize, a short-term prognosticator—another year of 20 percent growth in the S&P. Meanwhile, the Dow is almost certain to return more than 20 percent this year. [Note: He was right—both the Dow and the S&P returned more than 20 percent in 1999.]

From Ptolemy to Copernicus

Something profound has been happening in the U.S. stock market. A fourteenfold increase in seventeen and a half years. A twentyfold increase including dividends over that period of time. And yet, during this entire period, what have we heard from academics, from journalists, from Wall Street analysts? We've heard that stocks are fully valued or overvalued, that we're in a bubble, that we're on the verge of a crash. We hear it today, we heard it a few months ago, we heard it a year ago, we heard it two years ago, we heard it five years ago, when the Dow was one-

third the level it is today. We heard it ten years ago, when the Dow was at 2300. We've heard it all the way up. Indeed, that was a starting point for the work that Kevin and I decided to do.

Why is it that these smart people have been saying that the stock market is on the verge of a crash, that it's fully valued, yet it keeps going up? That's the puzzle. The first conclusion that Kevin and I drew was that these are indeed smart people, but they're looking at the market the wrong way. Their way of determining whether stocks are overvalued or undervalued or properly valued depends on tools that we believe are seriously flawed and that, clearly, at least over the past ten years and maybe longer than that, have been repudiated by the facts. So we set out to build our own model.

The best way to understand our book is as a paradigm shift. In 1964, a political scientist at MIT named Thomas Kuhn wrote a book called *The Structure of Scientific Revolutions*. Kuhn argues that in any discipline—he talks about science—experts gather around a model or a way of describing the discipline or describing the world. As more facts come out, the model is repudiated and a new model is introduced, not without strife. That new model represents a paradigm shift. We believe we are in a paradigm shift now in finance.

A good way to understand it is this. Kuhn talks about astronomy. Two thousand years ago, an astronomer in Alexandria, Egypt, a Greek named Ptolemy, had this notion that the earth was the center of the universe. We laugh at that now, but it actually wasn't

so screwy. He watched the stars move every night. They were there, then they moved there, and there, and he's staying still, right? So they were revolving around the earth. And so a model, the Ptolemaic system, was constructed with the earth at the center of the universe. But as telescopes got better, and people got more information about eclipses and things like that, it became quite clear that Ptolemy was wrong. Well over a thousand years later, the Copernican system replaced the Ptolemaic system, not without a great deal of strife and defensiveness on the part of the defenders of the old model.

We think the same thing is going on in finance. We're not saying we're Copernicus, but that's a good way to understand what's happening. It's not that something is going on in the markets that's so different. What's happening is that something is going on in our perception of the markets.

Most of us understand the old model of the market, the notion that certain measurements provide ceilings for stock prices. The main measurement is the price-to-earnings ratio, which is the number of dollars it takes to buy a dollar's worth of earnings in a corporation. For years, people have believed that there is a limit for the market as a whole on PE ratios—it used to be fifteen, and now they've kind of raised it to twenty—but once we get over that, there's supposed to be trouble. The market corrects itself, reverts to the mean, via a drop in stock prices. Another measurement is the price-to-book ratio, which most people

seem to have given up on by now. But PE ratios persist.

We don't dispute the fact that at a certain level, PE ratios have declined. But we think that's the wrong thing to look at. Certainly, over the past ten years, PE ratios have just gone up and up and up and up. If you believed strictly in the PE theory and actually acted on it, you would have gotten out of the market in the early 1990s and never gotten back in. It's more complicated than that, but that's basically the old model.

Cash and Choices

We decided on a new model with two basic elements. One is that what really counts when you're investing is cash. Not PE ratios, not price-to-book ratios, but cash. How many dollars can you put in your pocket? That's why you invest. If you were to buy a condominium as a rental property, what would you want to know? The rent. At a thousand dollars a month, you're going to take out \$12,000 a year. Your cash flow is what counts. It's not hard to value that condo once you know what your flow of cash is.

Same thing with stocks, although they are a little more complicated, because of dividends and the earnings the companies retain on behalf of their shareholders. Other parts of those earnings they plow back into the company. It's not all that easy to calculate, but it's not all that hard, either. What counts is cash.

Now let me step back for a moment. When we talk about investing, what

we're basically talking about is choices. Most investors are choosing between stocks and bonds. The interesting thing about investing is that there's no place to hide. If you decide you're scared of the markets and you're going to put your money under your mattress, you can be sure you will lose purchasing power over time. You have to invest somewhere if you want to see the value of your dollars appreciate, and you really have only two choices: stocks and bonds.

Stocks and bonds both generate cash. The difference is that, over time, bonds keep giving you the same amount of money every year. If you put a thousand dollars into a 6 percent bond, you get sixty dollars every year. With stocks, on the other hand, because earnings tend to increase—and we have a big historical record on this—you get more money every year. And even if it is just a little bit more, it mounts up. Einstein said that compounding is the most powerful force in the universe, and he was right.

One example of the power of compounding or increasing dividends that we use in the book is Exxon. Exxon is not the sexiest stock in the world. We went back twenty years to 1977. In the twenty years from 1977 to 1997, Exxon had some problems. You may remember the Valdez disaster. Oil prices were not that friendly to Exxon. In 1977, if you put \$1,000 into Exxon stock, you would have gotten a dividend of \$60. At the time, dividend yields were 6 percent, higher than they are now. But even though Exxon wasn't the hottest

stock of those twenty years, its dividend increased a little every year. By 1997, that original \$1,000 investment that you made was throwing off a dividend, in that one year alone, of \$270. From \$60 to \$270 and climbing. It's now about \$300.

If you had bought a bond in 1977—interest rates then were higher than they are now; the thirty-year bond was paying 7.5 percent interest—you would have been getting \$75 in that first year, more than you got from your Exxon dividend. But by the twentieth year, you would still be getting \$75.

And by the way, I didn't tell you that, meanwhile, Exxon's price went up by a factor of eight.

That's the difference between stocks and bonds.

Kevin and I related that example when we addressed the board of directors of the New York Stock Exchange. One of the directors said that was nothing. If you had invested \$1,000 in his company's stock twenty years ago, you would be getting a dividend today that's greater than your \$1,000 investment.

We don't guarantee that, of course, but even at a rate of dividend increase of about 7 percent a year, your investment doubles every ten years. And we're not just talking about dividends in our theory—a lot of companies don't pay dividends—but dividends are a way to see cash in a transparent way. A lot of companies hold what they could pay in dividends for the benefit of shareholders, and their stock prices rise commensurately.

That's cash. And that, actually, is

not particularly controversial. What's interesting is that over the years, stocks have produced oceans of cash, enormous amounts of cash, for shareholders. It's incredible, really. For the past seventy years—forget about the past twenty, we go back seventy, and we could go back even longer than that—the average return for stocks has been over 11 percent a year. For bonds, it's been about 5 or 6 percent. And that means if you keep reinvesting, your investment doubles every seven years. You don't have to do anything. Just buy a diversified basket of stocks. There are certainly ups and downs, but that's the average return. It's pretty amazing.

The Risk Premium

Why do stocks return so much more than bonds? Well, if you've got two assets and one of them is riskier than the other one, then the riskier asset has to have a higher return to compensate investors for that risk.

The easy way to understand this is junk bonds. In the book, we talk about a company called Chesapeake Energy. We don't mean to pick on it, but it was kind of a shaky company when we wrote about it, and it was issuing ten-year bonds. In order to get investors to put their money into the bonds, it had to attract them with an interest rate of 12.3 percent. At the time, Treasury bonds were paying 6 percent. The difference between 12.3 percent and 6 percent is called the risk premium or the spread. In order to compensate investors for that extra risk, Chesapeake had to offer bonds at a higher interest rate than the Treasury. At 6

percent, nobody would buy the bond. Nor at 8 percent or 10 percent.

That's the risk premium: something that's riskier than something else has to have higher returns.

Stocks also have a risk premium compared to bonds, and economists figure that historically it's about 7 percent. Only one thing wrong. Stocks, in fact, are no more risky than bonds over the long term. There should not be a risk premium of 7 or 5 or 3 percent, or even, in our opinion, 1 percent. Stocks and bonds are equally risky, so there should be no risk premium at all.

It is this conundrum, this paradox, that explains the incredible returns that stocks have produced. Stocks have been perceived to be far riskier than bonds and, therefore, have been returning more. We believe that investors are catching on to the true riskiness of stocks—and this is the controversial part of our theory—and as a result are bidding the prices of stocks higher. Let me quote Gregory Mankiew, whom I referred to earlier, in *Fortune*: “Perhaps investors, gradually learning that stocks are a terrific investment, are shrinking the risk premium toward where it should be and bidding stocks higher. It is hard to think of any other good explanation for the rise in stock prices other than, of course, irrational exuberance.”

Irrational Exuberance

Irrational exuberance is basically the theory, if you want to call it that, that stands opposed to ours. Alan Greenspan used the phrase in December 1996 at the annual dinner at the

American Enterprise Institute, where I work. I was there. It was a long speech about the history of the Federal Reserve, kind of a boring story. But toward the end, he referred to the “irrational exuberance” of investors. He was actually talking about Japan, but there was certainly the implication that he was worried about American stock prices. The Dow, at the time, was at 6437. In December 1999, let me remind you, it is a little over 11,000. In doing research for the book, we found that Greenspan had used this phrase, or something very close to it, earlier.

In 1958 the S&P was up, in that one year, 43 percent, and people were concerned that stock prices were getting out of hand, though in subsequent years they continued to rise. A young economist named Alan Greenspan was quoted in *Fortune* in March 1959 as saying he was concerned about the “overexuberance” of investors.

Greenspan gave his 1996 speech a few weeks after Robert Shiller of Yale and John Campbell of Harvard, two of the most articulate spokespersons of the old model of stock pricing, told the Federal Reserve that the market was in a serious bubble and stock prices could fall by two-thirds. That would have brought the Dow below 3000.

Our book is very optimistic, and I’m an optimistic guy. It’s funny: optimists really get in big trouble when they’re wrong. We still talk today about Irving Fisher, who was a Yale professor in 1929; he said that stocks had reached a “permanently high plateau.” Irving Fisher was wrong. No doubt about it. He was actually a great economist, but

he did make a little mistake, and we still talk about it seventy years later. We don’t talk about the mistake that Robert Shiller made in telling the Fed that the Dow was overvalued by a huge amount. If you had believed not only him, but also the many other bears who have been talking about how terribly overvalued the market is and has been for at least the past ten years, then you would have gotten out of the market. And you would have lost more money, at least in opportunity costs, than people lost if they had believed Irving Fisher. Now, that’s another story, but it does bother me.

Irrational Fear

But to get back to the main plot. We believe that investors are indeed waking up to the true riskiness of stocks and are bidding up the prices of stocks and bidding down this thing called the risk premium. It has now gone from 7 percent to about 3 percent. In October 1999, Alan Greenspan said that there’s no doubt that the reason the stock market is rising is the declining risk premium. The question is, is this decline permanent or is it temporary?

We posit another alternative. We would ask the question this way: Will the decline continue? We think that logic is on the side of a continuing decline in the risk premium. Where will it end? It will end when all irrational fear is priced out of stocks. Where is that? It’s at 36,000 on the Dow.

We didn’t just pluck this number out of the air. In the book we talk about four different ways that we derive it. It’s not easy to explain it

briefly, although I think we explain it very clearly in the book. This book is not written for experts; it's written for the average person. You don't have to be an economist or a professional investor to understand it.

Let me go back to something I said earlier that I didn't back up with facts. I said that stocks, in the long run, are no more risky than bonds. What am I talking about? If you buy a thirty-year U.S. Treasury bond for \$1,000 today, the U.S. Treasury will give you \$1,000 back. What could be less risky than that?

Well, it's almost certain that that \$1,000 won't be worth \$1,000 thirty years from now. You run two risks with bonds: a credit risk and an interest rate or inflation risk. So bonds are not truly riskless. But how risky are they compared to stocks?

In 1994, Jeremy Siegel, professor of finance at the Wharton School at the University of Pennsylvania, wrote a book called *Stocks for the Long Run*. It's a very important book, and it was very well received in the academic community. Siegel used his own research and research that others had done on stock prices and volatility—which is how we define risk in financial markets—going all the way back two centuries. Siegel came to this conclusion: “Although it may appear to be riskier to hold stocks than bonds, precisely the opposite is true. The safest long-term investment for the preservation of purchasing power has clearly been stocks, not bonds.”

If you're still puzzled by this, let me give you an example that he uses in the book, which is loaded with examples. Siegel looked at every twenty-year

period going all the way back to 1803: 1803 to 1823, 1804 to 1824, and so on—more than 170 of them. It's a big sample. He asked a simple question: What was the worst twenty-year period for stocks? The answer: a positive return after inflation of 20 percent. There's never been a twenty-year period in American history in which stocks have not returned an annual average of 1 percent, real, after inflation. Not great, but that's the worst.

What was the worst twenty-year period for bonds after inflation? The answer: minus 60 percent. And that's just one example. Siegel also uses standard deviations and other measures of volatility to make the same point.

The Long Haul

We don't say that stocks aren't risky. Stocks are extremely risky in the short term. Investing in the stock market in the short term is a foolish thing to do. It's like going to the casino: foolish unless you're doing it for fun. Set up a separate trading account and trade to your heart's content. You'll almost certainly find, though—unless you're truly a genius or truly lucky—that that account is not going to do as well as your buy and hold account.

Stocks are risky in the long term, too, but risk has no meaning except in a relative sense. The question is: more risky or less risky than something else? Between 1972 and 1981, stocks lost a total of about 20 percent. If you had invested in stocks, you would have lost 20 percent of your purchasing power in that period. That happens, by the way. When you invest in stocks, you can

lose money, yes.

But what if you had invested in bonds at that time? The annual average loss in bonds over that period was 5.8 percent or, compounded, about 60 percent total. You're always choosing between stocks and bonds, and in making that choice, you're actually exposing yourself to more risk in bonds than in stocks.

But we're wimpy guys, as Kevin likes to say, so we merely assume that stocks and bonds are equally risky. And if that's true, we take the Siegel research to its next logical step, and this is the paradigm shift. This is why we, two guys from the outside, have managed to make the shift whereas Siegel and others have not.

Siegel will tell you that stocks are less risky than bonds, but he won't take the next step. If stocks and bonds are equally risky, then, over time, they should return the same amount of cash, right? Equally risky assets return the same amount of cash; cash is what counts. So we did a simple calculation to figure out what the return on a stock should be if the stock is returning the same amount of cash as a Treasury bond. We assumed that Treasury bonds were paying about 6 percent interest. We assumed that the growth of earnings for stocks would be about the same as the gross domestic product, which is very low. In non-inflation-adjusted terms, it's about 5 or 5.5 percent. That's all we said: that earnings and cash flow were going to increase.

We made those assumptions, and we ended up with a remarkable number. We found that we could fully justi-

fy dividend yields as low as half of 1 percent for the market as a whole, for the S&P 500, which is about one-third of where yields are today. If you want to get there, prices have to triple. That's one of the ways we get to 36,000. We are comfortable with price-to-earnings ratios for the market as a whole as high as 100. People gasp at that, but we're already seeing that with certain stocks. But we're talking about the market as a whole: an average PE of 100. Right now, the S&P PE is about thirty, and people are freaking out at thirty. We believe it's going to one hundred.

I said earlier that the Wall Street Journal called our book dangerous. Burton Malkiel, who is a god of the financial profession, professor of economics at Princeton, author of the best financial book—well, now I would say one of the two best financial books—of the past thirty years, a book called *A Random Walk Down Wall Street*, reviewed our book in the Wall Street Journal. It was a good review in the sense that he seriously engaged our argument. For a proponent of the old model, he was very open-minded. At the end of the review, though, he said that our book was dangerous because people would see the title—Dow 36,000—and get irrationally exuberant, jump into the stock market without the proper preparation, and lose money.

We profoundly disagree. First of all, the advice that we give in the book is not reckless at all. We tell people to be in the market for the long term and to have diversified portfolios. We tell them not to chase the latest fads, including Internet stocks, but to buy

blue chips. It's very conservative, prudent advice.

We do tell people that they don't own enough stocks, though. Indeed, not to be in the stock market is what's dangerous. About half of Americans now own stocks, and that's great, but we think all Americans should own stocks. For the average American, stock ownership represents not just the best way, but indeed the only way, to acquire the kind of wealth that's necessary to enjoy a comfortable retirement. We shouldn't be scaring people out of the stock market. Public policies shouldn't deter investing and saving. We should be trying to get more and more people into the stock market.

Investing in the stock market the way we lay it out in our book is not dangerous. It is prudent, it is smart, and if we are right about what's going on with stocks, with this one-time-only rise in the Dow from 777 to 36,000 imminent, then, indeed, stock market investing is urgent.

Following his talk, James Glassman took questions from his American Experiment audience.

Dan Mulheran: How does your thinking fit with asset allocation?

James Glassman: We have a chapter on asset allocation in the book. We do believe that there is a place for bonds and cash, which is basically short-term bonds, in people's portfolios. But we think, in general, that people don't have enough in the way of stocks. And we're worried about people

who own only bonds or a whole lot of bonds in long-term accounts. That's a mistake. A lot of young people, people in their thirties, have half their 401(k) money in bonds because they think it's safer. That's wrong, and we're trying to encourage people to make that shift.

People ask us what proportion of stocks we have in our own financial portfolios. The answer is not 100 percent or 120 percent. I have not mortgaged my house to buy stocks. It's about 80 percent for both Kevin and me.

The truth is that we are certain that the old model has been repudiated. We are not 100 percent certain that our model is the one that is going to replace it. We encourage other people to come up with different ways to value stocks.

We're not hugely at odds with modern portfolio theory, but we do believe that an adjustment is in order. That's basically our point.

Mitch Pearlstein: Could you speak to the societal and political—though not in the partisan sense—implications of the fact that upwards of half of Americans now own stock, up dramatically over the last several decades, and your hope that many more will in the future?

James Glassman: Let me quote from Richard Nadler, writing in a paper that he did for the Cato Institute: "The most significant demographic shift of this century is the rise of history's first mass class of worker capitalists, men and women whose wealth-seeking activities include both wage earning and capital ownership."

That's a very important point. We are seeing the rise of an investor class in America. They're still working, of course. As Nadler says, they're both wage earners and capital owners. We've gone from 10 percent stock ownership in 1965 to 20 percent in 1990 to 48 percent, according to the most recent survey by the Investment Company Institute.

That is already having major political effects. What will happen as more and more Americans own stocks is that their interests will become more closely aligned with those of private businesses, and we will see less of the labor-management dichotomy—we're already seeing that. We will see much more interest in lowering taxes, in reducing regulations on business. I'm talking about at the margin—not a revolution that's going to happen overnight—but it's very important. It seems to me that people who believe in free-market economics and free-market principles should encourage stock ownership. That, to me, is the most important public policy aim that we ought to have.

People talk about Social Security going broke, and the need to reform Social Security. That's not why we need to reform Social Security and, by the way, it's not going broke. The reason we need to do it is, we need more people to acquire wealth through stock ownership. Half of Americans have no wealth at all. That's a shame. If we had encouraged all Americans to own stock at the beginning of the 1980s, we would have a much more secure and stable social structure in America today.

Chuck McShane: How does what happened to the Japanese market in the mid to late 1980s fit into your plan?

James Glassman: The Japanese market in the late 1980s reached 40,000 on the Nikkei, then declined very sharply. Even today, the Nikkei is only at 18,000.

Is this a lesson for us? Well, it may be and it may not be. We don't deny that bubbles can occur. Economists define a bubble as a situation in which people become obsessed with the "greater fool" theory: I may be a fool to buy this stock at fifty dollars, but I know I'm going to be able to unload it on somebody else—the greater fool—for sixty dollars. In other words, purchasing stock becomes divorced from fundamentals. That may well have happened in Japan.

We don't talk about Japan in the book because we don't think it's really relevant to the U.S. situation. We've got tons of U.S. data, and we know about the riskiness of U.S. stocks based on historical perspective. This is not to say that bubbles don't exist; we just don't think there's one in the U.S. stock market.

One other thing about Japan: there was a tremendous lack of transparency in Japan, and that's still true in many markets today. It's very, very hard to figure out what companies are really earning. It's very easy for them to conceal their earnings. That is not true in this country. There are complaints about that lately, but information is available. The fact is, the markets in

this country are unforgiving of companies that monkey around with their figures. In short, Japan and the United States are very different.

We've had a lot of response to our book from abroad, and the book is going to be published in other languages. We're frequently asked this question about other markets: Is our market overvalued? The answer is that we don't know. We haven't looked at the numbers. Our suspicion is that this misperception of risk is almost certainly stronger in U.S. markets than in other places, but we're just not sure.

Bob Benson: Could you comment on volatility and being able to withstand the huge swings in the market as we are patient in our long-term portfolios?

James Glassman: The stock market is really volatile. Let's just play that out. We had a stretch of three years—1995, 1996, and 1997, I believe it was—when volatility declined. It was wonderful: the market just kept going up. That was an unusual situation. The market has been particularly volatile the past couple of years, though it's not quite as volatile as it looks: if the Dow is at 11,000 and it goes down 100 points in a day, that's less than a 1 percent move. But still, volatility is the nature of stock markets.

Ben Graham wrote about that in 1949. He said that you have to be willing to tolerate a 50 percent decline in the price of a stock over a two-year period. If you buy the stock at 100, at some point in that two-year period, it is likely to go down at least to 50. If you

can't tolerate that, then you shouldn't be in the stock market.

One of the things we do in our book is try to teach people how to stay in the market during those periods—we have a lot of tricks for doing that. Kevin and I like to say that you earn your money in the market, and the way you earn it is by staying there during the rough times. There will always be rough times. Two or three times a year, the market is going to go down sharply, and you've got to stay in. That's the most difficult thing about investing: staying in the market when it's volatile. And it's always volatile.

Gordon Anderson: My question is about demographic shifts. The baby boomers have been putting a lot of money in the market, and they are a large segment of the population. As they cash out their retirement accounts, is less money going to be coming in, and doesn't this contradict your theory?

James Glassman: No, it doesn't. I'm glad I got that question. I don't think I've ever given this talk without getting it, and it's partly because of a fellow named Harry Dent who wrote a book called *The Roaring 2000s*. Dent has some very influential ideas. He basically comes out with the same number that we do, or close to it, but in a completely different way, based on demographics. He also believes that the baby boomers will start to sell. We reject that idea for a number of reasons.

First of all, we baby boomers are very self-centered, but the truth is, we're not the be-all and end-all of civi-

lization. The baby boom generation is actually smaller than what's called Generation Y—people who have been born in the past twenty years—and it's not all that much bigger even than Generation X.

Nor do I believe that when people get to be sixty-five, they will suddenly start to dump their stocks. This would be a big mistake, since the average woman lives for another twenty-two years, and the average man for another seventeen years. Ten years from now, it will probably be even longer than that. What we see right now with seniors is that they are net savers; they are not, in fact, eating their seed corn.

Another thing is that other investors will be coming along to pick up any slack left by the baby boomers. Only 8 percent of Germans invest in

the German stock market. That's going to change. It's an even lower percentage in Japan, where most people have their money in these things called postal savings accounts, where they're earning half a percent interest. At some point, they're going to wake up. Merrill Lynch is in Japan in force trying to convince people that a postal savings account is not a good place for long-term money. I think they're going to succeed in that, and a lot of that money will come into the U.S. stock market.

But I do not want to criticize Harry Dent. He sees what we see: the old paradigm is clearly out of date. We welcome the new ideas that are bubbling up to explain what's been happening to the market recently. n