MARKET CALLS

The End of the World[Com]

Wednesday, June 26, 2002

Donald Luskin

The latest accounting bombshell will have investors wondering "what is reality?" It could create a great buying opportunity.

Less than a month ago I characterized **WorldCom** as "Perhaps an interesting speculation" and wondered whether it would somehow get bailed out because it might be "too big to fail" (see "WorldCom: Is There Life after Death?" May 30, 2002). But WorldCom won't seem so big anymore after last night's bombshell -- the company's confession that it mischaracterized operating costs as capital expenditures over the last 5 quarters, and therefore would restate fiscal year 2001 and first quarter 2002 to show net losses. Now, to invert the famous motto of the brave engineers who rescued *Apollo 13*, "failure *is* an option."

RELATED REPORTS

Excuses, Excuses
June 25, 2002
Model Position: Buy S&P 500
June 11, 2002
WorldCom: Is There Life after Death?
May 30, 2002
Model Position: Short NASDAQ, Buy Bonds
December 10, 2001

So, mother of mercy, it's the end of WorldCom. But is it the end of the world? No, but this new accounting scandal -- that the *Dow Jones News Service's* initial dispatch last night immediately described as "...one of the largest corporate frauds in history..." -- may well be the trigger for an all-out market panic.

On the one hand, with WorldCom stock trading below a dollar already, with accounting investigations by the **Securities and Exchange Commission** already going on, and with **Arthur Andersen** having been their auditor until recently, no one should really act *too* surprised about this particular accounting scandal.

But on the other hand, this particular scandal might hurt in an especially intense way. For one thing, it *is* really big. To give it some scale, consider that WorldCom's $3.85 billion of mischaracterized operating expense *is greater than* ***Enron's*** *entire cumulative net income from 1995 through 2000* (which, reportedly, Enron fraudulently inflated in the first place).

But what's worse is the fact that the WorldCom fraud comes *after* the Enron fraud, *after* investors were supposedly sadder but wiser. Fool me twice, shame on you? Perhaps, but lots of bottom-fishers looked at WorldCom's financials *really hard* for the last several months (the way investors should look at the financials of *any* company they invest in, but rarely do). And when they emerged from their uncharacteristically rigorous analytical exertions they said to themselves, "Hey -- I did my homework on this one -- and this company's actually making money! *Billions!* Maybe they've got a lot of debt, but what's all the panic about? The profits will cover it!" Well, all the rigorous examinations didn't help. There were no profits. And *that's* what the panic will be about.

As the great financial economist **Frank H. Knight** pointed out in 1921 in his classic *Risk, Uncertainty and Profit*, the notion of investment risk derives directly from the way human cognitive processes apprehend reality. When our ability to perceive reality is diminished, our sense of risk escalates. For investors, accounting fraud means that there is no way to perceive reality. Risk becomes infinite.

The need to escape the sense of infinite risk is going to create a long-awaited buying opportunity by accelerating and intensifying the capitulation process we wrote about in yesterday's report (see "Excuses, Excuses" June 25, 2002). Remember, other than the technology and telecom sectors, stocks are fairly valued, or even somewhat undervalued now -- in fact they are as cheap as they've been in 5-1/2 years. And -- again, other than technology and telecom -- earnings are recovering. So the panic that will probably grip the market today *isn't about reality itself* -- it's about the fear that reality is being presented fraudulently and perceived inaccurately.

Such fears dissipate quickly when some alpha wolf steps to the head of the pack and assures the rest of us that *he* can see reality just fine, even if *we* can't. The markets recovered after 911 with the first reports of what was then called "Operation Infinite Justice." Perhaps *this* panic will be resolved when **George W. Bush** "does something." It could even be something silly and freighted with unintended consequences, such as appointing **Warren Buffett** to be America's corporate accountability czar, vesting him with the sweeping power to reform that was given to the first Commissioner of Baseball, **Kennesaw Mountain Landis**, after the Chicago "Black Sox" scandal of 1919. We can call it "Operation Infinite Ethics."

But until then, cheap stocks seem destined to get cheaper still, recovery or no recovery. We've already established a small pilot Model Position in long equities, and deliberately kept it small so that we could add to it opportunistically. And we've also kept in place the last quarter of our Model Position short the NASDAQ 100, suspecting that there would be one more vicious leg down for tech and telecom. Opportunity -- and vicious leg down -- coming right up. TM