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The Blue Sheets

A quarterly review of the markets and the economy
January, 2000

Bubbles, Roses and Ducks

Sometimes, at the close of a year, it is difficult to decide what aspect of the markets to write about. The final year of the twentieth century was *not* such a year! In 1999, more than 100 mutual funds (out of 7,000) registered returns in excess of 100%! The initial public offering (IPO) market was boiling all year long, with scores of first-time offerings more than doubling on their first day of trading. A ".com" in the name was usually good for at least a triple. Shares of Qualcomm dashed from 26 to 90 in the first ten months of 1999, but that was just a warm-up. In a frenzy of demand they soared to 650 before the Waterford crystal ball dropped in Times Square! The technology-heavy NASDAQ index rocketed 86%; its top 100 stocks closed the year at an unheard of 200 times earnings!

How can I write about anything but the speculative bubble?

A Rose is a Rose

Since the memory of man runneth not to the contrary, college freshmen have pondered Shakespeare's memorable phrase from Romeo & Juliet, "A rose by any other name would smell as sweet." The Bard certainly had a way with words. Three centuries later, Groucho Marx, no Bard he, expressed a similar conviction when he uttered his famous line, "If it walks like a duck and quacks like a duck, it probably *is* a duck!"

I doubt that many will long remember my saying, "Speculating is speculating even if we call it investing." I realize it's not a particularly memorable phrase, and I understand that someone who's made a fortune in AOL and Qualcomm may think it is not worth the ink to print it. Nevertheless, after a year like 1999, it might be profitable for us to ponder the distinction between speculating and investing.

I hope you will understand that the following is not a diatribe against speculation. As a matter of fact, the opportunity for speculation (that is, taking a flyer on the possibility, however slim, of making a big hit) is integral to the very idea of free capital markets, as we shall see. So I am actually in favor of speculation as an idea. What I am just not in favor of is speculating with money that I am counting on to pay my bills when I am retired or to leave as an inheritance to my grandchildren, for these are very important to me.

Lots of times it is not clear whether a particular course of action is *speculating* or *investing*. That is, the degree of risk to which one may be exposing one's wallet may not be altogether apparent. To improve our appreciation of the distinction, let's begin by looking at some basics.

A share of stock is a piece of paper (or, more often, an electronic entry) signifying an ownership interest in a business.

A business is an enterprise conducted for the purpose of making a profit.

One might be attracted to owning a business because any profits that the business might earn will accrue to its owner(s). An owner of a business might extract profits from that business for his or her personal use; we call this paying a dividend. Or, instead of taking a dividend from the business, an owner might choose to leave the profits in the business and use the money to *grow* the business. We call this reinvesting in the business.

Why would an owner *not* take profits out of his business? After all, the reason for owning a business in the first place is to earn a profit, is it not? Ah, but suppose that the business owner believes that building another factory, opening another store or hiring more employees will allow his business to earn even more profits in the future? Then it might make sense to reinvest the profit instead of paying himself a dividend, thereby creating the likelihood of even *bigger dividends in the future*.

So here we have the most basic model for "investing" in a business. It is a way of using one's savings to purchase an enterprise that can reasonably be expected to pay dividends to the investor. The expectation may be that dividends will be forthcoming *soon* or that they may be postponed in the hope of receiving greater dividends *in the future*. In either case, the core notion is investing one's money in a for-profit activity with the hope and reasonable expectation of receiving back a greater sum in the future. We call this activity "investing."

A stock is just a legal document indicating who is the owner of the business; an investment is made in a business, not in a stock.

Now let's jump from the concept of a business with a single investor/owner to the idea of public ownership and free capital markets where a business is owned by a large number of people who don't even know each other. People who, from a practical point of view, have no say in how the business is conducted or even in whether it pays dividends or reinvests its profits.

Most modern businesses require more capital than a single owner can provide, so it makes sense for a number of individuals to invest money in it. Their contribution to the total capital is represented by "shares" which signify their proportional ownership of the enterprise. But the essential idea is the same as in the case of a single owner; investing today with the expectation that profits from the business will eventually provide dividends so the investors will have more money than they started with.

But now, because there are many owners of partial interests in many businesses, and because these owners have access to large, liquid markets for their shares, we have created the possibility that a person could buy shares for reasons having nothing to do with a reasoned

appraisal of the underlying business. We have the possibility that people could speculate, if you will, on fluctuations in the market prices of shares. We have the possibility that shares can take on a life of their own and be perceived as having value apart from the reality which they signify (that is, the business) much as tulip bulbs did in Holland in 1636, Mississippi bonds in Paris in 1720, RCA shares in 1929 and most Japanese stocks in 1989. More about these later. For now, let's cover a few more basics.

Beyond Dividends

Let's keep in mind this simple notion of investing with the expectation of receiving dividends from a business, because that is and always will be the core principle of investing. But reality is a little bit more complex; for example, there are two basic ways in which an investor can experience a return on his investment. The first, of course, is by receiving dividends… paid from the profits earned by a business. The second is the possible increase in the value of the business itself, to be realized when it is sold. Stay with me, now.

In the case of a business owned by a single investor, when that investor wants to "cash out" of the business, for whatever reason, he needs to find someone else interested in buying the whole enterprise from him. Buyer and seller would discuss the current profitability of the business and its future profit-making potential as well as the possible risks to the business. Eventually they would agree on a price that was acceptable to both; that would be a price that reflected some realistic appraisal of the dividends which that business might provide to its owner in the future and any possibility that the business might eventually grow more profitable and therefore be able to be re-sold at a higher price.

There is a certain level of expected return that would motivate a person to put his or her savings at risk in a business. Obviously that required expected return is not the same for everyone. Some businesses inspire more optimism about future returns than others do. The perception of risk and future return is something about which reasonable people often disagree. This is what makes a market a market. Differences of opinion about what a business is worth are what provide the *liquidity* which individuals require if they are to participate as passive, minority investors with no control over the decisions which influence the success of the business.

> *The very fact that the stock market is liquid and accessible to everyone is what makes it possible for people to buy and sell shares in businesses without any examination of the business risks or the potential for that business to generate profits and pay dividends to the share owners. It makes it possible for persons who are naïve and uninformed about a business to buy its shares in the open market in the hopes of selling those shares later to someone else at a higher price.*

It would be unusual for a person to buy a *whole business* without examining its prospects in the vague hope of selling the *whole business* later at a profit. We would probably consider such a person foolish, wouldn't we? But it happens with shares of stock every day. People "invest" thousands of dollars to own pieces of paper representing ownership of businesses about which they know little or nothing. Why is that?

First of all, some people will gamble on a stock with a relatively small amount of their money, primarily for emotional reasons … for the adrenaline rush, to be "in the game" and not feel like an outsider or "old fogey", or to be able to swap stories at the club. If the risk of loss in a particular transaction is small relative to an investor's net worth, he might be willing to buy a stock based on a rumor, a hunch or a tip. By doing this, he is becoming a part-owner of a business (though he isn't thinking of it that way) simply on the basis of a vague hope or possibility of reward, and not because of a rational expectation that a business will be profitable and grow in value. Whether his venture is successful or not, if the sum involved is relatively minor, it matters not in the grand scheme of things whether we call this investing or speculation, does it?

> *If a roulette player in Caesar's Palace puts $10,000 on black because he has a hunch or a hot tip, do we call that investing? Or a rose? Or a duck?*

If a person wants to *gamble* or *speculate* that the price of a stock will rise (while making no reasoned judgment about the profit prospects for the underlying business), with a little bit of his or her money, and *knows* that the transaction is a longshot, that is one thing. Maybe it will work out well and maybe it won't, and perhaps the experience alone is worth the price of admission. No harm done, eh?

But what if a person speculates with an amount of money that is *significant* to her life and well-being? Worse yet, suppose that she believes that the activity is what we have always called "investing", meaning that she believes the odds are very high that she will become prosperous because of the "investment" in respected companies?

And what if this approach to buying stocks becomes prevalent? What if a large percentage of stock purchases begin to be made by persons who are naive and uninformed about the underlying business? And what if their enthusiasm for the "game" causes the prices of shares (that is, the prices for the *businesses*) to become much higher than would ever be paid by a private buyer for that business? Does this matter? Is there any harm done? Any potential for harm?

Does the inflation of share prices due to increased speculation by the public alter the nature and complexion of the market process? And if it does, what are the implications for the participants and for the society of which they are a part? Does ebullience necessarily set the stage for a major market decline? Would a major bear market have a significant impact on consumer behavior, on the availability of jobs, on corporate profits?

> *Perhaps most important of all, does a long period during which stock prices rise much faster than business profits have to be followed by a period of normalization? Or is it conceivable that the relationship of stock prices to profits can be more or less permanently shifted to a new, higher level? Why must there be a limit?*

A Reality Check

These are more than theoretical questions. They go to the heart of our continuing inquiry into how to *protect* and *grow* our clients' wealth to achieve longer-term personal goals. So let's take a little closer look at the questions in light of recent experiences.

As a matter of record, the pricing of securities *has* changed significantly in the past 18 years, most dramatically in 1999. Prices of shares increased about 19% a year on average since the beginning of this bull market in 1982. This is *double* the 9.3% long-term average appreciation of stocks in the preceding 56 years. For the most recent 5 years, ending with December, 1999, annual share price gains for large companies has averaged almost 30% a year!

And there is ample evidence that the relationship of share prices to the actual earning power of the underlying businesses has become more and more remote. In the 18 years since 1981, corporate profits have grown at about an 8% annual pace, and that's counting from the bottom of a recession to the top of a record 9-year expansion. The long-term average growth of profits is about 7%, so nothing special has been going on there, in the aggregate. What, then, can be said to reasonably support the growth of share prices at more than twice the rate of earnings growth for such a long time?

The traditional way of relating share prices to business profits is, of course, the Price-to-Earnings (P/E) ratio. The average P/E over decades of stock market experience is about 14 times. One way of expressing how stock valuation has shifted since 1982 is to note that the Price-to-Earnings ratio (using the Dow Jones Industrials) has soared from 8.2 to 26. If we look at the Standard & Poor's 400 Industrials we see an absolutely extraordinary 40 P/E! Should we even mention the P/E for the 100 largest companies in the NASDAQ Index on the last day of the twentieth Century was 200. I'm not kidding. 200.

To put current market P/Es in some kind of perspective, flash back with me to the example of buying a neighborhood diner that we wrote about a while back. Readers will recall we were wondering what an early retiree might be willing to pay for a successful diner that had been in his town as long as he could remember. The business, after all expenses, regularly showed a cash profit of $100,000, year in and year out. Would you be willing to pay $500,000 to own the diner? That is five times annual earnings. Your profit would be 20% on your investment each year.

What about $1,000,000 or 10 times earnings. That's a 10% cash return. Most real people whom we interviewed balked somewhere between 5 times earnings and 10 times earnings, citing the possibility that something might go wrong and the business may not always earn $100,000 a year. (Ah, yes, business risk.)

With that in mind, it is hard to imagine that people would be willing to buy a slice of the economy at 40 times earnings. Or 200 times earnings! Unless they were just not paying any attention to the underlying business numbers. Unless they were really just buying shares because they expected, for no particular reason, to be able to sell them to somebody else for

more money at a later date. Unless their main motivation for buying shares is that everybody seems to be getting rich doing it, so "why not me." Unless, in a word, they were "speculating".

~~Wall Street~~ Main Street

There is no question that the prices of US stocks, in the aggregate, are more dear relative to the cash-generating power of American businesses than ever before in our illustrious history. After so many years of superior return experience, it has become common wisdom that, as long as you hold on and "buy the dips" stocks are a virtually risk-free vehicle. In a recent survey, investors opined that they expected to earn about 19% a year in their portfolios over the longer term. I guess that's why stocks and stock mutual funds make up 40% of household financial assets today, up from just 11% when this bull market began in 1982.

> *I believe that there have been two fundamental changes in the financial services industry in the past 20 years which have a lot to do with the fact that stock prices have become disengaged from the real-market value of the businesses which they signify; defined contribution pensions and style-specific mutual funds.*

Let me explain, first about the change in pension plans. During the period following the Second World War, up to the early 1980s, Americans working for major corporations like AT&T, General Motors and Standard Oil, were accustomed to retire on a traditional monthly pension when they hung up their brief case or their tool kit. The company's pension plan documents defined the benefit level that a person would be entitled to after so many years of service. Hence the term, Defined Benefit Plan.

In order to be sure that they could always pay these pensions, the corporate employers contributed money each year to the company's pension plan. There was a Pension Committee, usually overseen by a Board Member; the pension committee would hire professional investment advisors from New York, Chicago and L.A. to ride heard on the billions. The committee would break up the assets into portfolios assigned to Morgan Stanley, US Trust, T. Rowe Price and the like, and a bevy of analysts, economists, strategists and portfolio managers would exercise their best professional judgment on behalf of the pension portfolio. They would analyze businesses in great detail, make projections of their future profits and decide what the securities were worth on the basis of their analysis. All that has changed!

Beginning about 20 years ago and gathering steam since then, more and more companies have shed the responsibility for paying monthly pension benefits to their employees. Instead the companies' Pension Plan documents now define how much money the firm will set aside for each employee each year. This is called a "Defined Contribution Plan". The money is contributed, not to a general fund for paying pensions, but to the credit of each specific employee. The Pension Committee is disbanded and now each employee (in most large companies) is responsible for deciding how his or her own retirement money is invested!

What has happened here, is that decisions formerly made with serious deliberation by investment professionals began being made by data processing personnel, marketing executives and assembly line workers. That is a profound shift of responsibility.

Change number two: Style-specific mutual funds. About the same time that large employers began to switch from Defined Benefit plans to Defined Contribution plans, the mutual fund industry began to experience an increase in demand for their products. With that came a flurry of innovation as Fidelity tried to woo investors from Vanguard and so on. Innovation took the form of creating new mutual funds with something unique about their charter that might differentiate them from others in the public's mind. From the mid-eighties to the early nineties, fund sponsors sliced and diced the business into more than 7,000 separate and (more or less) distinct mutual funds.

Each fund's prospectus defined a style, usually a fairly narrow definition, that was to characterize its approach to security selection. One was a "small cap growth fund", another a "mid cap value" fund and yet a third said it would focus on "Post-venture-capital" securities, and so on.

The most significant change that resulted from the popularization of style-specific mutual funds is the transfer of decision-making authority from the professional fund manager to the individual investor. The same individual who had just taken over responsibility for his own pension fund! How did this happen?

Well, I believe the many causes can be summarized under three captions: Morningstar, Schwab Mutual Fund Marketplace and Modern Portfolio Theory (MPT). Because there were so many different kinds of mutual funds with an extremely wide range of investment results (very few of the old-style "balanced " funds which tended to produce results bunched in a fairly narrow range), competing for investors' attention, there was a need for an arbiter, a credible third party source of information to help people decide what funds were best for them. The Morningstar service with its star ratings emerged to fill this need.

The service quickly developed a huge following among professional and amateur investors alike. Although it was not the intention of the talented folks at Morningstar, their star rating system soon became a shorthand for indicating whether a fund was "good". A recent calculation revealed that something like 80% of all new money flowing to funds went into those rated 4 and 5 stars. What this means is that Main Street investors are plowing their money into whatever style has been hottest recently. Now, think about the consequences.

If "small cap value" has been outperformed by technology funds, investors sell the small cap value fund and transfer the money into the high tech fund. Before Schwab popularized the concept of owning mutual fund shares directly in a brokerage account (Schwab's Mutual Fund Marketplace) it was a pain in the neck to move money out of, say, a Vanguard Small Cap Value fund into the T. Rowe Price Science and Technology fund. You had to redeem the shares at one organization, get a check in the mail, and send it to the other. But now it's as convenient as a phone call to Schwab (or one of the many other brokers which now provide the same service) or a few clicks of your mouse if you trade on-line. So investors who used to be pretty loyal shareholders are now hot money managers.

When money quickly follows the fund with the best recent record, you get a self-fulfilling prophecy effect. The small cap fund has to sell some of its stocks to raise cash to meet its shareholder requests for redemption. This puts pressure on the price of the stocks it owns,

making their performance for the new quarter poor again, which will cause more redemptions, and the beat goes on. The high-tech fund has the opposite experience. New money is coming in, so the manager goes out and buys more of the shares she already owns, which pushes their price up which causes performance to be good again!

But doesn't the professional investor who is managing the fund and all his analysts still make judgments about whether securities are trading at a price that makes sense relative to the profit prospects of the underlying business? Think about it from his point of view. You run this high- tech mutual fund and get paid a million dollars a year to oversee $3 billion of investments. New money is flowing in at the rate of $100 million a month; on an annual basis, that means an extra $15 million of fees to your employer. You can probably argue for a hefty raise.

On the other hand, if you don't invest that new money because you think the stocks that fit your style mandate are too expensive, you are probably going to lose your cushy job because you are supposed to stay fully invested; that's the unspoken rule. He usually opts to buy the stocks even though the prices look ridiculous. And, guess what. So far he's looked like a hero by doing so. Talk about reinforcing behavior!

> *So here's the significance of this style mandate. When does a portfolio manager buy stocks? When Main Street sends in more money. When does she sell stocks? When Main Street pulls money out. Now I ask you, who's in charge here?*

The amateur investor, who may be a marvelous surgeon, plumber, attorney or teacher, but who is often choosing his stocks and mutual funds based on what's been hot, is now running the country's pension funds and mutual funds. Decision making has been wrested from the professionals. That was not the case 20 years ago, and I believe it helps explain both the narrow concentration of the market as well as the historically high valuations.

A Dangerous Time?

I don't want to begin drawing parallels with the famous crash of 1929 and the ensuing Great Depression. It is a fact that we have a significantly better understanding of the working of financial markets and more sophisticated tools than were available in 1929 for coping with market swoons and panic among investors. No one can say for sure it couldn't happen again, but it is likely that the pain of a major correction in market valuation, if it should happen, could be better contained than it was last time. But our markets are free; free to run to extremes in either direction and free to reverse course with no announcement.

Just because stocks are very expensive does not mean they will have to fall; but it does tell us something about the risk. There have been quite a few other times in history when a general rise in the level of speculation has let to silly valuations and market instability, there are lessons to be learned from those events.

I just finished reading the memoirs of the enormously successful Roy Neuberger, a 94-year old still active in the investment business. ***"So Far, So Good—The First 94 Years"*** is a fun Read. Roy came to Wall Street at age 26 in March of 1929. He tells how he invested $30,000 of

inherited money in stocks and was thrilled to see it worth $35,000 by Labor Day. Then prices began to sag, nearly every day, and he was back to $30,000 by the end of September.

In his words: "The most actively traded stock at that time was Radio Corp. of America. I studied that company more than any other. Radio Corp reached a high of 574. I set out to discover why the stock was so high and so active. Nothing seemed to justify the seemingly excessive price. I asked older, more experienced investors, but I received no definite answers. People explained that, "We were entering the radio age—simple as that."

That sure sounds a lot like the rationalization for the astounding price levels of internet stocks, doesn't it? "Why, we are entering the internet age ," seems to be all the explanation people need to bid up a dot com stock to where a company with little more than an untested idea is worth billions on paper.

Roy Neuberger reflects that his original portfolio of "blue chips" like AT&T, General Foods and Union Pacific did fall less than the overall market; but that's not saying a lot because the market fell 90%. But he sold short $30,000 of Radio Corp (later to be RCA) at 500 a share in October, 1929. The stock eventually plunged to $10. That stroke of genius and courage helped him survive the great crash.

You have to at least wonder if such could be the fate of Amazon, Qualcomm and others. Last week we had a few examples of how vulnerable even the shares of profitable, respected companies really are when optimistic speculators have bid their prices to lofty levels. Lucent announced its sales would be flat for the quarter. The shares plunged 29% in a day. Gateway, the big computer maker, is selling at 61, down from 84, after saying its quarterly profit will not meet analysts' expectations.

Amazon, of course, is the largest on-line retailer at the moment, with sales of books and everything else amounting to $650 million in the last quarter of the year. But it seems the more they sell the more money they lose. Founder and CEO Jeff Bezos says they'd be crazy to try to show a profit; rather, he says, they should spend every available dollar to build consumer awareness so they can eventually dominate the consumer on-line retail industry. There are believers (evidently, since the shares nearly tripled last year without earning a penny of profit in the business) and there are skeptics.

Alan Abelson quoted one skeptic in Barron's last weekend, Paul Kasriel the economist at Northern Trust in Chicago. He calls Bezos' scheme a variation of the Ponzi scheme. "In a Ponzi scheme, funds are raised from new investors to pay off promised returns to previous investors. In the Bezos scheme, Amazon raises money from investors (by selling stock) and passes it on to customers by selling things below cost!" The economist points out that if you continue to sell things below cost (which you can tell they are doing because they are losing money) you can't help but capture more market share. "In this era where 'hits' take precedence over profits, investors line up for the privilege of transferring more of their wealth to the customers of Amazon."

As this is being written, AOL has announced it is buying Time-Warner, the largest of the traditional media companies for $160 billion of AOL shares. It's the biggest merger in history. The shares of AOL *fell* 10% on the announcement. Could the bloom be off the rose?

Mandatory reading for anyone wanting to get a feel for the crowd psychology of a speculative period is "Extraordinary Popular Delusions and the Madness of Crowds" written by Charles Mackay in 1841. He describes in living detail the booms and subsequent panic surrounding several famous speculative periods including The Mississippi Scheme (Paris, 1720), the South Sea Bubble (London, 1711) and of course the Tulip Bulb Mania (Holland, 1635). In these few passages from The Tulipomania you may recognize the boundless enthusiasm, the unexplainable prices and the broad impact on the culture that we currently observe in day trading and the internet mania (USA, 1999).

> "In 1634, the rage among the Dutch to possess them (tulip bulbs) was so great that the ordinary industry of the country was neglected, and the population, even to its lowest dregs, embarked in the tulip trade. As the mania increased, prices augmented, until, in the year 1635 many persons were known to invest a fortune of 100,000 florins in the purchase of 40 roots (bulbs). (A suit of clothes cost 80 florins then, so that a Florin might equate to 4 dollars today. That means a single tulip bulb brought about $10,000.)
>
> The demand for (certain) tulips increased so much in the year 1636, that regular marts for their sale were established on the stock exchanges of Amsterdam, in Rotterdam, Harlaem, Leyden, Alkmar, Hoorn and other towns. Symptoms of gambling now became, for the first time, apparent. At first, as in all these gambling mania, confidence was at its height, and everybody gained. The tulip-jobbers speculated in the rise and fall of the tulip stocks, and made large profits by buying when prices fell, and selling out when they rose. Many individuals grew suddenly rich. A golden bait hung temptingly out before the people, and one after the other, they rushed to the tulip-marts, like flies around a honey-pot. Every one imagined that the passion for tulips would last forever, and that the wealthy from every part of the world would send to Holland, and pay whatever prices were asked for them. The riches of Europe would be concentrated on the shores of the Zuyder Zee, and poverty banished from the favoured clime of Holland. Nobles, citizens, farmers, mechanics, seamen, footmen, maid-servants, even chimney-sweeps and old clotheswomen, dabbled in tulips. People of all grades converted their property into cash, and invested it in flowers.
>
> At last, however, the more prudent began to see that this folly could not last forever. Rich people no longer bought the flowers to keep them in their gardens, but to sell them again at cent per cent (sic) profit. It was seen that somebody must lose fearfully in the end. As this conviction spread, prices fell, and never rose again. Confidence was destroyed, and a universal panic seized upon the dealers.
>
> The commerce of the country suffered a severe shock, from which it was many years ere it recovered. "

It seems human nature has not change much in 365 years. In an age of widespread speculation, many a questionable new enterprise becomes accepted and rationalized by investors. It is not always easy to distinguish a foolish scheme from a legitimate innovation with enormous potential. Sometimes it takes time, and sometimes it takes the harsh light of a bear market to show up the flaws. Sometimes it just takes common sense and a dash of reality. Neuberger

says that common sense is sometimes a scarce commodity on Wall Street. People do tend to get swept up in the momentum of the crowd and to believe the utterances of popular oracles. So, don't be afraid to think for yourself.

How dangerous is a period of extreme overvaluation? You don't have to go back to 1635 or even 1929 for an answer. In 1989, it seemed Japanese companies could do no wrong; the Nikkei Average in Tokyo reached 38,900. It sank 66% in the ensuing ten years. Today, eleven years after its top, it sells at only 18,100. Eleven years is a long time.

Gold was all the rage in the decade of the 1970's because inflation was high and gold is traditionally believed to be a natural hedge against inflation. The price of gold peaked at $850 an ounce in 1979. Today it changes hands at $282.

The Dow Jones Industrial Average sells at 26 times earnings today, nearly double its long-time average of 14. Even if corporate earnings did not go down, a return to the long-term norm would drop the Dow from 11,500 today to about 6,400. Ouch, we would notice that!

There's Always a Silver Lining

One popular saying that survived the grim 1930s is, "Every cloud has a silver lining." We are investors, and as I have often said, one of the top five rules of investing is, "You've gotta put it someplace." You can't park your wealth on a cloud someplace in the ether and come back to retrieve it when the coast is clear. If you have savings and investments, you have to put that money somewhere, even if it's a mattress, a hole in the backyard or a savings account with government insurance. But there are better places to invest. Every environment does present opportunities.

When the investing public's focus is on a narrow list of securities, opportunities are going unnoticed elsewhere. Long-term Treasuries were the pariahs of 1999. The 30-year interest-bearing bond lost 7% even after paying 6% in interest. Their current interest yield is almost 7%! I want a full position in these beauties in our client portfolios because they are a great value at a 7% current yield. I also want them because if the speculative bubble should burst, as bubbles usually do, a panic among investors literally drives money into the Treasury market as a safe haven. We saw a version of this in the summer of 1998 when treasury prices soared 10% in just a few weeks. Other than selling stocks short (a *very* risky venture), owning long Treasuries is the best hedge that I can think of against a burst balloon.

Value stocks and small caps are another place to go shopping. Both have a long-term history of producing higher returns than the stock market as a whole. Yet as Main Street took the reins from Wall Street (see above), pouring cash into everything having to do with technology and the internet, they also pulled cash out of the value and small cap funds. As explained above, this forced managers to sell their stocks to meet redemptions, which, in turn, pushed their stocks even lower and caused even more redemptions.

This self reinforcing spiral has created a most extraordinary discrepancy in valuations. Auto stocks can be scooped up at 7 times earnings while investors fall all over each other to pay 100

times *sales* for businesses which may never earn a dime. It is a strange world, but one can find opportunities for profits if he is not afraid to go against the popular trend.

Two of our favorite groups of investment analysts are the folks at Tweedy Browne and Longleaf Partners. These mutual fund managers are very disciplined about only buying the stocks of profitable businesses with good prospects and only when they can buy them for 50% to 60% of what they are worth *as businesses*. Both firms' US mutual funds had pitiful 2% returns in 1999 because they were not where the action was. But the funds own great companies that make lots of profits. Companies like Federal Express, Knight Ridder, Marriott, McDonalds, American Express and Pharmacia-Upjohn.

Like a little more adventure? While internet technology is all the rage and wildly overpriced, there is another exciting pool of scientific innovation seething with potential, that has been ignored for several years… biotechnology. In some of our more aggressive portfolios we have owned H&Q Healthcare Technology. This closed-end fund sells at a whopping 20% discount from the market value of its holdings. It invests in promising little companies with scientific breakthroughs that could make a big contribution to health care. A third of H&Q's investments are not even public companies yet, so it holds some exciting IPO potential. Much better to buy these sort of things when they are not popular.

One of the big unanswered questions about what will happen when a bubble bursts is, "Will the panic in overpriced stocks spread to the whole market?" In the brutal market correction of 1973-1974, the damage was pretty widespread. For example, small stocks declined by 45% and large cap stocks by 38%. There is a Wall Street adage that says, "A falling tide drops all the barges," which makes intuitive sense. That's one reason I believe it is important to be significantly invested in Treasuries when the stock market is in a bubble.

However, the gap in valuations between the hot momentum group and ordinary businesses is even wider than was seen in the heyday of the nifty-fifty stocks. It is very conceivable that a turn of events could trigger the deflation of the internet-related stocks and that investors, especially institutional investors like Tweedy Browne, Longleaf Partners, Warren Buffet and the many patient, value-oriented firms, could turn their attention to the rest of the long-neglected stocks. We could well see the reversal of the self fulfilling routine where money flowing *into* small cap and value funds causes them to buy more shares, driving the prices up which would improve their performance, draw in more money and so on!

At any rate, to own shares of good, profitable, well-run businesses at prices that make sense when measured against their profits and growth potential is always a good idea. If it turns out that money flees the tech sector and drives up the prices of the businesses we own through our value and small cap funds, then we'll just have to enjoy another Wall Street Adage, "You never go broke taking a profit."

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January 15, 2000