



INVESTMENT STRATEGY UPDATE

March 28, 2002

CROWD “CYCLE”OLOGY – A COMING WAVE OF CONSERVATISM

In the late 1950s, during the height of the nuclear arms race, American poet Robert Frost gave a lecture at Brandeis University which was attended by this writer. Mr. Frost talked about a world gone mad. Responding to a question about whether he was fearful of dying in a nuclear holocaust, he commented that he was not, because “there is comfort in togetherness.” As we have watched the stock market over the years, we have come to realize that “there is comfort in togetherness” can be used to describe investor psychology, as well. What would surely be considered foolish behavior by an individual seems somehow okay when undertaken by the crowd. One need look no further than the recent technology bubble to realize how far the crowd can stretch reason.

“Bubble Index” and the NASDAQ Composite



Source: The Bank Credit Analyst

History is full of manias, be they in stocks, gold, real estate, or tulip bulbs. But, what happens after the peak? As shown in the chart above, there is a definite post-mania down cycle, which seldom stops at fair value and rarely reignites quickly. In fact, most often the

backside of a mania becomes an overreaction itself. Usually, it takes several years to fully work off the previous excesses. Our expectation is that the aftermath of the Nasdaq and technology-sector bubble will follow the typical post-mania pattern. The final give-up stage will take time to develop. Investor psychology moves in waves. There are cycles within cycles. We believe the stage is set for a change in the way investors perceive risk. If the 1990s were marked by extreme speculation, might not the current decade be marked by a new wave of conservatism?

Looking back to the mid-1990s, the stock market was reasonably priced. The Iraqi War was over, interest rates were trending lower, and the economy, which had come out of recession earlier in the decade, appeared to have legs. In addition, increasing notice was being given to the fact that the aging baby-boom generation had entered its prime savings years and was ready to invest for retirement. In 1995, the stock market advanced 37%. The two years that followed added another 23% and 33%, respectively. Stocks were getting expensive, but that didn't seem to matter. It was a new era and with continuing investment returns in the high teens or better; we would all be able to retire in style. What ensued was perhaps the greatest stock market bubble of all time but, inevitably, it burst. Relatively few had the wisdom to cash out. The signs were all there but as in manias past, greed outweighed wisdom. Hindsight is wonderful.

So what now? The baby-boomers are older and a few years closer to retirement. For most, the dreams of posh retirements are gone. Yet, many investors continue to hope that the last two years were just a nightmare. Perhaps they will soon reawaken, to find their technology and other aggressive stock holdings once again reaching for the sky. That isn't going to happen, in our opinion. For aggressive investors, the party is over and the hangover is likely to linger. We think the dreams of great wealth will gradually give way to a new mindset – the need to invest conservatively for capital preservation and total return. It seems inevitable. The baby boomers will come to realize that they have what they have. And if retirement is not that far off, they cannot afford to put their capital greatly at risk. High single-digit investment returns will not sound too bad in a low inflation environment. Furthermore, if investors can get a portion of their return through interest or dividends, then they won't really have to invest that aggressively in order to add a few additional percentage points in gains each year. Most investors have not yet embraced this state of mind, but we think it will be the reality of the next few years.

Current Environment – The Economy

Entering the year 2002, many of the investors with whom we spoke were pessimistic about the economic outlook. We on the other hand, believed that the economy was already in the process of forming a bottom and would soon begin to rebound, albeit more slowly than in a typical recovery. But since year-end, the economic data has come in much stronger than anticipated. As a result, investor sentiment has also undergone a radical shift, with many now expecting a robust economic rebound. While the data clearly shows the bottom is behind us, we continue to believe a more muted recovery is likely.

On the consumer side, spending is being temporarily bolstered by growing tax refunds and a milder-than-normal winter. However, the consumer is quite heavily indebted, and we are doubtful that consumer spending can strongly rebound from levels that were not that depressed to start with. In the industrial sector, inventories are being rebuilt, and there are even some signs that capital spending has begun to pick up. But growth in final demand remains sluggish and, given the excesses of the pre-recession period, we think it will take longer for a meaningful capital spending rebound to get underway. On the positive side of the ledger, corporate profits growth should compare favorably this year, particularly as viewed against the severely depressed results of 2001. In addition, we believe the restructuring and cost-cutting efforts of corporate America are beginning to bear fruit.

Inflation and Interest Rates

Last year, the Federal Reserve Board pumped significant amounts of liquidity into the system and sharply lowered short-term interest rates in order to help jump-start an economic recovery. But now that the recovery is underway, there are suggestions that the Fed is about to start raising short-term interest rates once again. Not yet we think, or at least not very much. Typically, the Federal Reserve Board doesn't push interest rates higher following an economic downturn until there is firm evidence that both the unemployment rate has turned down and that economic growth has accelerated to the point where rising inflation might become a future problem.

There is little evidence of any inflation risk at this time. And contrary to the implications of the most recent economic news, we are not expecting meaningful improvement on the employment front for several more months. In the current environment, companies have very little ability to raise prices. Competition is fierce and, as previously stated, final demand remains sluggish. So for the time being, the ability of corporate America to grow profits will depend largely upon its success in lowering the costs of doing business. As such, we expect continued efforts to increase productivity by further reducing labor costs. The Federal Reserve Board has recently shifted to a neutral economic bias. It follows that the Fed may soon choose to become less stimulative by slightly increasing short-term interest rates, but following that we would expect little further action in that direction until later this year.

While the Federal Reserve Board determines short-term interest rates, longer-term rates are determined in the marketplace. And in line with the improving economy, longer-term rates have been rising. Since registering a low point of 4.2% last November, the yield on the ten-year U.S. Treasury Note has risen to levels now exceeding 5.3%. We have been anticipating that the next big move in interest rates would likely be up, so we have kept the maturity schedules in our clients' fixed-income portfolios very short. We may be nearing the time to undertake a *moderate* lengthening of maturities. By year-end we will likely lengthen maturities further, as we are expecting the yield on the ten-year to rise toward the 6% level. At current interest rate spreads, we still favor corporate bonds and notes over both Treasuries and tax-free municipal debt issues.

The Stock Market

The stock market has been rising since early February, and it's no wonder. There is a mountain of liquidity on the sidelines, sitting in short-term money market funds earning very low rates of return. All it took was a little good news to move some of that money back into stocks. But now, the valuations of many stocks have once again become extended relative to their underlying fundamentals. How is it possible that stocks could have become too expensive this early in a new uptrend? The problem is not so much with how far stocks have risen, as it is with the levels from which they started. Valuations were so stretched during the bubble years that they remained very high, even after the bear market of 2000-2001. Valuation didn't matter that much during the great mania, but we believe it does now.

Our opinion is that stocks have entered a new bull market, but prices have come a long way in a short period of time. So while the market may work higher in coming weeks, we also believe that we are nearing the onset of what could be a several-month period of limited additional progress. A pause would allow fundamentals to catch up with stock prices. A catch-up period seems particularly necessary in the technology-stock arena where, during the down phase, the fundamentals deteriorated almost as much as the stock prices. As a result, technology-stock price/earnings ratios stayed at very high levels which, in our opinion, more than discount their future prospects for recovery.

As mentioned in previous *Investment Strategy Updates*, the great mania was relatively concentrated. Many stocks were left behind, and while most of those have since risen, there are still good relative values among some of the more well-known old-line companies. Relative value also remains favorable in the non-technology mid- and small-cap arenas.

Our expectation is that by year-end stocks will again be moving higher. For the year as a whole, stock market returns should be reasonable, particularly when considering the low rate of inflation and relative to the returns of alternative investments. And finally, in keeping with the theme of this *Investment Strategy Update*, we strongly believe that the current investment environment is very different from that of the previous decade. Stock market returns will be positive, but much more moderate than before. In such an environment, investors will pursue more conservative strategies. Dividend yield will become more important, and it will pay to invest for total return.

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