INVESTMENT STRATEGY UPDATE

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THE YEAR 2000 - A LOOK AHEAD

As we enter a new millennium, we find ourselves in the midst of great technological change. In many ways, the effect of this change on our daily lives will rival that of the Industrial Revolution. The pace and manner in which we obtain information, engage in commerce, and communicate with each other have been altered forever. It is an exciting adventure, and this is just the beginning.

The last years of the Twentieth Century brought one of the strangest stock market environments we have ever seen. While technology, telecommunications, and media stocks soared to extreme valuations, little else seemed to work. For example, on the New York Stock Exchange close to 70% of all stocks are actually priced lower now than they were a year ago. And according to a report by Merrill Lynch, 57% of New York Stock Exchange stocks and 65% of Nasdaq stocks are currently trading more than 30% below their 1998/1999 highs. Still, the capitalization-weighted stock market indices managed to rise quite handily. Also of note were the onset of online trading and the millions of new participants who followed the stock market minute by minute via CNBC and the Internet. Speculation is rising, and we are told that the average holding period for the shares of DoubleClick stock is 5 days, 7 days for Amazon.com, and 8 days for Yahoo. That is not investing.

Internet and technology stocks have risen to maniacal levels. While the technological changes are real and many of the companies have very exciting futures, the prices being paid for ownership are far beyond any basis in reality. Technology may be undergoing quantum advances, but the human emotions and crowd psychology that can take hold of the marketplace and drive investor decisions remain unchanged. History is replete with investment manias, all of which have ended badly. A recent strategy piece published by Morgan Stanley Dean Witter recalled the great technology stock run of 1967 and 1968. Stocks of companies such as Control Data, University Computing, Mohawk Data, and Recognition Equipment rose to triple digit price/earnings ratios. But by 1970, the stock market had corrected and the aforementioned stocks, and dozens like them, had lost more than 80% of their market value.

In spite of our concerns regarding the current valuations of today's stock market leaders, we remain quite positive about the years ahead. The fundamental environment, which drove the great bull market of the 1990s, is still intact. What will happen to the rest of the market when the Internet stock bubble bursts? At first there is certain to be spill over, probably affecting the vast majority of stocks. But the baby boomers are saving for retirement and billions of dollars are currently invested in equity mutual funds. Those monies will still need to be invested someplace, and there are many stocks which currently sell at very reasonable valuations.

The Economy and Inflation

During recent years and numerous *Investment Strategy Updates,* we have been avowed disinflationists. Cyclical pressures not withstanding, we remain so today. The spread of capitalism and breakdown of world trade barriers have resulted in a truly competitive global business environment. In such a world, goods are manufactured or provided by whomever can produce them most efficiently. There is little doubt that geographical shifts in production have created numerous local disruptions, but the end result has been constructive for global economic growth and a significant positive for prices.

The growth of discount retailing and the blossoming of the Internet has provided consumer and business purchasers alike with a widening variety of buying alternatives and near perfect access to information upon which to base their choices. As markets broaden and large numbers of business competitors improve their product quality and marketing know-how, price becomes the only true differentiator. The resulting competition is intense, and we the consumers are the primary beneficiaries.

So we believe the secular trends suggest a continued environment of low inflation over the coming years. However, from a shorter-term standpoint, cyclically generated inflationary pressures are building. Our labor markets are very tight, and wages are beginning to rise. And with an improving global growth rate, there is upward pressure on a variety of commodities and raw materials prices. These are the pressures the Federal Reserve Board will respond to if necessary.

The current U.S. economic expansion has become the longest on record. Yet amazingly, there are few signs of deterioration which might be associated with an aging advance. The global economy continues to strengthen, and like the Eveready® bunny, U.S. consumers just keep on spending. Nonetheless, we are expecting growth to slow over the next quarter or two. Computer orders should soften, following what was accelerated Y2K related spending. An overhang of inventories built to protect against Y2K related disruptions will have to be worked down. And we expect rising interest rates to weigh further on housing and housing related purchases.

Interest Rates in the Bond Market

Federal Reserve Board Chairman Alan Greenspan has expressed his concern. With a fully employed labor force, he believes the economy is growing faster than its non-inflationary potential of just over 3% -- labor force growth of 1% per year plus annual productivity improvement of slightly more than 2%. As a consequence, the Federal Funds target rate was recently raised for the third time, essentially reversing the 75 basis point decreases enacted during the fall of 1998.

Whether short-term rates are raised further will depend upon the pace of growth. If U.S. economic growth fails to slow, or alternatively slows only temporarily, an ever-diligent Fed will surely take additional restrictive steps. We must be mindful, however, that the year 2000 is a Presidential election year. History would indicate that the Fed will try to minimize its effect on the election outcome.

At current levels, long-term bond yields seem to fairly reflect the continuing economic advance. Given our beliefs that there is little in the way of secular inflationary pressure and that the Fed will act to gradually reduce the rate of economic growth, we do not think that bond yields will need to rise much higher. On the other hand, sooner or later the U.S. will enter another period of economic slow down or possibly even experience a recession. When that occurs, interest rates will recede back toward the 5% level, and the resulting returns on quality, fixed income investments will be quite positive. Today's financial markets are volatile, and we would not be surprised to see periods of moderately higher interest rates during coming months. We plan to use such opportunities to lengthen fixed income maturities. With stock valuations so high, the protective nature and total-return characteristics of higher quality bonds and notes currently seem quite attractive.

The Stock Market

The stock market's underlying fundamentals are quite positive. Inflation and interest rates are low. Our government is in budget surplus, at least for now. U.S. companies are highly competitive in the global arena. And the world economy is in the early stages of an economic expansion. The only problem is valuations. Many of the stocks which have fared so well in recent years have already discounted an extraordinarily positive future. As uttered recently by the famed Warren Buffett, "The market has greatly over-capitalized a good idea." There is no room for disappointment.

Stock market returns are a function of earnings growth, dividend yield, and changes in valuation. This is so for individual companies as well as for the market as a whole. Dividends grow as earnings grow, and valuations fluctuate with investors' hopes and expectations. So while earnings and price trends can diverge over the short term, longer term, a company or stock market average cannot out-pace its underlying earnings growth. Occasionally, divergences can last for quite a while, such as occurred in the nifty fifty era of the early 1970s and, more recently, with many of the technology and large capitalization growth stocks. But in the end, the relationship between investment return and earnings growth is always restored. The fundamentals of great or promising companies may be real, but there is just so long that their stock prices can go beyond that reality.

There are valid reasons that stock market valuations have increased -- low interest rates, low inflation, and terrific increases in productivity, to name a few. In addition, economic volatility has been successfully reduced. But since valuations are already as high as they have ever been before, we think it unlikely that they will increase much further from here. In the long run, corporate earnings growth approximates nominal GDP. In other words, labor force growth plus productivity plus inflation, should lead to 7 to 8% earnings growth for the S&P 500. So, we find it hard to believe that the S&P will be able to provide investment returns much above high single digits over the next three or four years.

Stock market leadership during 1999 was one of the narrowest we have ever witnessed. Except for technology and a handful of other momentum-driven cult stocks, few performed well. It was a year in which valuation did not seem to matter. It was a year in which investors were actually penalized for following the time-proven low-risk strategies of diversification and value investing. Still, value stocks have outperformed growth stocks over a long period of time. Currently, a large number of stocks are priced at valuations which are well below their historic norms. The result is significant upside potential. We believe the average stock will do much better in the year 2000.

Technology

The current Internet mania reminds us of the great California gold rush. While there were significant discoveries of gold, most of those attempting to strike it rich eventually came up empty handed. However, others found ways to prosper indirectly by providing provisions, banking services, entertainment and, lest we forget, blue jeans. Today's gold rush is in technology and Internet stocks. We are believers in the revolutionary potential of the Internet and the ongoing advance of technological innovation. Dozens of companies will benefit from the changes at hand. These range from content providers and telecommunications pipelines to systems manufacturers and packaging and distribution companies. But many of the companies being carried along by the frenzy seem to have little economic reason to exist. For now, the fact that few are likely to ever deliver earnings does not seem to matter to investors. But, it will.

In hindsight, we have had too little participation in the technology craze. Too great an effort was made to protect client assets by not getting caught up in the mania, and thus we were too rigid in our valuation disciplines as they applied to technology-based companies. We expect *the* coming correction in technology stocks to be quite sharp. While the result will be painful to many, it should also provide us with the opportunity of reasonable entry points. We are currently pursuing actions to bolster this firm's technology and technology-related research capabilities.

May You Live in Interesting Times

It seems that each year, as we prepare our annual outlook, we are reminded of an ancient Chinese curse: May you live interesting times. We have referred to those words on more than one previous occasion, but surely now they seem more appropriate than ever before.

The early years of the new millennium hold great promise for mankind, nations, and investors alike. Much of the globe is just awakening to the opportunities at hand. As former Third World nations emerge and then flower in this time of open competition, free trade, and new technologies, the benefits can accrue to us all.

But we must be ever mindful that the path of such promise is not also without substantial risk. The world is not as peaceful a place as it may seem from our rather insulated viewpoint. The spectres of separatism, nationalism, and terrorism continue to rise. Those who would disrupt the process are also advantaged by the new technologies, and they are better armed than ever before. We must remain ever vigilant and diligent. The current prosperity was born by peace, open competition, and free trade. Those processes must be allowed to continue.

We wish all of our clients and friends health, happiness, and prosperity in the first year of this new millennium.
