March 28, 2000

MARCH MADNESS

In the world of collegiate basketball, March is the month of truth. It is NCAA Tournament time, when the nation's top sixty-four teams face off in a single elimination tournament to crown the national champion. Over the years, this unpredictable competition has come to be known as "March Madness." But to the growing legion of stock market investors, "March Madness" may have recently taken on new meaning; for this March was surely one of the wildest and strangest stock market environments we have ever witnessed.

In just the first nine weeks of 2000 the Nasdaq stock average had risen almost 25% -- and that followed a gain of more than 85% last year. Yet aside from technology, telecommunications, and media and entertainment, most stocks were trending lower. By mid-March the Standard and Poor's 500 stock average was down 7.5%, while the Dow Jones Industrial Average was a full 13% lower than it was at the end of 1999.

Finally, the tech stocks began to correct. In the five days starting March 10 the Nasdaq was down 466 points, or 9.2%. Then on March 14, the stock market apparently turned upside down. In the next two days, investor loyalties shifted big time. The Dow rose 819 points while the Nasdaq fell yet further. In the days since, stocks have been all over the place. The Federal Reserve Board raised interest rates once again, and yet, as we go to press, the Nasdaq, Dow, and S&P are all moving sharply higher.

Bifurcation

As has been so well documented in the financial press, this nation is in a period of massive technological change. So it is only natural that investors have sought to capitalize on the sizable opportunities at hand. In the process, however, a massive bifurcation has ensued, separating those companies thought likely to benefit from what is referred to as the new economy from those seemingly mired in the old economy.

New economy companies are most often young technology-related endeavors whose shares are traded on the Nasdaq. They are said to be the wave of the future and are highly coveted for their potential to rapidly grow revenues. While many are not yet profitable, investor expectations are ebullient. Old economy companies, on the other hand, are thought to be the sleepy blue chips and cyclicals listed on the New York Stock Exchange. Investors seem to believe that these established companies have been too slow in making the necessary expenditures to fully join the high-tech revolution, and therefore, may have difficulty competing in this rapidly changing world. While most investors understand that old economy stocks represent solid value by traditional measures, they also believe that if nobody cares, valuations may not improve.

There have been periods of powerful innovation before in our history -- a national railway, the factory assembly line, radio and electricity, to name a few. But the current divergences between favored and unfavored stocks have reached levels never seen before -- not even close. The top 100 Nasdaq stocks with earnings sell at nearly 90 times earnings, while the non-tech companies in the S&P are trading close to 17 times earnings. To illustrate the lopsided favoritism of tech- and telecom-related stocks, consider the market capitalization of JDS Uniphase, a fiberoptic components company with 1999 revenues of $860 million. JDSU is a terrifically positioned company with very exciting future prospects, but at current prices its shares are valued at 20% more than the entire Dow Jones Transportation Index, twenty well-known companies with combined revenues and profits exceeding $154 billion and $8 billion respectively, including names like Southwest Airlines, Federal Express, Delta, United, and Union Pacific.

The New Economy -- Who Really Benefits?

Let's examine the new economy. Who really benefits? It seems to us that in order to compete almost every company will be driven toward high-tech solutions. It's not a matter of choice. Can a retailer look toward the future and hope to compete without an Internet distribution capability? Can a distribution company survive without making its products and services available via what is increasingly being recognized as the most efficient and price effective means of connecting buyer and sellers? Or will a bank or financial services company be able to attract a sufficient number of new customers without an electronic commerce capability? In other words, if more and more transactions are taking place or services being delivered via the Internet, how can any company not pursue that means of commerce?

The effect of these changes will be widespread, but when all is said and done, we can't help but wonder if the result will be lower rather than higher overall corporate profit margins. When virtually every manufacturer, distributor, retailer, or banker is conducting new economy business, the total volume of goods and services being delivered is unlikely to grow significantly faster than it is now. Yet the pricing environment may become much more difficult. In an open, competitive economy, very few companies will be able to differentiate their product offerings in a meaningful way. Rather, it will be price, service, and marketing that determine who will make the sale.

In fact, as long as investors, and investment bankers acting on their behalf, are willing to continue supplying capital to revenue-growing, money-losing cyberspace ventures, prices may remain even lower than the eventual long-term equilibrium level. In the end, it is sure to be a self-correcting process and some semblance of pricing stability will be reached, but at this time we have no way of knowing how long that will take.

So who are the primary beneficiaries of the technology driven changes in distribution? In our opinion, the consumer may be the big winner due to lower prices and superior information. Companies that provide the tools, hardware, and software for engaging in electronic commerce will clearly benefit as well, as will the companies that provide the services for high-speed data transmission, for which demand is increasing at an astonishing rate worldwide. In addition to the obvious participants, there are numerous back-door beneficiaries, including many of the so called old economy companies. Among the more apparent are the package delivery services. And with the growth in package shipments associated with E-commerce, the sales of protective packaging materials will rise. Of course, there are and will be many other beneficiaries that are not so obvious at the current time.

Whither the Fed?

Fed Chairman Alan Greenspan has stated his intention to slow the economy's growth rate to a non-inflationary level. Furthermore, he has suggested that the continuing high level of consumer spending is largely a function of the stock market-generated "wealth effect," which may be boosting real GDP growth by a full percentage point. While he says that it is not the Fed's intention to target the stock market, it seems to us that the only way to reduce the "wealth effect" is to bring down the most speculative part of the stock market.

In its effort to slow the economy, the Federal Reserve Board has several tools at its disposal. These include jawboning, raising interest rates, restricting monetary growth, and increasing reserve or margin requirements. Thus far, the Fed has employed three of these tools. To date, attempts to jawbone, or talk the stock market down, have had little lasting effect. Short-term interest rates have been raised in five steps over the last nine months, but typically such moves affect the economy with a lag of a year or so. Rising interest rates may or may not be affecting the stock market, depending on which market one chooses to measure. These days, the "wealth effect" seems more associated with the Nasdaq than the broad market, and that average is still up strongly for the year.

Changes in the rate of monetary growth also affects the economy with a lag, but stock prices tend to react more quickly. During the later part of 1999, in preparation for Y2K, substantial liquidity was added to the system. A meaningful portion of that liquidity flowed directly into financial assets, with the result being a rapid rise in stock prices during the fourth quarter. Since year end however, and after a notable lack of Y2K problems, the Fed has aggressively drained excess liquidity from the system. But the effect on stock prices, at least prior to mid-March, was simply to shift money out of old economy stocks into the ever rising Nasdaq.

So where are we now? Despite the Fed Chairman's clear determination to slow the economy, Fed efforts to date have had little effect on consumer confidence. In fact, it almost seems as if tech investors are thumbing their noses at the Fed. It is not so much that they do not believe Alan Greenspan can accomplish his goal to slow the economy. Instead they are totally convinced that the earnings of their companies will grow so fast that it doesn't matter what the Fed does.

While we believe in the growth of technology, we place our bet in favor of the Fed. Unless the economy begins to slow notably, short-term interest rates will likely be raised further, until there is evidence of a slowdown. Margin requirements might have to be raised as well.

At the least, we expect the “wealth effect” and therefore the tech-stock mania to be substantially dented.

Outlook and Strategy

Please don’t misunderstand us. We believe the Fed will be successful in its attempt to achieve an economic soft landing, and therefore, the longest U.S. economic expansion in our history is likely to continue. In addition, we remain bullish longer term on the U.S. financial markets. The basic factors that produced the great bull market of the 1990s are still in place. Furthermore, the broad market, a.k.a. old economy, is quite attractively valued at current prices. The risk we see is the probable deflation of the speculative bubble in the technology sector and the effect that may have on the rest of the market.

“March Madness” foretells a changing environment, but it is too soon to know whether the current strength in the broader market will persist. We consider it highly unlikely that value would bottom concurrently with tech topping. It seems more probable that coming Fed actions will result in at least some period of general stock market weakness. But these days, anything is possible.

The information revolution is evolving at what seems an increasingly rapid pace, bringing enormous changes to virtually every aspect of our daily existence. As always, with change comes opportunity. But while the opportunities in technology and telecommunications are abundant, many of the participants’ stocks are currently being chased by too much money, and the price to play is exceedingly steep.

As far as stock and sector selections are concerned, we seek to bridge both tech and non-tech. We plan to establish additional technology-related holdings, but we will steadfastly avoid the lottery-like plays in the stocks of companies with very questionable fundamentals. In the non-tech arena there are a significant number of old economy companies with strong management teams and excellent research and development efforts that are successfully transitioning into the new economy. In addition, we plan to increase our international stock exposure, as we believe that most foreign economies have yet to realize the full extent of restructuring and productivity enhancements.

We are confident that the stock market’s “March Madness,” with renewed investor interest in value, is a precursor of things to come.