INVESTMENT
STRATEGY UPDATE

October 1, 1999

PROLOGUE

The stock market has officially reached correction status, declining more than 10% from its recent highs. But the fact is that most stocks have been in a declining trend for more than a year.

According to Ned Davis Research, the average stock in their more than 7000 stock universe has declined 22.6% since April 1998. And that was prior to the most recent stock market weakness. The New York Stock Exchange advance/decline line, a measure of market breadth, has been in negative territory for the same 17 months (more declines than advances). Further evidence was provided in a September 20 Wall Street *Journal article indicating that 62% of New York Stock Exchange stocks are lower since the beginning of this year, with the median stock on that exchange down nearly 5% This is a strange bull market indeed.*

Will the correction continue? No one can say for sure, but deteriorating stock market breadth has historically been a prelude to coming weakness in the popular averages. In our opinion, the long-term fundamental bullish case for stocks remains intact. However, the relatively small number of mega-capitalization stocks which dominate the popular stock market indices are still priced too richly.

The U.S. economy continues to chug along. Our labor markets are very tight and the Federal Reserve Board may have to raise interest rates further to stem the inflationary effects of an ebullient economy. The Fed's announcement Wednesday that it is increasing its regulatory oversight of the banking system may serve much the same purpose by effectively tightening credit. This action may not bode well for stock prices in the short term. So we would not be surprised to see the correction carry further, perhaps even reaching bear-market proportions (a 20% decline). Following such a decline, however, the bull market should resume.

As a consequence of the performance divergences during 1998 and 1999, many stocks currently sell at attractive levels based on fundamental valuation. As the market decline continues, these stocks should begin to demonstrate positive relative performance. They should also fare quite well in the bull-market phase which follows.

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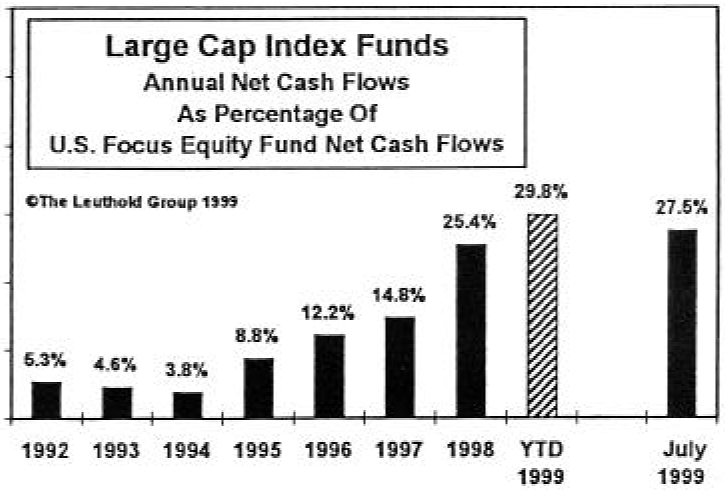
INDEX OR ACTIVE



Source: The Leuthold Group

Recently, we were asked to compare the merits of index fund investing to those of active investment management. Index funds have performed quite well in recent years, eclipsing the performance of most investment managers. As a result, these funds are commanding an increasing level of investor attention. As shown above, large cap index funds are garnering almost 30% of equity mutual fund net-cash flows, up from less than 5% earlier in the 1990s. Why the substantial increase? One reason is performance. Another is that investors tend to 'fight the last war,' reacting to what has been successful, rather than what is most likely to succeed going forward.

In our opinion, active investment management provides investors with substantial advantages over indexing, not the least of which is the likelihood of superior relative performance, going forward. We believe the equities markets are undergoing an evolutionary change -- one that will favor hands-on active management over indexing for several years to come.

For the uninitiated, an index fund is simply a basket of stocks that attempts to mirror the performance of a particular stock market index or category of stocks. There are index funds for a variety of indices, but when the average investor discusses index funds, he or she is generally referring to Standard and Poor's 500 Index funds. Among the often-mentioned advantages of index funds are lower fees, lower turnover, and lower transaction costs. Not so often mentioned is the disadvantage of huge embedded capital gains on which, in the event of net redemptions, taxes would have to be paid.

Most of the popular stock market indices are capitalization weighted. In other words, the influence each component stock has on the index is weighted by its total stock market value. So, when calculating the change in the index value, the price change of Microsoft's stock has roughly 10 times the influence on the index than that of General Motors Corporation's stock, and 1,900 times the influence of Fruit of the Loom Ltd. (the 500th stock in the S&P). As the price of a company's stock rises, so does its capitalization.

What Has Been

In recent years, the capitalization-weighted indices have been driven higher, largely by just a few mega-capitalization stocks, which have risen significantly. As more money flowed into index funds, additional purchases of the largest component stocks had to be made. In this somewhat self-fulfilling process, these stocks distanced themselves from the broader stock market. Consequently, most have reached valuation levels never seen before.

In order to have matched the S&P 500 Stock Index in 1998, an investor would have had to have held over-sized positions in just a few very expensive stocks -- a dangerous practice at best. In fact, ten stocks accounted for fully half of the index's 1998 return. Among them were Dell, selling at 78 times earnings, Cisco at 74 times, Pfizer at 62 times, Microsoft at 61 times, and Lucent at 58 times. The price/earnings ratio of the S&P 500 on August 31 was 32. 1, compared to 15.3 times earnings in 1990 and less than 8 times earnings in 1980.

But, while the capitalization-weighted indices soared in recent years, the majority of stocks have hardly participated. As a result, numerous stocks remain attractively priced. For instance, as calculated by Morgan Stanley Dean Witter on June 30, using the next twelve months forecasted earnings, the largest twenty stocks in the S&P 500 sold at a price/earnings ratio of 31.3, while the remaining 480 stocks were about 16 times earnings. The narrow leadership of the last two years has produced one of the largest valuation divergences on record. Why did this happen? As detailed in our July 2, 1999 Investment Strategy Update, the Asian financial crisis and an uncertain global economic outlook drove investors toward those companies with the most predictable earnings.

The Years Ahead

Based upon both historical precedent and the underlying fundamentals, the valuation gaps between the growth and value sectors of the stock market, and between the largest capitalization stocks and the rest of the market are unjustified. Thus, we are convinced that there will be a substantial reversion to the mean in the coming years. In the process, value stocks will outperform growth stocks and the broader stock market will outperform the capitalization-weighted stock market indices. So, too, will money managers outperform, particularly those managers diversified from the mega-cap stocks that dominate the index weightings.

There are two primary reasons behind this expected reversion to the mean. First, there is an obvious historical precedence -- it has always happened before. The spread between the price/earnings ratios of value and growth and between the largest capitalization stocks and the rest of the market widen and narrow over time. In the past, each period of widening spreads has been justified by the belief that 'this time is different.' Those justifications seldom, if ever, prove warranted. Is this time different? Of course not. Second, the value sector and small- and mid-capitalization stocks typically perform better when the economic outlook becomes more visible. The Asian crisis has passed and world growth has been improving. Improved global growth will benefit a wide variety of companies.

For the most part, the higher-priced growth stocks, which currently dominate the S&P 500, represent wonderful companies. They should sell at a premium. The problem is the stock prices of these companies are much too high, even when considering their terrific long-term fundamentals. The current period reminds us of the early 1970s nifty fifty mania. Following that manic period, the previously dominating large-capitalization growth stocks underperformed the broader market for the next several years, even though most of the favorable fundamental expectations, such as earnings growth, proved to be correct.

Conclusion

It goes without saying that for an investor with special needs or circumstances, active asset management makes sense. Such needs may include tax considerations, yield orientation/income needs, large holdings of low cost stocks, the need to diversify from the investment focus of one's primary occupation, and social or moral objections to certain industries, such as tobacco or munitions companies.

However, in the current environment, active asset management also makes sense for most other investors. Actively managed portfolios are likely to outperform index fund portfolios over the next several years, as the broad market outperforms the S&P 500 Stock Index. Note that in the early 1990s, a period when the broad stock market was performing quite well relative to the S&P, the popularity of index funds was declining. As our expectations unfold, we believe that once again, the popularity of index funds will wane. These trends too, should be somewhat self-fulfilling. As index funds are liquidated in favor of individual stock selection and active investment management, the stocks that comprise the largest positions in those indices will be placed under selling pressure, further exacerbating the under performance of index funds. Accordingly, going forward, it makes sense to be invested in a well-researched, diversified portfolio of value stocks.

Is This Time Different?

We were fortunate to be tuned to National Public Radio on August 24 for the *Market Place Morning Report.* In a commentary by Stephen Hugh-Jones, Business Editor of *The Economist* magazine, the unparalleled advances of recent years were compared to those of previous times.

It turns out that while today's amazing pace of progress is huge, it is not unprecedented. The 1800s saw a tremendous rise in manufacturing and service employment. In 1800, 80% of working Americans were employed in farming. By the end of the century, with twelve times the population, that percentage had been halved. As further evidence, this nation's output of steel rose six-fold during one twenty year period. And talk about a telecommunications revolution. Mr. Jones points out that, "In 1830, the fastest way for a message to cross the Atlantic was about 30 days by a sailing ship. Fifty years later, telegrams were crossing almost as fast as emails do now."

Yes, we are in a period of incredible change and progress. Surely, the world as we have known it will never be the same. But is our pace of progress truly unparalleled? Consider the economic and social consequences of the advent of electric power, the telephone, railroads, the automobile, radio and television, air travel... and the list goes on.