The Blue Sheets

A quarterly review of the markets and the economy
May 1, 2001

I hate to tell you this, Virginia…

After more than a year of wrenching declines in popular stocks, Wall Street's proffered wisdom is that a "market bottom" is forming and before long the good times will be rolling again. These assurances are very tempting, indeed. But an objective examination of the data suggests that the extraordinary stock market of the last decade was a temporary emotional phenomenon that caused distortions in both the capital markets and the economy that may take a long time to correct. There will still be great investment opportunities, but they won't be the same ones that worked the last time.

Remember when you believed?

I was seven years old that year. I remember waking up early the morning after Christmas, still energized by the thrill of the big day. Mom and Dad and my three sisters were still sleeping upstairs. There were a few empty Coke bottles and coffee cups on tables in the living room where my grown-up relatives had been chatting and laughing the night before. Toys and presents had been pushed more or less back under the Christmas tree with scraps of wrapping paper that had escaped the hurried clean-up.

I picked up my Humphrey Pennyworth wind-up toy and gave it a few spins around the carpet, but then I started feeling, I don't know, a little empty. I lay on my back on the couch with my hands clasped under my head and my little feet perched up on the arm, and stared out the window at the gray winter sky. The sad thought came to me that on the day after Christmas the magic is gone, completely gone. And it will be 364 long, boring, normal days before it comes round again. After all these years, I still remember that sinking feeling, the letdown from euphoria to reality. But the worst was yet to come.

The next December, our cold Ohio weather and seasonal decorations in school began to stir up in me the annual excitement about Christmas. I wanted real cowboy boots that year, and I was hoping against hope for a wristwatch. Was this a great time of year or what? One afternoon, I was walking home from school on Wilson Street, keeping a respectable distance behind my younger sister Molly and a few of her second-grade girl friends. As long as I live I will never forget hearing Molly say so matter-of-factly to her companions, "Well, I *know* there is no Santa Claus. Last year I sneaked downstairs and saw Mommy and Daddy putting everything under the tree. Daddy was drinking the hot chocolate and eating the cookies we put out for the reindeer."

I didn't let the shock show on my face, and I purposely kept up a brisk gait the rest of the way home as I let this devastating news seep into my soul. Before, it was just a long wait between the appearances of Santa and his gifts. Now, it was never going to happen again. This was easily the worst day of my life.

What is real?

Sometimes there is a fine line between the real world and the world of our imagination. Other times, the delineation is ever so plain but we prefer to blur the distinction because the imagined world is more pleasant than the earth-bound version.

The myth of Santa Clause is a good example. Generation after generation of parents perpetuates the story, myself included, even though they had been personally disappointed when reality snatched their dream from them as children. I suppose they believe that the few years of innocent delight are worth the eventual pain of disillusion.

In 1897 eight year-old Virginia O'Hanlon was wrestling with personal doubts about the existence of the jolly man from the North Pole who whisked into town every Christmas to bring dolls and skates to good little girls and boys. She asked her father about it, but he was a little evasive on the subject. In her family, whenever any doubts came up as to how to pronounce a word, or some historical fact was in question, they would write to the Question & Answer column in the New York Sun. Virginia's father would always say, "If you see it in the Sun, it's so."

Armed with this confidence, young Virginia wrote to The Sun to find out the real truth. Her letter found its way into the hands of veteran editor, Frank P. Church. He felt burdened to reply publicly to Virginia's inquiry on this sensitive matter, and to do so truthfully. His carefully written editorial, "Yes, Virginia, there is a Santa Claus" is now a beloved classic. In it, he assured Virginia that, "He exists as certainly as love and generosity and devotion exist. The world would be intolerably dreary without Santa Clause. The most real things in the world", he wrote, "are those that neither children nor men can see. No Santa Claus? Thank God he lives and lives forever. A thousand years from now, Virginia, nay, 10 times 10,000 years from now, he will continue to make glad the heart of Childhood."

Letting Go

Frank Church did a masterful job of answering Virginia's concerns about the icon of the Christmas Spirit. I am not sure that I could be as gracious if a latter day grown-up Virginia asked me whether the '90s bull market was a reality she could count on. As a matter of fact, "Virginia" *does* ask me regularly. She is that prospective retiree who doesn't want to work five more years just because John Bogle (founder of Vanguard) suggests that the market's P/E will decline and stock investors will collect just 3% a year. What can I say to her if I think Bogle may be right, or other respected thinkers like Peter Bernstein who thinks Treasuries may earn as much as stocks, or Robert Schiller who sees negative stock returns for the next five or even ten years?

Maybe I could write: "Yes, Virginia, bull markets do exist, just as surely as our collective hopes for a better life. They are of a piece with the American Dream. The world would be intolerably dreary without bull markets. The one you have come to know and love may take a little rest, because even bulls need their beauty sleep. But he will be back. And what if it takes a few years? That is nothing in the grand scheme of life. Over the next thousand years there will be bull markets aplenty. You will tell your children and your grandchildren about the generosity of the bull market and they, too, will come to believe and enjoy in their day."

Maybe that would help Virginia cope with the shock of discovering that the 1982-2000 bull market has run its course, and help her keep the faith that one day the world will know again the sheer joy of 25% annual returns from an unmanaged index fund. But will it make her retirement more secure? As her advisor, I think I owe her a little more information. I think my letter to her would be more direct than Mr. Church's, but maybe a little more helpful as Virginia tries to cope with her new reality.

Tell it like it is

The gentle approach is tempting for two reasons. First, because none of us actually knows what the markets are going to do in the future, so who can fault us for adopting the philosophical "everything will work out" point of view? Second, because optimism based on recent experience is much better received than some sober concept based on something that sounds like the work ethic. Like everyone else, I like people to like me, so I don't want to be perceived as a scrooge. But the grown-up pre-retiree Virginia needs some practical help if she is ever going to retire in comfort. If I use sober assumptions about investment returns, it is just possible she may decide to work a little longer than she planned. Helping her make that decision may, in the long run, be a better service than patting her on the hand and telling her that the good old days are right around the corner.

I would rather have my clients go out and earn their Christmas presents than sit by the chimney for the next ten years staring at cookies and milk! I would rather take responsibility to make their portfolios creative and resilient than to hope for the return of the good old days and risk ruining their lives.

> I would write something like this:
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> "I hate to tell you this, Virginia, but you are not going to see a bull market like this again in your lifetime. Get a grip, girl! It's not the end of the world. I know it's upsetting to realize that we can't always count on 25% annual stock price gains in a world of 3% GDP growth. But there it is! Worse yet, it's payback time, Virginia. You know that 23x P/E ratio on the S&P 500? Well it's going to come down; maybe to 14x, maybe less.
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> But we can deal with this, Virginia. Life is still good. I know, it takes money to retire, but there are things you can do to assure your financial security. Practical things that people have done over the years, like saving a little more, working a little longer, spending a little more prudently. And there will be lots of opportunities to build a creative, diversified portfolio. There, there, Virginia. That's not so bad, is it?

Not so bad? Hey, are we forgetting? This is America, land of opportunity, home of the free and the brave! Isn't this still the most prosperous and most resilient economy the world has ever known? Of course it is! We'll just need to be careful not to confuse opportunity with a free lunch. The opportunities of the next decade will be different from the last. They may be less obvious. They may require research to uncover them, and courage to go against the tide. But we will be able to make money even if the overall market needs to go through an extended period of returning to rational values.

I realize that part of why I wanted to believe in Santa Claus, as a kid, was simple greed. New skates, cowboy boots; who wouldn't want to believe? In much the same way, investors today, and many professional advisors as well, want to believe that the heady days of the New Economy are a permanent reality. Who wouldn't? We all like retirement models that assume consistent double-digit

equity returns. It is comforting to recite the mantra, "over long periods of time, stocks will always return more than bonds." But the reality is that at age 65, five or ten years can seem a very "long period of time", and sub-normal returns in an index fund can shatter retirement dreams.

Even when my eight year-old self was confronted with the evidence, I didn't immediately embrace the Santa-free reality. I tried to keep my selfish faith in tact for one more season. Investors who rode the fantastic 18-year wave of stock price gains came to believe that constantly flowing, abundant returns were reality. Today, many clients are finding it hard to accept the past year's evidence and the quantitative ponderings of respected investment thinkers that this was a once-in-a-lifetime experience.

So pleasant was that era that even some seasoned advisors don't want to admit that the last few amazing years were "real" only in the imaginations of millions of players. As one writer (Harold Evensky, Financial Advisor Magazine) puts it, "The recent stock price performance is neither a result of real asset pricing or a new paradigm economy. The explanation is behavioral." If he is right, and I believe he is, above average investment returns will come from anticipating the comings and goings of investor emotions, not from believing that the most recent iteration will continue endlessly.

The late, great bull market lasted much longer than most children's belief in Santa Claus. But that doesn't make it a permanent reality. As we grew up, we learned that Santa is never going to come down our chimney. As adults, we confronted the even more sobering reality that *we* are the Santa our children expect. We went to work to earn money to buy their Barbies and in-line skates, which were made not in the North Pole but in China! Similarly, we each have to provide for own retirement security. This includes both saving appropriately and investing our savings prudently.

Many who were relatively new to investing in the 1990s believed that all you needed to do was buy a technology stock and hang on for dear life! And it was absolutely great while it lasted. But real life is not that generous, and novices are coming to understand that the stock market is not Santa Claus. Rather, it is part of a complex adaptive system for allocating capital to its most profitable uses.

To become a successful investor, then, we must acquire a sober appreciation of the risks and opportunities inherent in capital markets. This includes recognizing that the expiration of a wild and wooly bull market can trigger an extended period of very poor stock returns. We need to read widely, set rules of discipline for ourselves and develop a thoughtfully diversified investment portfolio. The passing of the greatest bull market of all time is regrettable in one sense, but in the long run, reality is easier to cope with than myths.

If you don't believe me, ask my sister!

Why am I telling you this?

I used the Santa Claus analogy because many of us know personally how it felt to believe in something so wonderful and then to discover that reality was somewhat less wonderful. A bull market that goes on and on can create a similar kind of innocent expectation and unconscious desire to keep on believing even when evidence to the contrary is accumulating. I believe that the letdown from the easy money of the eighteen-year bull market is not yet complete, though Wall Street believes it is. This does not mean that we cannot find good investment opportunities… in fact I believe we will. But it probably means that we will not make money by returning to what worked from 1990 through 1999.

It is important to keep in mind that Wall Street (by which I mean brokers, investment bankers, mutual fund managers, analysts and prognosticators of every hue) looks at the world through rose colored glasses. They believe in rising prices. They benefit from rising prices. They preach rising prices. They don't forecast recessions. They don't issue "Sell" recommendations. It is very hard for them to see risks. With few exceptions, Wall Street is a one-song choir. If there is ahead of us an extended period of time when the overall stock market is not rising, we are not going to learn about it from Wall Street.

"Creative destruction" is underway

From 1982 to 2000, a long wave of investor enthusiasm carried market prices of many stocks to levels far above what would have been established by a rational capital allocation process. As a matter of fact, this recent period saw valuations significantly above anything experienced in a hundred years or more. Each consecutive year of generous stock market returns reinforced the confidence of participants and attracted even more party goers, laying more American savings at the feet of ambitious business executives, particularly those developing new technologies.

There are natural consequences of such an extended investment binge. One of these is a phenomenon known as "creative destruction," which is a business version of Darwin's survival of the fittest theory. Weaker competitors are extinguished by stronger ones. Two of the environments in which this struggle takes place are a) periods of industry overcapacity and b) periods of rapid technological change. Today, both of these environments exist simultaneously.

Overcapacity can result when a business with rapid growth and high profits attracts other entrepreneurs hoping to enter the same wonderful business and experience the same prosperity. The rush of new entrants into this business eventually causes the industry's productive capacity to overwhelm the demand for its goods or services. Soon selling prices begin to fall as competitors scramble for market share. This, of course, is generally deleterious to profits! Eventually profits fall so low that some producers close their doors, capacity and demand work their way back to a balance and we end up with an industry producing healthy but not exceptional returns on invested capital. The winners in this struggle are those with competitive advantages such as financial staying power, more efficient production or a superior product.

The Internet phenomenon that powered that late bull market enjoyed a little twist to this ordinary boom-bust pattern. So exciting were Internet's growth prospects that new entrants did not wait to emulate *profitable* businesses. Rather, with the help of imaginative investment bankers they developed the "First Mover" theory. The idea is that, when it comes to new, fast growing technology businesses, building a giant market presence before anyone else is more important than earning profits. Being first and biggest, they reasoned, will eventually put a company (Amazon in the book business, for example) in the position to raise selling prices to what ever level is needed to earn spectacular profits once their market position became unassailable.

Well, the jury is still out on this "first mover" theory. Many would-be Internet vendors have already been tossed on the scrap heap of financial history. They are examples of the second common environment for creative destruction… periods of rapid technological change. Others, ones that have

survived so far, such as Amazon, have built a major presence but not yet earned a profit. In the meantime, Amazon's stock price plunged from 105 to as low as 8; investor enthusiasm has waned!

In the industrialized world we have *public* capital markets, which means that everyday people with no business experience and no operating responsibility can become part owners of both large and small businesses. What's more, these ordinary people can sell their shares in these businesses any day to other regular people who believe it might be profitable to take their place. As you know, in the US we have very active share markets and more than half our citizens participate in them. Trading shares has become an enormously popular activity.

In the 1990s we experienced the confluence of all these powerful forces; profitable businesses attracting new entrants, exciting new technologies with enormous growth potential, and rapidly expanding public participation in the trading of shares. There were other factors which contributed to the uniqueness of this period, but these three potent forces were enough to create an environment of self-reinforcing enthusiasm which resulted in valuations for businesses far higher than any seen previously except in the great financial bubbles of history (South Sea Island, Tulip Mania and such as we have written about before.)

The concern to which I would like to draw your attention is that the unwinding or normalizing of such a long and extreme period is likely to require more "creative destruction" than we have yet seen since the stock market topped out in the spring of 2000.

We still have very high debt among consumers and corporations. Corporate debt that was incurred for the expansion of capacity, much of which is now unneeded. And consumer debt that was incurred based on stock market wealth (including stock options), much of which has already evaporated. Despite the correction of the past year, we still have stock price valuations (using the S&P 500 Index for a broad sample) more than half again the long-term average multiple of earnings. And, I hasten to add, this multiple is based on peak profits, a peak that might not be bested for some time.

If business still needs to unwind excess productive capacity and the survival of the fittest struggle must still run its course, and if debt burdens need to be 'normalized' either by writing them off or growing into them, and if competing technologies (I am thinking of communication and media, for example) must still battle to the death, then we have probably not seen the last of the negative surprises for this cycle. Thus, it seems to me unreasonable to expect that we will immediately launch another period of investor enthusiasm such as we experienced in the late1990s. Without enthusiasm, it seems unlikely that the S&P 500 will continue to be valued at anything like an enthusiastic 23 times earnings.

By way of explanation, paying 23 times earnings for a share of a business represents a very unexciting 4.3% return on investment. One would only acquire an investment with this paltry return if he or she were confident that the return would increase in some reasonable period of time. Recent corporate profit margins were near an all-time high, and if we are facing a period of creative destruction, what are the odds that corporate earnings will increase rapidly enough to entice people to buy stocks earning 4.3%?

As a matter of fact, amidst the market tumult of the past twelve months, businesses have begun to report that operating profits are *falling*, and nagging doubts about the durability of this new economy prosperity have seriously weakened the universal enthusiasm for technology stocks. In March 2000, a

few investors began to take their chips off the table, representing the first crack in the dike. Others picked up on their concerns and headed for the exits. Enthusiasm quickly became mixed with uncertainty and a real bear market in technology stocks got under way. A bear market, like a hanging, wonderfully focuses the mind. People whose stocks are in freefall take a new interest in how far down the bottom might be, which leads them inevitably to a search for the defensible business value of their securities.

Over 75 years of US financial history, publicly owned stocks have sold at an average of about 14 times per share earnings. A year ago, at the crest of the bull market, the S&P index of 500 of the largest firms was selling for more than 30 times earnings (expressed as 30 x). This was a higher ratio to late-cycle earnings than our markets have even seen, completely attributable to investor enthusiasm for buying shares.

After twelve months of generally weak stock prices, the P/E is now down to around 23. Should economic developments continue to erode investor enthusiasm regarding future earnings growth, one would not be surprised to see the P/E continue falling toward something approximating the historic average, or less. That would imply a further 40% decline in the price of the average stock. Not a happy prospect.

But there's always a way to make money!

Capital markets ebb and flow. But there are cross currents and eddies of opportunity no matter which way the river is flowing. An investor concerned that we may be in for an extended period of stock market malaise while things work themselves out will be interested in finding investments where returns are independent of the general trend.

Clients of Financial Advantage are familiar with the arguments for investing in fixed income securities; bonds represent not only a stable income stream but also the possibility of capital gains even during periods when the overall stock market is in decline. We will continue to explore and find opportunities in bonds. The Loomis Sayles Bond Fund, for example, owns a portfolio of bonds issued by companies and governments all over the world. This portfolio has an average credit rating of BBB (investment grade) and a yield to maturity of 11.5%! The portfolio could suffer a number of defaults and still produce a return higher than the long-term average return for stocks.

Another alternative to investing broadly in large cap stocks such as those represented by the S&P 500 is to invest in stocks the valuation of which is more or less independent of the direction of the stock market in general. For this reason, we have long emphasized deep-discount value mutual funds such as Third Avenue Value and Longleaf Partners. These funds are managed by professionals who conduct extensive research on the earnings prospects of businesses, and who adhere to strict value principles when choosing their investments. Their portfolios include companies whose undervalued operating assets could become the target of a takeover at a premium to the market price. There are also stocks of companies engaged in a restructuring that could dramatically enhance the business's earnings prospects.

Another approach to investing against an unsupportive market backdrop is to develop a list of stocks and bonds that are made attractive by a particular economic or demographic development. At Financial Advantage, one such "thematic" approach to investing is currently under development. I

expect to concentrate on this theme in the next edition of The Blue Sheets, but I would like to give you the outline of the thesis now so you can be thinking about it.

The Power Theme

As we all know by now, California is struggling with a serious electric power shortage. You may or may not realize that the problem is more widespread than California, and an electric power shortage could actually become an impediment to continued orderly growth of the US economy.

Our information economy is even more dependent on the continuous availability of electricity than was the industrial revolution. A decade ago, we had a generous surplus of power generating capacity in the United States. But a number of political groups raised environmental concerns that were credible enough to essentially halt any meaningful addition to our base of power generation plants. At the same time, we experienced a steady increase in the number of electric devices in use by businesses and consumers, such that an increase in power consumption for air conditioning on a hot day can now cause mandatory brown-outs. California made the headlines first, and authorities say that New York City is probably the next victim!

Traditionally, electric & gas utilities have been regulated monopolies. Local Commissions set prices and established limits to their returns on invested capital so that the companies could not take unfair advantage of consumers. This arrangement worked reasonably well for a century or so. However, over time electric companies became hidebound by bureaucracy, regulatory agencies became politicized and the whole enterprise of producing and selling power was generally deemed inefficient and unresponsive to new technological opportunities.

The resulting dissatisfaction with the electric power industry led to a deregulation movement intended to make power companies more responsive to free market forces. So far the results are mixed, which probably should not surprise us when such a fundamental policy transformation is working itself out in an industry as large and as pervasive as electric power.

Several things are very apparent, it seems to me. ***First, that a dependable source of electricity is essential to the continued growth of our modern economy. Second, that the present state of this industry is unsatisfactory. Third, that all the potential solutions to the challenge, of which there are many, are capital intensive. And finally, that the world's richest and most resilient economy will solve the problem, no matter what political, economic or technological hurdles it may have to overcome.***

As an investor, I am very excited by the inevitability of this thesis. It portends an enormous redirection of capital flows toward activities that can help assure the US a supply of dependable, reasonably priced electric power. Vendors of the solutions will be as diverse as power plant owners and builders, generating equipment manufacturers, the oil, gas and coal industries, pipelines, alternative energy concepts, electricity marketing and transmission companies, and systems management firms. As a generalization, these businesses will become whatever it takes to attract the required amount of capital. They will have the pricing power necessary to bring big profits to the bottom line. They will attract the best available talent. The stocks of businesses that have traditionally been viewed as cyclical or defensive industries will become "growth" stocks with high P/Es.

Whatever it takes to draw the capital, that is what we can expect to evolve because the solutions are all capital intensive and because not to solve the problem is completely unthinkable.

Even political obstacles will be overwhelmed by this coming tide of capital because the stakes are so high for the entire economy. I think it is interesting that at this very juncture in history the White House is occupied by business people.

A shift in capital flows as large as I am envisioning is also potentially disruptive. Since capital is a finite resource, as some businesses absorb a larger share of it others will find it more difficult to raise money; so the contest can affect interest rates and P/E ratios. It is also possible that this big a shift in flows may have an influence on employment opportunities, savings rates and inflation, perhaps similar to what we saw during the fuel shortages of the OPEC era.

So, we are not at all discouraged by the likelihood that we will not soon see a repeat of the technology-led bull market of the 1990s. Rather, we anticipate that enormous changes in the allocation of scarce capital resources in the US economy will provide excellent opportunities for the value-conscious investor. These opportunities will be the focus of our research at Financial Advantage in the months ahead, and I look forward to sharing the insights with you.

DJIA	10890
Nasdaq	2160
IBM	117

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