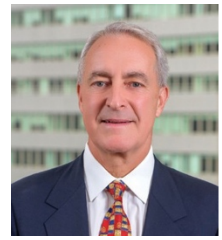
Thoughts for Investors



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FALL NEWSLETTER

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"Liberty is generally born in stormy weather, growing with difficulty among civil discords, and only when it is already old does one see the blessings it has brought."

-Tocqueville

Well, it's finally arrived. After eleven years, several presidential elections, the fall of the Berlin Wall, the fall of the Asian economies, the Persian Gulf war, Mark McGwire breaking Roger Maris's single season home run record and Texas Instruments' announcement that it has begun selling its new 0.07 micron transistors, the bear market has finally arrived. Or is it a "correction"? Much of the financial press and many investors are being distracted by a semantic debate. Few are paying attention to the opportunities this international fiasco has created.

First, The Real Stats

Call it a "correction" or a "bear market", the stock market as a whole has gotten walloped and it's not at all evident by the popular indexes. The indexes tell us that year to date through August 31, 1998, the Dow Jones Industrial Average (DJIA) is down 3.54% and the S&P 500 is up 2.14%. Yet according to work done by Smith Barney, through that same date the average New York Stock Exchange stock is down 38% and the average NASDAQ (Over-the-Counter) stock is down 49%. The indexes hardly correlate to what investors are feeling and many investors are beginning to question their investment discipline, i.e. what they are invested in and how long to be patient with an investment. This is a very dangerous move since investors end up believing they are doing something wrong. The logical reaction is to correct that by "chasing performance", by investing in areas that are "hot". Unfortunately, these investments soon grow cold and without another round of chaos, their performance, like the seventeen year locusts, disappears for a long time. Electric utility stocks and gold stocks are two prime examples. The perceived "safety" of electric utilities has made them a hot investment right now and their performance has been very good compared to the rest of the market. Questions remain, however, about the enormous unfunded cost of decommissioning their nuclear power plants and increasing competition as a result of deregulation. In addition, electric utilities are getting into businesses such as telecommunications (which they know nothing about) and doing it with managements not used to operating competitively.

Investors are also drawn to the dividends yet some of the best electric utilities are cutting dividends in order to preserve capital for investment into these other businesses. Investing in electric utilities now is far from a "lay up". The temptation to change your investment philosophy is great. The rewards for staying the course may be greater. Most investors changing today are not doing so for fundamental or proactive reasons, but rather for emotional or reactive reasons. They are "chasing the puck". In an earlier newsletter I mentioned the philosophy of the greatest hockey player of all time, Wayne Gretzky. While most hockey players skate to where the puck is, (and collide with everyone else in the process); Gretzky, at 6 foot, 170 lbs, said about his success, "....I skate to where the puck is going to be".

The Investor Dial

Emotions drive stock prices in the short run, and with regard to stocks, investors seem to have only two settings on their emotional dial - greed or fear. When set on greed everyone has the Midas touch. America On-line had a chat room where investors could discuss the merits of Iomega, the maker of a computer hardware product whose share price eventually hit $100 a share. Magazines, not necessarily financial oriented ones, ran cover stories with headlines such as "This Man Can Make You Rich." Greed spread like wildfire and the press fanned the flames. Now the dial is set on fear. Iomega, it turns out, makes a commodity product with many competitors and its stock price now is $3 per share. No one talks about it much anymore. Instead of the "Asian Tigers" we worry about the "Asian Flu".

A Case for Growth

In a letter to shareholders dated May 25, 1994, Fred Meserve Jr., the president of the Flag Emerging Growth Fund, spoke about a great growth company named Walmart. The case for long term investing despite short term volatility is powerful. Walmart has had its share of volatility in the past. "During each of the 22 years from 1970 through 1992 the stock price declined at least 15% from a high to a succeeding low. In 15 out of the 22 years the price declined more than 20%, and in the bear markets of 1973-1974 and 1987, it declined 80% and 54% respectively." Yet "had an investor purchased $1,000 worth of the stock at its highest price in 1970, it would have been worth $1,200,000 by the end of 1992." Updating that through August 31, 1998, the original $1000 investment would now be worth approximately $2,700,000. The cost of fear is very high.

What to Do!

The best action right now is to sit in the lotus position and chant repeatedly "volatility is NOT risk, volatility is NOT risk, followed by a chorus of "emotions drive stock prices in the short run, fundamentals drive stock prices in the long run." After that re-read John Train's The Money Masters. (The first edition). The book is a compilation of the philosophies of nine of the greatest investors. Each has his own methods yet they all share the common principle that fundamentals of a stock drive its price in the long run while emotions drive its price in the short run. This was recently reiterated by both George Soros and Peter Lynch. Too often people react to short term emotional events involving interest rates, currency fluctuations or politics and ignore a company's fundamentals. Just as bad is to depend on newspapers, magazines, the internet or family members for fundamental research. Technical analysis, the tracking of a stock's price fluctuation (or supply and demand), is also inadequate. When asked if the stock market's price movement was a good predictor of a recession, Paul Samuelson, MIT professor, Nobel laureate and author of several college textbooks once quipped "......the market has predicted nine out of the last five recessions."

Rather than debating whether we are in a bear market or a correction, investors should be filtering out the noise of the market and searching for great growth companies at reasonable prices. Now is a great time to be putting together your "wish list" of stocks that may have been pricey before. Missing this opportunity could prove costly in the long run, as anyone who has studied the stock market knows.

Now the Important Stats

In 1990 the S&P 500 index was down 6.6% thanks in part to the Persian Gulf War. In 1991 the index was up 26.3%. A long term approach does pay off, you'll say. That's not the real news though. The real news is that 18 .5% of that 26.3% return came in a five week period starting in January 1991. Procrastination, or waiting "for the other shoe to drop", or "until the dust settles", or "until things look better" would have caused you to miss almost 3/4 of 1991's recovery.

Conclusion

No one, financial press included, is going to blow a whistle to tell you that the train is about to leave the station. It's adherence to your investment philosophy, your patience and our help in identifying growth or value companies with great fundamentals that will help you capitalize on the opportunities now presenting themselves.

"Any man who is a bear on the future of this country will go broke."

– J.P. Morgan

"A bear market is what returns stocks to their rightful owners."

– John D. Rockefeller

P.S. You might be wondering about the importance of the new 0.07 micron Texas Instruments transistor. The Intel 386 chip contained 400,000 transistors, the Pentium II contains 4 million. You need at least 40 million for a computer that operates by voice command instead of receiving instructions via a keyboard. With the 0.07 micron transistor you will be able to fit 400 million transistors on a single computer chip the size of a fingernail. Imagine the increase in performance and functionality this creates.

AUDI PARTEM ALTERAM

Hear the Other Side

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