“The Long and Short of It”

Quarterly Newsletter from
Robinson Wilkes, L.L.C.

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Momentum Mania
The average U.S. diversified fund returned a mere .93% in the first quarter, according to Lipper, Inc., because of the continuing free fall in small-cap and value equities. Yet the S&P 500 returned a healthy 4.9%. Thus, while the market is somewhat expensive, it is not so much the average stock that is expensive. Our work shows that the average stock may only be 7% to 10% overpriced, so whether the market is expensive, fairly priced, or cheap depends on how you define “the market.”

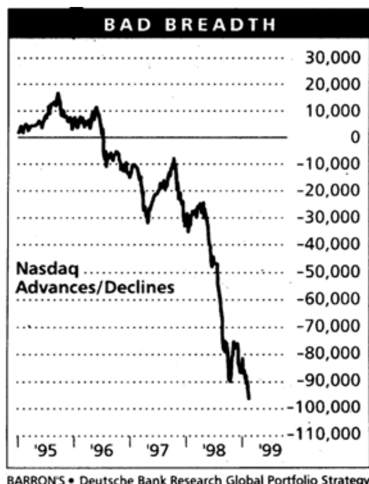
Since 1994, equity prices, as measured by the S&P 500 Index, have outpaced earnings growth by a margin of 4 to 1. The S&P 500 has risen 174%, while corporate earnings have gone up just under 40%. The P/E has doubled from 14 to almost 28, which explains about 80% of the surge in share prices.

The current valuation extremes lead us to believe the U.S. equity markets are in a mania resulting from an excessive enthusiasm for a particular style of investment decision making called momentum investing. Over the last four years this approach has focused its enthusiasm more and more narrowly on a few stocks that determine the returns of most indices. Dramatic narrowing of this leadership leads us to believe we are near the end of this mania.

In the markets, a mania occurs when investors (or buyers) are willing to pay more for something than it could possibly be worth in terms of intrinsic value. More precisely, a mania can be identified as a group of investors imposing, with the sheer weight of their dollars, a new pricing logic on the stocks they buy, causing those who invest according to traditional or rational valuation models to be driven out of those stocks. With that definition in mind, let's look at the results of the mania sweeping the marketplace.

First, momentum investing has replaced both value and GARP (Growth at a Reasonable Price) as the most popular approach to decision making. Growth oriented investors primarily, yet also many who call themselves value oriented, are using momentum concepts like ‘earnings surprise’ and ‘earnings momentum’ for decision making. As long as a company avoids any negative surprises, momentum investors will only buy or hold. They will not sell. The problem with this approach is that there is always some price that is too high for even the best of companies. The problem with a mania is that when too many people are thinking the same way, the window for exiting gets very small if any excesses are discovered.

The current momentum mania focuses on stocks with a huge market capitalization and an unusually large P/E. In 1998, large caps outperformed small caps by 26.8%. Growth



BARRON'S • Deutsche Bank Research Global Portfolio Strategy

outperformed value by 28.1%. Last year, a baker's dozen of stocks accounted for roughly one-half of the S&P 500's total return, and 10 stocks were responsible for 40% of the NASDAQ's gain. Without the 10 stocks, the NASDAQ would have been down 18%. In the first quarter of 1999 two stocks, America Online and Microsoft accounted for 50% of the gain in the S&P 500. The result is the greatest ever divergence between over priced stocks and under priced stocks. As shown on the chart at left, most companies are not participating in the advance made by a few large growth companies that constitute the bulk of most index returns.

Because of the growth stock leadership since 1994, the S&P 500, though meant to be a broad market benchmark, has effectively become a highly concentrated growth-stock portfolio skewed heavily to companies priced at huge valuation premiums and limited sector or cap-size diversification. In other words, a bad stumble by a few could pull down the index's return rather dramatically.

Excellent Companies Can Be Overpriced

Powerful companies like Microsoft, Cisco, Intel, Merck, Pfizer, General Electric, Coca Cola, and Dell embody many attributes of the so-called New American Economy and contribute greatly to the current reputation of the U.S. as the world's economic leader. For some time, these companies' growth rates may have justified the high multiples on their shares. Today however, they simply cost too much. The S&P 500 Growth Index trades at a precedent setting 40 times historic earnings and more than 10 times book value. The S&P Value Index, by contrast, is trading at its largest valuation discount in history.

Coca-Cola, Dell, Gillette, IBM, Intel, Merck, Microsoft, and Wal-Mart, averaging 21% earnings growth over the last 10 years, would have to average 25.3% per year to offer double-digit returns at a future P/E of 23. 1998 earnings for these 8 companies grew only 15%. And analysts, tending to be optimistic, currently place their expected long-term growth rates at 20%. Remember that the next ten years are expected to be a slower growth, lower inflation environment than the last ten. For Coke to make the grade, its sales in 2003 would need to be nearly as large as the estimated size of today's entire global soft drink market.

One of the stellar stocks driving the S&P 500 is Dell, which hit a bumpy patch earlier this year. The company reported earnings gains of 38% in the three months ending January 29 and promptly lost 40% of its stock's value. Apparently, analysts were expecting more.

This little setback put Dell's share price at $80, which (if we weren't so old-fashioned) would have been a great price dip to buy in for clients so they could catch the next wave. However, *Newsweek's* Wall Street editor, Alan Sloan, calculated that if the stock were to continue rising at the same rate over the next five years as it has for the past five, Dell would be worth $12 trillion in 2004 -- more than the entire gross domestic product of the United States, and more than the current value of all the S&P 500 companies put together. Moreover, the current share price assumes that Dell's sales will continue to rise at roughly the same rate in the future as during its

recent history. Fair enough? At that growth rate, the company would have to sell 950 million computers in 2003. That's roughly one computer for every household in the world. Of course, the following year, Dell would have to sell many more to keep its stock price from dropping dramatically.

Everybody Loves Momentum

Lately, appreciation begets more appreciation. The expensive get more expensive, the cheap get cheaper. For stocks that did not disappoint, the ride up has been tremendous. But, because fewer and fewer companies have continued without some disappointment, the market has been carried higher by a shrinking group of very large, increasingly pricey companies.

A recent Merrill Lynch survey of fund managers shows that, over the last decade, momentum has become the most popular approach to investing. Most managers are using earnings revision, earnings surprise and other momentum approaches. Only 25% are using book value, and just 13% are using dividend yield, compared with 50% in 1989.

“People hate value,” says Robert Friedman, chief investment officer of Franklin Mutual Advisers and co-manager of its two largest funds. He believes the sight of individuals paying outlandish prices for Internet companies with no earnings has made most professional managers more comfortable paying 40 to 65 times earnings for Coca-Cola Co. or Gillette Co. The lack of discipline may be okay today because momentum is here. But eventually it could come back to haunt them.

Will We See A New Paradigm…

Today, static noise and biased information penetrate a growing number of novice investors who trade much more rapidly than any other group of investors in history. Lots of new money pours into this ever-accelerating cycle and valuations of certain stocks are leaping beyond the boundaries of rationality. Some people are making big money in a hurry, which encourages normally rational investors to question the wisdom of traditional valuation measures. For many, this raises the question, “Is this really a new era?” The new paradigmers contend that “what you pay for a stock is irrelevant (as long as everyone else is buying it),” and assert that “As long as they remain profitable, I will never sell.”

…Or, Reversion to the Mean

We do not believe in the new paradigm theory. We do believe this is just another bubble, inflated beyond belief by some old misconceptions. When this bubble collapses, stocks that seemed to have no limit to their upside potential will suddenly reverse themselves, and the traditional market valuations will reassert themselves with a vengeance. Companies with real earnings, real growth of book value, solid management and a policy of providing shareholders with an ever-increasing dividend will prevail.

John C. Bogle is Senior Chairman of the $450 billion Vanguard Group of Investment Companies which he founded in 1974. In 1976, he created the first index mutual fund – Vanguard 500 Index Fund. With $80 billion in net assets, it is now the nations second-largest fund.

The following is his reply when *AIMR Exchange Magazine* asked whether the outperformance in 1998 of growth stocks over value stocks by the greatest margin in two decades meant it was time for value investors to switch strategies. "If I were a contrarian and a value investor, I would certainly not change. If I were a growth investor, I would think about changing now. Because in the long run the market is one great reversion to the mean. Growth does better for a time, then value. The same thing is true of small caps and large caps. There appears to be no inherent advantage over time."

Robert Sanborn, at Harris Associates in Chicago, manages the Oakmark Fund, a large-cap value fund that has been hard-hit. He likens the situation to Samuel Beckett's absurdist play "Waiting for Godot," in which two bums wait in vain for a friend to return. As he wrote in a recent letter to shareholders, "So it is with us, as we continue to adhere to our disciplined value philosophy and wait, and wait, and wait for the momentum market that has prevailed over the past three years to die a deserved death."

Buying Opportunity?

We believe the market has reached the inflection point in its valuation imbalance. Most technology and Internet companies sold off from their recent highs, but we do not believe the sell off represents a buying opportunity for those stocks. Instead, we postulate that after an extraordinary pacesetting run these past three years, a stretch in which the techs exploded from accounting for less than 11% of the S&P 500 to an unprecedented 21%, they are now embarked on a journey down the other side of the mountain.

Currently, few other professional investors embrace the value approach. We did find a good summary of the situation in a letter from Sanford Bernstein & Co. who wrote:
"Mega-cap growth stocks, mostly in the technology, telecom and health care sectors, drove the U.S. and European markets; commodity producers and other companies exposed to emerging markets were left far behind. Some investors read these incredible disparities as proof that value is dead. We see tremendous value opportunities. The unusual conditions depressed the returns of value portfolios, particularly in the U.S., the U.K., Germany and Finland, but they are not sustainable, in our view. We therefore find compelling opportunities in value, particularly in the U.S. and the U.K."

We consider ourselves to be just a little bit more value oriented than Sanford Bernstein & Co. Thus we would reverse the logic of the last two sentences; i.e., "we are finding compelling opportunities in value oriented stocks which can only mean that the unusual conditions which depressed returns of value portfolios are not sustainable." Like Bernstein & Co. and Mr. Sanborn mentioned above, we continue to embrace our approach more now than ever and remain positioned for a return to rationality.

PS Over the last two days, April 14th and 15th, we have seen a dramatic shift toward stocks of economically sensitive companies. As a result, the portfolios of value managers who have been buying these attractively priced equities are benefiting greatly. Over these two days, our model equity portfolio rose 4.19% in price, versus +.17% for the Russell Value Index, -1.99% for the S&P 500 index, and -3.45% for the Russell Growth Index. Hopefully this is more than

another chink in the armor of growth and the market will begin to pay you and us for our patience.

Recent Portfolio Activity
In January, February, and March of this year we established and added to a position in **BMC Software, Inc. (BMCS),** which develops, markets, and supports data and application management software primarily intended to maintain integrity, reliability and availability. When BMCS's price dropped from its September high of $60.25 to $41.57 in January, we established an entry position in this high quality company. It dominates the market for its type of mainframe software, has no long-term debt, and has $1.03 billion, or $4.72 a share, in cash and liquid securities (mostly tax-exempt municipal bonds) on its books. It has been growing at 25% to 30% per year over the past several years, and is expected to do the same in 1999. It typically trades between 40 and 70 times earnings. At $33.01 per share, the price at which we added in March, it was trading at approximately 25.5 times earnings. Pessimism surrounding BMCS has centered around three issues: (i) Y2K concerns, as with all software manufacturers, (ii) restatement of BMCS's 1998 earnings due to the SEC's recent industrywide change in accounting rules for pooling acquisitions, and (iii) uncertainty concerning BMCS's future direction due to its three large acquisitions in the past year. While most software manufacturers have been hurt by Y2K concerns, demand for BMCS's software has increased. The SEC's accounting rule changes only effect the timing of income and not the total income generated. Entry into new businesses does create uncertainty, but BMCS's fastest sales growth has been in its newer business of open-system products. It is not often that you can find a company in the tech sector of this quality and stability with this kind of valuation.

On February 5, 1999, we established a position in **UnitedHealth Group, (UNH)**. UNH owns and manages health maintenance organizations (HMOs) and provides specialty managed-care services through wholly owned subsidiaries. UNH's price dropped significantly, along with the rest of the health care industry, leaving it priced very attractively against all measures of fundamental value. To operate more efficiently and increase profits, UNH reorganized its corporate structure into six separate businesses. It plans to remove $300 million from its cost structure by 2000 and reduce its headcount by 1,750 employees. Additional profit increases are projected from (i) expected wider margins in its commercial health plan business, which constitutes 65% of total revenues, (ii) new contracts for its Uniprise unit which designs health benefit solutions for large organizations, and (iii) exiting unprofitable markets. We believe the importance of healthcare to Americans, combined with American demographics, bodes well for the long-term success of UNH despite rising medical costs, the uncertain future of health care legislation, and UNH's ongoing reorganization.

On March 18, 1999, we reestablished a position in **Rite Aid Corp (RAD),** which is one of the nation's largest drug chains, with 3,827 drugstores in operation in 31 states and D.C. as of December 1998. Some may recall the nice profit realized in RAD at $39 when we exited our position last July and August. RAD has been on an aggressive expansion program having acquired Perry Drug in 1995, Thrifty Payless in 1996, K&B and Harco in 1997, and PCS Health Systems in January of this year. Momentum continued to push RAD to a very rich price in excess of $50 earlier this year, but it again retreated to $37 by March 11, 1999. A negative earnings surprise drove its price down to $22.5625 on March 12, 1999. The earnings surprise

was due primarily to the short-term events we predicted in our third quarter 1998 *Your Portfolio*. They were the costs of opening and relocating 206 stores in the last half of the fourth quarter, greater than expected losses on inventory liquidations, and costs related to the acquisition of PCS.

On March 17, 1999, we cut back the position in **Marsh & McLennan Companies, Inc. (MMC),** locking in some of the gains as recent performance had caused MMC's position size to become too large. In addition, based on our measures of fundamental value, it had become fairly priced. In fact, some measures suggested it had become somewhat overpriced. MMC has been in the model portfolio since October 1994, and has been an excellent performer.

On February 25, 1999, and again on March 23, 1999, we cut back the position in **Office Depot (ODP)** to lock in some of the recent gains, as well as to reduce the position size which had become too large a percentage of the equity portion of the portfolios.[i]

Tax Time

If you have been approached about a plan to buy life insurance with tax deductible dollars, watch out! The technique is called "Charitable Split-Dollar Insurance." Under this scheme, taxpayers transfer money to a charity, and the charity then uses the money to pay life insurance premiums on the life of the transferor or another person. The beneficiaries of such life insurance policies generally include members of the transferor's family. The transferor claims a charitable deduction for money that is actually benefiting the transferor or his or her family. House Ways and Means Committee Chairman Bill Archer introduced a bill February 9, 1999, to stop the perceived abuse. In response to the proposed bill, a representative of the life insurance industry stated that "many in this industry are open to proposals that seek to end abusive tax practices involving split-dollar insurance arrangements." So, it looks like the bill's chances of becoming law are pretty good.

Another warning! Many charitable causes sound worthwhile, but you need to make sure your money is going to the cause. For example, the Internal Revenue Service challenged the United Cancer Council's tax-exempt status when $26.5 million of the $28.8 million in donations raised went to the fundraiser.

Another warning is in order if you have not filed your 1998 tax return due to a late K-1. *In LFAM Corp. v. U.S.,* the Court of Federal Claims held that a taxpayer who passively waited for its K-1 from a partnership was not excused from a late filing penalty because it received its K-1 after the return due date. If you are like so many of us waiting on K-1s, get extensions to file and pay if necessary.

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