"The Long and Short of It"

Quarterly Newsletter from

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The Bubble is Ripe

The averages put in another good showing in 1999, but the broad market did not fare so well. In fact, as investor focus became even narrower, more stocks fell in price last year than rose. Last year, the 10 biggest companies in the S&P 500 Index returned 38.8%, on average, compared with just 4.4% for the smallest 200 companies in the same index, according to the Leuthold Group, a stock market research firm in Minneapolis. In addition, if you removed all the technology stocks from the S&P 500 Index, its 1999 return would have been just 3% last year versus 21%. Further evidence of current market anomalies, as observed by Ed Keon, director of quantitative research at Prudential Securities, is that the 193 companies in the S&P 500 with dividend yields over 2% fell 12.3% last year.

Returns for periods ending December 31, 1999:

Type of Investment	**3 Months**	**9 Months**	**1 Year**
Morningstar Large-Cap Value Funds	6.5%	-0.1%	6.6%
Morningstar Mid-Cap Value Funds	6.2%	2.7%	6.7%
Russell 1000 Value Index	4.9%	4.3%	5.4%
S&P 500 Index	14.9%	15.3%	21.1%

From our point of view, investing has given way to a speculative frenzy that is focused on shares of companies in the technology and telecommunications industries. Evidence supporting this view abounds, but some of the most compelling pieces are 1) bullish enthusiasm and rhetoric are at an extreme, 2) average holding periods for investors are collapsing, and 3) valuations are at premium levels.

Excessive Enthusiasm

Through the course of time, a consistent indication that a bubble exists has been excessive enthusiasm for the investments creating the bubble. Every day we hear talk of the "new economy" (which we heartily believe in). However, the speakers lose us when they conclude that, for this or that reason, traditional valuation principles do not apply in the "new economy". In the long run, value does matter. You just have to look out a little further in time before multiples will make sense in high growth situations. At some point, the sales have to show up, the margins have to be positive and cash flow must be generated.

One of the more entertaining quotes this quarter came from Rudolph-Riad Younes, head of international equities at Bank Julius Baer. He says that it is time to expand the traditional categories of stocks. In addition to "value" and "growth," Baer wants to include "hypergrowth" stocks as "some stocks, especially new companies with innovative and revolutionary products, are in an ultra-hypergrowth, or transient state." In a sense he is right, but really now…."transient state?"

Average Holding Period Collapsing

Last year, investors held stocks for just over eight months, on average. Among NASDAQ stocks, the average holding period was five months. That is well short of the two year average holding period that was typical a decade ago, according to Sanford Bernstein, an investment research firm. In addition, the equivalent of 79 percent of all New York Stock Exchange shares traded hands last year, up from 46 percent

in 1990. The NASDAQ turnover amounted to more than twice its entire share base, more than three times faster than any major industrialized market in the world. Its turnover was 88 percent in 1990. Of this data, Steve Galbraith of Sanford Bernstein says, "It does look suspiciously like a game of musical chairs and you do wonder when the music is going to stop. Three week holding periods is not investing in my view, it is speculating."

Premium Valuations

In the January 3, 2000 issue of Barron's, George Gilman's research depicts the price-to-earnings ratio of the NASDAQ moving from a typical range of 15 to 30 over the last two decades to a year end level of 200. Yes, that is right, 200 times earnings. Unstoppable bull markets have a way of stopping and bubbles have a way of bursting. We are never inclined to say when a bubble will burst, as logic does not apply once this kind of momentum takes over. But, we do feel comfortable saying that average valuations for technology and telecommunications stocks have gone beyond what is considered reasonable, removing much of the future potential returns from those stocks.

Below is a table we created for an investor requiring a 14% annual return on an investment in the NASDAQ for the next ten years. It shows the average level of annual earnings growth required on the part of the NASDAQ to end up with certain price-to-earnings levels in 2010. For example, in order to end up with a P/E ratio of 20, and for our investor to get a 14% annual return, the NASDAQ companies would have to grow earnings by an average of 44% per year for the next ten years. For perspective, Microsoft, the best performing stock of the last twenty years -- due arguably to its monopoly power -- has grown its earnings over the last ten years by an average of 42% per year. In other words, for an investment in the NASDAQ to return 14% annualized over the next ten years - and the NASDAQ to then have a P/E ratio of 20 - the average earnings growth of all companies in the NASDAQ will have to exceed Microsoft's earnings growth over the last ten years. In addition, allowing for higher P/E ratios in 2010 does not offer much relief.

Potential P/E ratio in 2010 for the NASDAQ	**12**	**20**	**30**	**40**	**50**
Average annual earnings growth required	**51%**	**44%**	**38%**	**34%**	**31%**

Another interesting statistic came in November form Barton Biggs of Morgan Stanley who reported that "The 241 major Internet stocks have a combined market value of $549 billion, with combined sales of only $24 billion and a combined loss of $7 billion." These are extraordinary times.

Finally, Wells Fargo economist Sung Won Suhn points out, over the past five years, Commerce Department figures show tech companies accounted for 6% of the nation's economic production capacity. Yet technology now accounts for over 28% of the capitalization of the S&P 500 Index. Margins typically erode as industries mature. Therefore, for one to believe the technology sector is fairly priced one must rely on the assumption that, as margins decline toward long-term sustainable levels, technology sales will grow to become approximately 28% of the economy. We find it difficult to believe that this will happen.

As evidenced by the last nine months, we are seeing a return to a more rational pricing environment. We are grateful for your patience, which will be rewarded. In the long run, value does matter.