

April 14, 2000

Unwinding 1999

We believe the recent volatility in the stock market is a direct result of the excesses that occurred in the technology and other high growth companies in 1999. We detailed our analysis of these excesses in our year-end letter. In that letter, we described the performance of the markets in 1999 as a year of surprises: surprisingly good performance for technology stocks and surprisingly bad performance for almost everything else. Indeed, we pointed out that if the Tech stocks were eliminated from the Standard and Poors 500, it would have produced an annual rate of return of only 2%.

As we looked closer at the top performing stocks, however, we found another surprise--it was not just the Tech stocks that did well. The clearest delineation between the winners and the losers in 1999 was high earnings growth companies versus low earnings growth companies. Stocks that generated earnings growth of at least 20%-25% performed well above average, and stocks with slower earnings growth fared poorly. Among the 30 stocks in the Dow Jones Industrial Average, we found that the top 15 performing stocks had a median earnings growth of 26.3% and the bottom 15 performing stocks had earnings growth of only 5.2%. This 5X differential in earnings growth, however, produced nearly a 20X differential in price performance, with the top 15 increasing over 50% and the bottom 15 producing just 2.7% growth. The obvious question was, why did the top stocks produce returns almost twice their earnings growth rates, while the bottom stocks could eke out capital growth of only about half their earnings growth rates? The numbers suggest that investors erected a kind of financial hurdle in the path of all companies. That hurdle appeared to have been an earnings growth rate of somewhere between 20% and 25%. Those companies that could exceed the hurdle were rewarded with excess capital growth, while companies that failed to clear the hurdle were penalized.

The Hurdle

Why was the hurdle so firmly planted around the 20%-25% level? We believe the answer is really quite simple: Long-term interest rates rose during 1999 by about 25%. Rising interest rates affect the typical company in three ways: (1) because most companies have debt, higher interest rates increase costs and squeeze profits; (2) higher rates directly increase the costs of all products that are financed such as homes, cars, and other so-called durable goods. The price of the product or service may not go up, but the financing costs go up and the affect on the consumer is identical. These higher costs ultimately lead to a slowing of demand. (3) In addition to these actual barriers, perhaps the biggest impact of higher interest rates is psychological—institutions and individuals must ask themselves if they should be expanding debt at a time when economic growth may be slowing. In short, rising interest rates tend to dampen the economic activity and a slowing economy is ultimately felt by almost all businesses.

However, our research reveals that some companies can overcome the dampening effect of rising interest rates if their earnings grow at a faster rate than that of interest rates. We believe this dynamic may have been the primary reason that companies with earnings growth of between 20% and 25% in 1999 were the big winners.

Let me give you a pop quiz. What kind of company is relatively immune to the aforementioned barriers? You are right, the technology companies. (1) Most of these companies have little or no debt. Their capital structure is mostly common stock because investors and investment bankers have been only too willing to give them all the money they need, so higher interest rates don't impact their earnings. *Furthermore, many of these companies don't have earnings to be impacted.* (2) Prices have been falling so rapidly for most technology equipment and software that the effects of higher interest rates on financing costs have been rendered meaningless, (3) from the psychological perspective, the greatest fear for consumers and businesses alike is not what will higher interest rates do to me in the future, but if I don't get "wired" and quick, I'm dead anyway—"Where do I sign?"

So, while the higher rates erected a hurdle, both real and psychological, in the path of almost all so-called old economy stocks, Tech stocks were relatively unaffected. Indeed, as we will show, they were probably given a boost by the troubles of the old economy stocks.

Of Laggards and Leaders

At the beginning of 1999 the 15 stocks in the Dow Jones that would ultimately end up with the poorest performance had a projected earnings growth rate of 9.4%. The average projected earnings growth of all stocks in January of 1999 was near 13%. Thus, the stocks that ended the year as laggards began the year as laggards from an expected earnings growth perspective. But not only were they laggards at the beginning of 1999, they further sealed their fate by failing to meet their already reduced earnings growth targets. As we showed earlier, the bottom 15 performing stocks actually generated earnings growth of only 5.2%. This is the epitome of a bad idea going bad. These slow growing companies were the recipients of what we will call a triple whammy. (1) They were slow growing to begin with, (2) they failed to meet even their low targets, and (3) the fast growing companies not only met their targets but exceeded them.

As the year wore on and the interest rate picture became clearer, these kinds of slower-growing companies were increasingly scorned and, consequently, liquidated. The majority of the bottom 15 companies fall into three industry sectors: utilities, financials, and multinational consumer products companies. The first two industry sectors were directly affected by the rising interest rates because they are big borrowers. The multinationals, while not normally big borrowers, were hammered by the rising dollar versus most other currencies, which was the direct result of higher US interest rates. The top performing stocks were all the benefactors of the surging economy and the tremendous increases in consumer and corporate spending, in which, of course, technology played a prominent role.

1999 Was Abnormal

But we want to state emphatically that, in our judgement, 1999 was an **abnormal** year and the forces at work that produced the hurdle effect and the outsized gains for the high earnings growers should not be projected ad infinitum. **In fact we believe the forces that drove the markets in 1999 will likely be unwound in 2000.**

What made 1999 abnormal: Y2K? Tech mania? The New Economy? President Clinton's impeachment trial? In our opinion, none of these events were at the root of what made 1999

abnormal. The near 20% increase in Fed Funds during the year ranks as the second largest annual increase in 10 years. But the sharp increase in Fed Funds, in our opinion, was also not at the root of the abnormality, either. The abnormal thing that happened in 1999 was simply that the Federal Reserve raised rates. Although we talk a lot about the Federal Reserve and its influence on interest rates, Alan Greenspan and his friends have not raised interest rates very often in the last 10 years. On average the Fed has raised rates about every three years. The table below shows the annual net changes in the Federal Funds rate over the past 10 years.

Annual Changes in Federal Funds Rates

1990	-1.25%	1994	+2.25%
1991	-2.75%	1995	-0.50%
1992	-1.00%	1996	0.00%
1993	0.00%	1997	+0.25%

You will notice that for most of the last ten years Fed Fund rates have been falling. Only in 1994, 1997, and 1999 did the Federal Reserve raise rates for the calendar year and in 1997 by only a quarter of one percent. Thus, in reality, in only two of the last ten years has the Fed embarked on an extended and significant period of rate increases. Because periods of rising interest rates have been so few in the last ten years, we have maintained all along that it was dangerous to draw too many long-term conclusions from the actions of stocks and bonds in 1999. In two sentences this is what we have been saying all year long:

The technology revolution is real, BUT!

Do not assume that every Tech stock is worth what it is selling for, and do not assume the old economy is dead.

The Readjustment

If you think that it is normal for Tech stocks, or any stock, or any investment for that matter, to go up every day like the Techs did in 1999, you have not spent much time looking at the history of booms and busts. Such price action is a sure sign that a mania is underway, and manias do not end gracefully. We are utterly convinced that the companies that were able to clear the earnings-growth hurdle we spoke of earlier may have added as much as 50% to their returns over what may have been expected under a neutral interest rate environment. This is very ironic because Mr. Greenspan complained often about the "irrational exuberance" of the market, yet we believe history will show that he may have had a role in causing it. We are quick to add, however, that we do not think he had any choice, given the tools at his disposal to slow the economy. During the remainder of 2000 the markets are likely to readjust themselves to a more realistic appraisal of the values of almost all stocks. This is not likely to be a knee-jerk reaction and does not mean that all Techs stocks are going to get trashed, nor does it guarantee that the worst performers of 1999 will be the big winners in 2000. It just means that the Fed's rate increases last year likely contributed to the mad rush to own anything with technology or dotcom in its name, and some of the madness has to be worked off. This can happen in two ways: (1) the Tech stocks could experience an extended period of sideways price movement, or (2) the Tech stocks could continue to have a series of rolling corrections. Either of these courses of action will allow the earnings growth to catch up with the prices.

Because the technology revolution is real and far-reaching, we do not believe that the dominant technology companies with bona fide sales and earnings are at great risk. We do believe, however, that the concept stocks and many so-called e-tailers and e-sellers are in for a rough ride. The old economy bricks and mortar companies know they are in a fight for their lives, and they have something that most of the new economy stocks do not have--cash flow. Cash flow in this instance is like bullets. Bullets, even shot from old bore guns, are very effective in the battle when the other fellow's clip is empty. We believe that very few of today's dotcom companies will survive in their current form in five years.

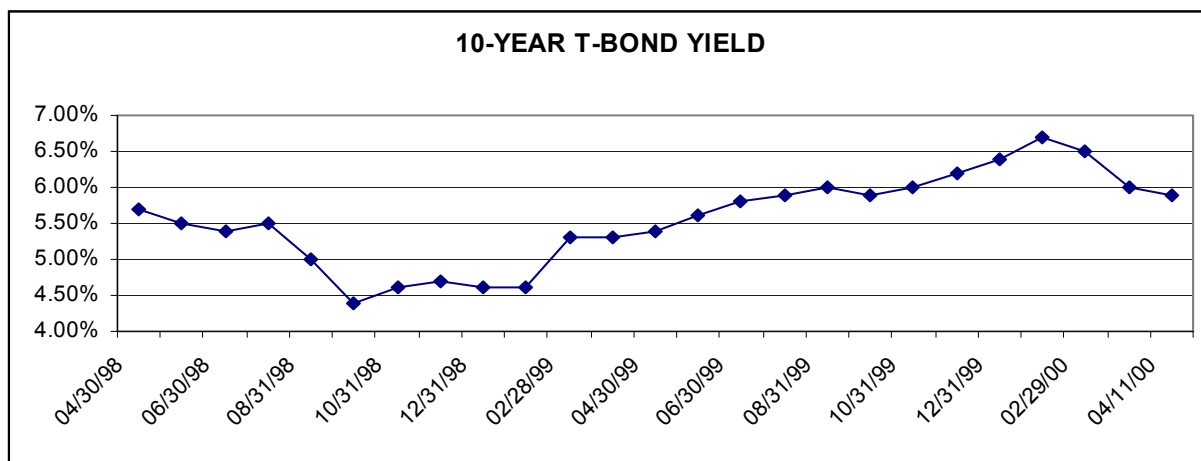
The Catalyst

We said at the first of the year that the stock markets were due for a change of leadership. We believe that the catalyst for the shift away from the market's infatuation with Tech and other high growth stocks will be the same catalyst that caused the infatuation in the first place: interest rates. The spell will be broken when interest rates begin to fall, and, indeed, as we will show later, some important interest rates have already begun to fall. Falling interest rates will have the opposite effect on the various stock market sectors as did rising rates. This is, again, because of the hurdle effect. But this time the hurdle will be falling and ultimately disappearing, and with every rung of the hurdle that interest rates fall, another group of slower growing companies will come to life. High growth stocks will likely retreat during the initial stages of the fall in rates as money rotates back into the "old growth stocks," but this retreat should end once it is clear that the economy is slowing, which should occur by mid-year. Again, we would like to emphasize that we are big fans of the high growth Tech stocks and firmly believe that they will regain their place in the spotlight in the coming year, but right now almost all of them are overvalued, and they need time for their earnings to grow into their prices.

Falling Interest Rates?

Earlier, we said that some interest rates have already begun to fall. That would seem to defy the headlines, because the Fed just raised rates and has promised to raise them again. So what rates are falling and how is it possible with the Federal Reserve on the warpath? Long-term interest rates are falling and in the case of stocks, they are the most important rates. The Federal Reserve directly controls the so-called Fed Funds rate. The Fed Funds rate is the rate of interest that banks charge each other for overnight loans. The Fed has no direct control over the interest rates of longer-term notes and bonds. Thus, the level and trend of these longer-term interest rates are set by the market and can be a very valuable tool in analyzing investors' perceptions of economic strength and inflationary pressures. A rising trend of longer-term interest rates signals that T-bond investors, the great preponderance of whom are professionals, see inflationary forces building. Falling longer-term interest rates indicate that investors believe that inflationary pressures are diminishing. So, if we watch the trend of long-term interest rates, say 10 year US Treasury bonds, we can discern the inflationary expectations of professional investors. This is a very important group to keep an eye on because these large institutions dominate the US Treasury bond markets. By watching the longer-term T-bond rates, you can get an idea of what the Fed is probably thinking because the movers and shakers in the bond market and the members of the Federal Reserve are cut from the same cloth. Chart 1 below shows the trend of interest rates for 10-year US Treasury bonds over the last two years.

Chart 1



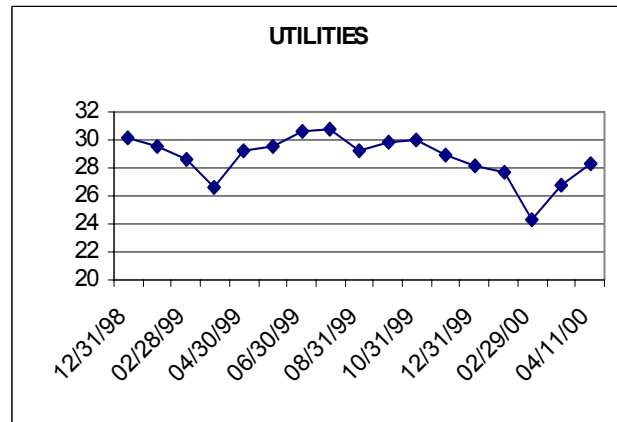
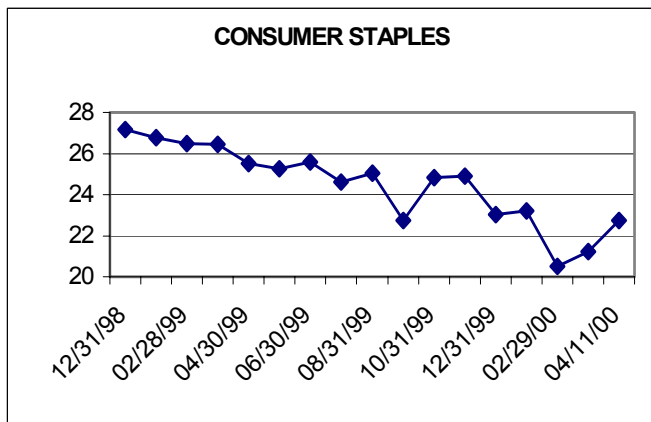
During 1999 the bond market made it very clear to the Federal Reserve that it thought the Fed was not raising rates fast enough or high enough to slow the economy. This can be seen by the steadily rising interest rates on long-term bonds all throughout the year. However, the chart shows that in late January 2000 long-term rates peaked and started down. This was about the time that Mr. Greenspan presented his Humphrey Hawkins testimony. In that report to the House and Senate banking committees, he stated that it would likely take multiple rate increases during 2000 to rein in the strong economy and dampen inflationary pressures. This was the news that T-bond investors were awaiting. For most of 1999, they were worried that tight labor markets resulting from the strong economy would surely push inflation higher. Now, Greenspan's clear message before the House and Senate that the Federal reserve was intent on slowing the growth of the economy was just what bond investors were waiting to hear, and they began to buy. The chart shows that interest rates on 10-year bonds have fallen almost 1% since their January high of 6.8%.

Winds of Change

The following four graphs show the price performance of the strong Technology sector and the three lagging industry sectors, Utilities, Financials, and Consumer Staples over the past year. The chart of long-term bonds on the previous page shows that interest rates peaked in late January and have been trending lower for the past two months. The three lagging sectors began to move higher in February and the Tech sectors finally reversed course and started heading lower in March. The graphs clearly show that the inflexion point in interest rates caused an almost coincident inflexion point in the four industry sectors that we have been discussing. We believe the graphs show that it was rising interest rates that drove the three lagging sectors lower in 1999, and it is now falling interest rates that are pushing the lagging sectors higher. It is less obvious, but we believe no less true, that it was also interest rates that were the driver of the Techs. Does this mean that the Techs will now go lower as long as long-term interest rates go lower? No. It only means that Techs will go lower until the excess price gains that they made at the expense of the slow growing companies in 1999 have been

corrected. As we said earlier, many Technology and other high growth companies ended the year as much as 50% above where we would have expected them to be based on their earnings growth for the year. In the current market correction, we believe this overvaluation will be diminished or eliminated. It is a little tricky to discuss this in percentages, so let's use an example. If ABC Tech ended the year at \$105 and it was 50% overvalued that would mean its true value would have been somewhere around \$70 per share. Thus we can easily see that most of these types of stocks would need to correct about 30% to be back in line. We think this is what has been happening in the markets for the last month.

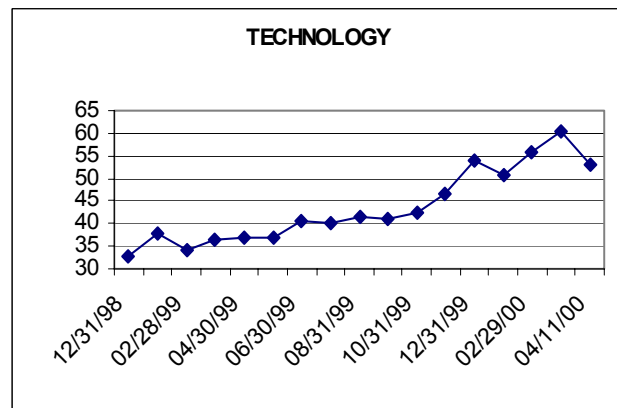
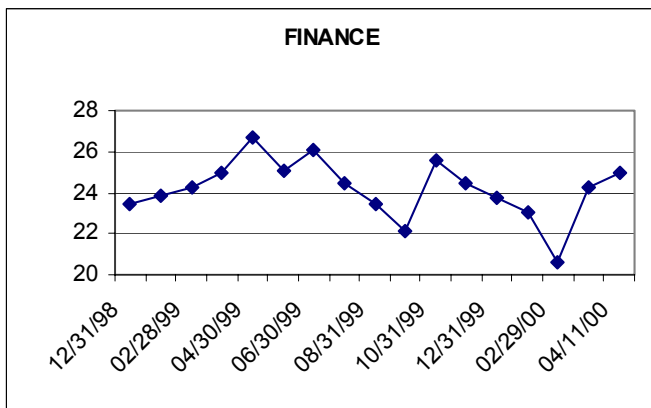
You may ask, if we believe this why don't we sell all our Tech stocks and run for cover. We have taken some profits, but we are strongly convinced that the Tech companies we own have a very bright long-term future. Why sell out if we believe that most of these companies will shrug off the selling pressure within the next few months and start higher again? Furthermore, most of these companies have earnings growth near 30%, so even if they did not correct at all, by the end of this year their rapid earnings growth would have brought them back to being



fairly valued.

In closing this quarter's letter we would like to take the unusual step of quoting our year-end letter. We are even more convinced now in light of the recent sell-off that the direction the markets will follow a path along the lines of what we described in our January letter.

"For 2000, we expect the economy will begin to slow by the second quarter, if it hasn't already. With that in mind, you can watch for long-term interest rates to peak in the first quarter. Until they do, Technology stocks will continue to do well. Once rates peak and the interest rate headwinds subside; the market should find companies with somewhat more



modest, but much more predictable earnings growth, increasingly attractive. These are the characteristics of industry sectors that performed very poorly in 1999 and are now undervalued by historic standards: Drugs, Financials, and Consumer Staples. Stocks of this kind are likely to get an added boost once the earnings surprises in Technology stocks become more balanced. The pressure for more accurate earnings projections for the Tech stocks will mean fewer positive earnings surprises and more earnings disappointments. This will add an element of uncertainty to Technology stocks that has not been present for the last two years. The Technology revolution is in no way finished. We just see the year 2000 giving some of the Tech stocks a needed pause."

Blessing to you and your families,

Greg Donaldson
Director of Portfolio Strategy

Mike Hull