Quality at Any Price

> When a share price, or an index, goes higher than it's ever been before, it's telling you buyers are finding a new reason to pay more than they ever have before. This is Starship Enterprise on its way. The market is going where no man has gone before.
>
> Robin Griffiths, HSBC Securities, Investors Business Daily, January 8, 1999

For the fourth straight year, the U.S. stock market turned in a stellar performance. After the late summer/ early fall panic, when investor selling caused a mini-bear market with the Dow Jones down 19.2% and the NASDAQ down 29.2%, the stock market stormed back in the fourth quarter, closing the year at an all time high. At least large capitalization growth stocks did. The total return in 1998 from the Dow Jones Industrial Average was 18.12%, while the Standard & Poor 500 Index's total return was up a remarkable 28.53%. The NASDAQ Index, propelled by *Starship Enterprise* Internet stocks, turned in an astonishing performance of +40.11%. High-grade corporate bonds had a total return of 10.47%.

While 1998 was a banner year for shares of large capitalization growth companies, the majority of stocks on the New York Stock Exchange and NASDAQ were actually down. The total return of the broad-based Value Line Index was down 1.81%, while the total return of the Russell 2000 Index, which tracks small and medium capitalization stocks, was down 2.55%. It was also a difficult year for REITs, which, after turning in double digit gains for the three preceding years, had their worst year since 1990; the Morgan Stanley REIT index (total return) was down 16.9%. In short, the breadth of the market's advance was very narrow. A handful of stocks sporting P/E ratios between 40 and 60 (Microsoft, Dell, Cisco, Pfizer and Lucent) accounted for more than 50% of the S&P 500 Index's performance due to the market capitalization weighted formula for calculating the index. If the S&P 500 Index were calculated on a basis that weighed each stock price equally, the index would have been up only 10.8%.

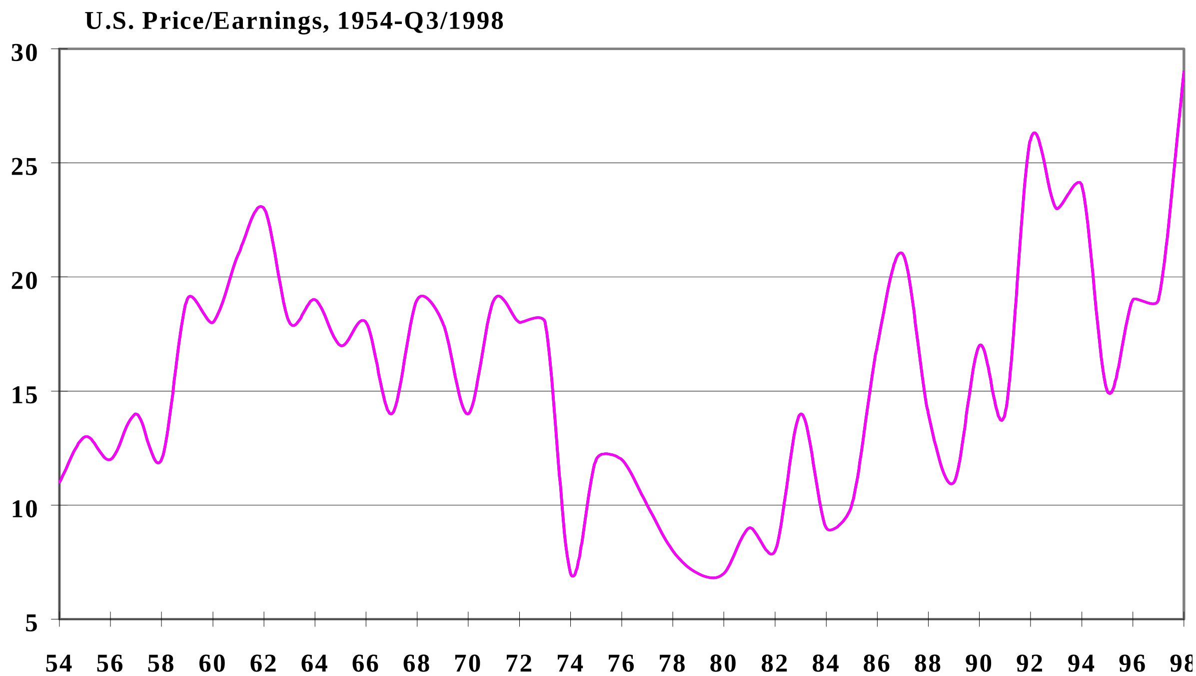
In our January 1998 investment commentary, Bradley, Foster & Sargent, Inc. went out on a limb and forecast that the S&P 500 Index, after increasing 125% in 1995-1997, would turn in yet another positive year. Our prediction was that the S&P 500 Index would continue its amazing streak with an 8-10% increase in 1998. In July, it appeared as if we had been too cautious as the combination of near zero inflation, falling bond yields and good corporate earnings propelled the S&P 500 Index to a 20% advance. However, the combination of the Russian government's devaluation of the ruble and default on its bonds, and the collapse of the Long Term Capital Partners hedge fund, caused investors to believe that global deflation would indeed halt the economic expansion in Europe and the U.S. Our prediction began to appear too optimistic as investors pulled the plug on stocks creating a double bottom which occurred on August 31st and October 8th. Chairman Greenspan moved quickly to lower the Fed Funds and discount rates in the U.S., to help arrange for the rescue of Long Term Capital Partners by its creditors and to provide liquidity to markets. The coordinated rate cuts by central banks around the world-persuaded investors that the deflationary threat would not reach the shores of Europe or the U.S. With the Federal Reserve cutting rates three times in two months, investors piled back into the U.S. stock market, propelling the averages to all time highs at year-end. Thus, our forecast last January proved to be too cautious.

Price Earnings Ratios at an All Time High

The stock market's advance was all the more remarkable in light of the essentially flat operating earnings of the S&P 500 in 1998 - up only .3% for the year to $44.88. This was far below the consensus forecast a year ago of $48. Thus, the S&P 500 Index advanced 28.53%, while corporate earnings stayed nearly flat. As a result, P/E ratios increased by more than 25% during 1998 due to declining interest rates and near zero inflation. The chart below tracks trailing P/Es for the S&P 500 Index since 1954:

There are many similarities between the recent U.S. economy and the decade of 1958-1968: robust corporate earnings, high corporate operating margins, strong cash flow and very low inflation. Notice, however, that the P/E ratio during that period exceeded 20 only once, while the P/E ratio now for the S&P 500 Index (trailing earnings) is approximately 27.3. This is based upon estimated 1998 operating earnings for the S&P 500 of $44.88 with the S&P 500 at 1225. On S&P 500 forward earnings estimated at $48.00 for 1999, the P/E ratio still remains a lofty 25.5.

Historical U.S. Price/Earnings Ratio



Quality at Any Price

Market observers tend to address the valuation of the stock market averages and their price performance. However, there has rarely been such a clear example of the disparity in valuations between market averages and individual stocks as in 1998. During the past year, there have been major sectors of the stock market which investors have shunned. These include almost any company producing a commodity (such as paper, metal, chemical, or oil or gas) or manufacturing capital equipment for these industries. It also has included small and medium capitalization companies as well as many cyclical companies. The stock market has focused narrowly on large capitalization growth companies - the bigger and the more global the better. And the company, for which almost no price is too high, is a large company with global reach which can produce a significant and apparently sustainable growth in revenues, good operating margins and steep earnings increases. Most of these companies are currently found in the technology, telecommunication or health care sectors, although there are also examples in the retail and financial areas. P/Es for the highest quality companies with the above characteristics such as Microsoft have reached 60 times projected 1999 earnings, and America Online currently sells at 200 times 1999 earnings. These levels have rarely been seen in the history of U.S. financial markets; the last time was in 1972 with companies such as Polaroid and Avon and other "nifty-fifty" stocks with P/Es exceeding 100.

The question, of course, is whether the market, which generally overshoots the mark both on the upside and on the downside, is now valuing these superstocks at dangerously excessive valuations. The usual justification for paying 50 or 60 times earnings for a great company with earnings growth of 25% a year is as follows: If the average company in the S&P 500 Index only has earnings growth of 8% a year, for which the market is paying 25 times earnings, why shouldn't an investor pay twice as much (50 times earnings) for a company growing three times as fast? There is something to be said for this logic. The rebuttal is that should anything happen on a macro basis or at the company itself to slow its earnings growth (or perhaps even cause an earnings decline), it would be a painful fall (60%) from 50 times earnings to 20 times or less. Generally, the approach at Bradley, Foster & Sargent, Inc. is not to limit our investments to these superstocks but to invest primarily in well managed growth companies with good prospects whose shares are at reasonable prices (i.e.; at below the market P/E).

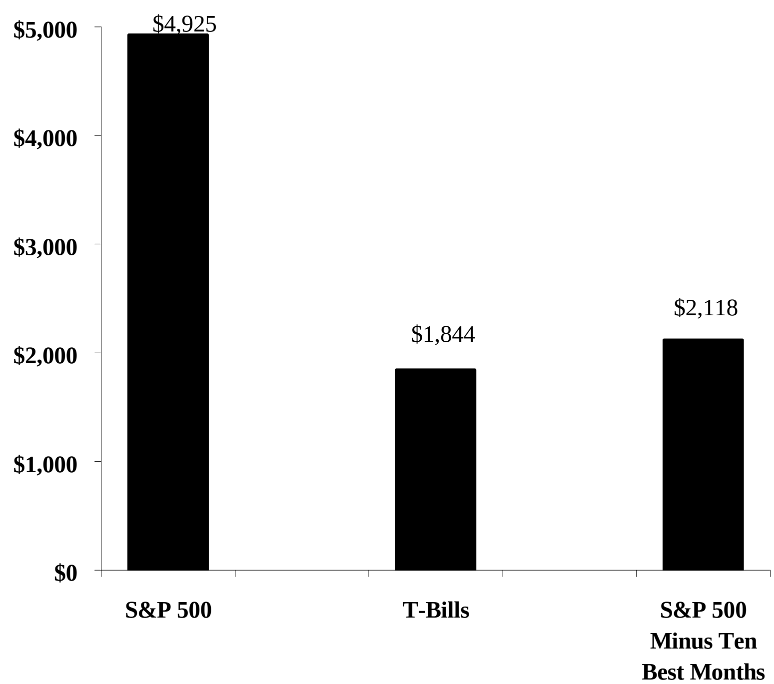
Internet Valuations

It is rare to live through a full scale investing mania such as the Internet speculation which has engulfed the stock market. As revolutionary as the Internet is (and it has already changed our lives) and as extraordinary as the growth prospects of many Internet companies are, the valuations of most of these companies remind the observer of the tulip mania in Holland in the 17th century. Speculators and gamblers there were willing to plunk down the equivalent of $10,000 in 1999 currency for a single tulip bulb. In our own Internet mania, investors are valuing companies at 50-200 times a company's annual *revenues*. Actually, only a handful of companies have earnings and a business model which can sustain rapid earnings growth. It is true nonetheless that as the Internet develops, there will be many companies worth investing in. But currently, the market for these shares is in the hands of Internet junkies and day traders for whom waiting 10 seconds for an Internet image to appear on their computer is beyond their attention span. Naturally, waiting a year or two for a stock to double or triple is old fashioned, and one witnesses almost daily stocks which quadruple in a single day. Some have gone up ten or twenty fold in a single year. In addition, one receives frequent tips from painters, construction workers, barbers, mailman and teenagers, many of whom are ‘gambling” on Internet stocks. Unfortunately, it will end badly as all such manias do, and much money will be lost. But much money will also be made by investors who can separate the wheat from the chaff.

Timing the Market

With valuations for high quality growth stocks richly valued, does it make sense to try to “time the market”? In this case, timing the market means to sell all or a significant portion of one’s stocks, and hold cash reserves until such time as the stock market’s valuation for these stocks are more modest. There are several problems with this approach. The most important one is that the market makes most of its major upward moves in short periodic bursts, and these often take place at the most unlikely times. If an investor misses even 10% of the best months to be holding stocks, the investor misses most of the gain. The chart on the following page demonstrates this principle.

Timing the Market
[1987-1996]



Source: Fidelity Investments

A second reason why this approach is usually ineffective for most taxable portfolios is that selling profitable holdings means paying short or long term federal and state capital gains taxes which generally total at least 25%. Unless the stock market declines more than 25%, the investor loses more than he

This chart shows that from 1987 through the end of 1996, if you were out of
stocks for the 10 best months of the market, your return would have been

gains. Moreover, it is often difficult to bring oneself to re-establish positions in stocks that one has sold - especially if one has to buy that stock at a price higher than it was sold at. Accordingly, the approach at Bradley, Foster & Sargent, Inc. is not to try to "time the market." It is rather to stick to the asset allocation guidelines that are appropriate for each client and portfolio. It is also to ensure that each client has carefully considered the risk-reward parameters of his or her portfolio and maintains realistic expectations of investment returns for each asset class. But when it is appropriate to sell a stock, rather than the market, we shall do so.

1999 Forecast

Never before has the S&P 500 Index had four straight years of double digit increases. The market's P/E ratio has never been higher. There is a mania in Internet stocks. These factors alone dictate a cautious approach for 1999. Other potentially negative factors are the impeachment and trial of the President, the possibility of damage to the global economy from the Y2K problem, and the impact of deflation on Asia, Russia and Brazil. On the positive side, conditions in the U.S. economy have rarely been better - with a strong economy, near zero inflation, strong demand for equities from retirement plans and baby boomers, a technological revolution in full bloom, a budget surplus and strong global trade. On balance, it is likely that the market averages will trend higher - not from an expansion in P/E ratios but because of higher earnings (7-8%). Accordingly, our guess is that the market will edge higher in 1999, nearing 10,000 on the Dow Jones, but that it remains vulnerable to a 20%+ sell-off from any serious, unanticipated event such as a war, unexpected severity of Y2K problems, the re-emergence of modest inflation, removal of the President from office or higher interest rates. In short, the bull market is not dead, but it is a time for caution and lower expectations.

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