The Long View

> The truth is that there is no investment which does not
> involve some risk and is not something of a gamble.
>
> Bernard Baruch, *My Own Story*, 1957

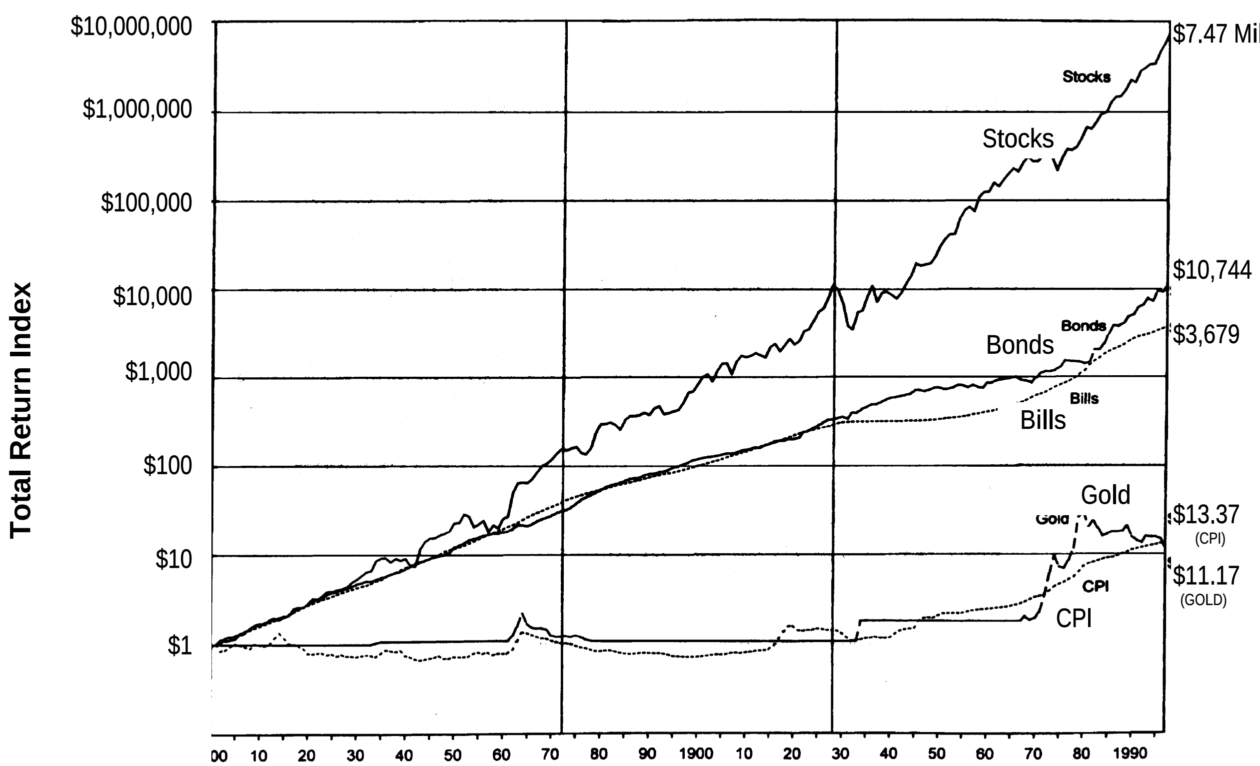
The first six months of 2000 in the stock market were not a time for the fainthearted. The NASDAQ soared 24.1% during the first ten weeks of the year, while the Dow Jones declined 14.8%. The speculative fever in NASDAQ hit its peak on March 10, 2000 with the Composite reaching 5045. Then the sellers got the upper hand; the NASDAQ dropped a terrifying 34.2% over the next month and finally reached its intraday bottom of 3043 on May 21. In less than two months, the NASDAQ tumbled 39.7%. While not subject to the same volatility, the S&P 500 Index was down 13.8% from its March peak when it bottomed in mid-April. During the second half of May and June, the stock market indices have been slowly clawing their way back. By June 30, the NASDAQ was only down 2.54% for the first six months, while the S&P 500 Index was just short of breakeven at -.44% for the same period. The Dow Jones, with larger weightings in the Old Economy cyclical names, was down the most at -8.45% for the first half. Since the Federal Reserve began its series of rate hikes a year ago, the Dow Jones is down 4.77%. High quality corporate bonds, on the other hand, showed a positive total return of 2.54% for the first half of the year. Investors, evidently believing that the Federal Reserve does not have many interest rate hikes remaining this cycle, have bid up intermediate and long-term bond prices despite the string of short-term interest increases.

During the second quarter, money flowed out of the more speculative sectors and into financial, drug and energy stocks as well as the traditional defensive sectors such as utilities and REITs. Sectors especially hard hit were telecommunication and media stocks, satellite TV companies, software and, of course, Internet-related names. When the carnage was over, many of the stronger technology and Internet-related stocks were down 50% or more, while many of the weaker and more speculative names were selling at single digit prices. It was a period characterized by extreme volatility and rapid sector rotation. Many technology leaders such as Yahoo and Qualcomm dropped over 50% with little or no change in their fundamentals.

In a nervous and volatile market such as this one, there is no room for complacency. One is reminded of the above statement by Bernard Baruch about the inherent risks in all investments. Well known, large capitalization companies with global brand names can plunge 40-65% in a matter of days when investors are running for the exits. While investors should expect a high flying market leader such as Yahoo, which at its peak in January sold at 600 times this year's earnings, to be highly volatile, it is disconcerting to see a high quality, well managed growth company like Procter and Gamble fall 50% on disappointing earnings. The stocks of established growth companies with strong brand names and good balance sheets have often suffered the most extreme declines in price when their earnings or prospects disappoint. Over the past year, each of these companies has seen the price of their stock fall by more than 50%: Motorola, Microsoft, A T & T, Allstate, Xerox, Unum/Provident, Procter and Gamble, Computer Associates, and Worldcom. In many cases, most of the damage to the stock price took place in one or two days with the stock gapping down 25% or more (i.e.; gapping is when the stock trades at one price and the next trade takes place at a price far lower (or higher) than its last trade). In fact, every investment has some level of risk, and the current climate in the stock market serves to emphasize the inherent risk of even apparently risk-adverse investments.

The Long View

In times like these with all the major market indices in negative territory and with the stock prices of strong companies diving, it is easy to lose perspective about the long-term record of U.S. equities. The chart below helps one maintain a sanguine approach to the stock market in the face of a difficult period. The chart, taken from Jeremy J. Siegel's excellent book, *Stocks for the Long Run,* chronicles the astonishing record of the stock market over a 195-year period.



The chart shows the cumulative total returns of various asset classes over the last two centuries. During this period, inflation increased approximately thirteenfold, while gold, not quite keeping pace, increased eleven times in value. However, one dollar invested in U.S. stocks for 195 years (with all dividends re-invested in stocks) would have grown to nearly $7.5 million. An almost unimaginable record of long-term growth. In the table on the following page, Siegel also breaks down this growth into various sub-periods and shows not only the nominal growth rates but also the real, inflation-adjusted rates of return.

Annual U.S. Stock Market Returns 1802-1997*

Periods	Annual Average Return % (Nominal)	Annual Average Return (Inflation adjusted)	CPI
	1802-1997		
1802-1997	8.4%	7.0%	1.3%
1871-1997	9.1%	7.0%	2.0%
1926-1997	10.6%	7.2%	3.1%
	Post World War II		
1946-1997	12.2%	7.5%	4.3%
1966-1997	11.5%	6.0%	5.2%
1966-1981	6.6%	-0.4%	7.0%
1982-1997	16.7%	12.8%	3.4%

* *Stocks for the Long Haul,* Jeremy J. Siegel, 1994

The most significant point in this table is that the real after-inflation, compound annual return of stocks has averaged 7% per year over the entire 195-year period. At this rate of return, purchasing power has, on average, doubled in the stock market every ten years. In *Stocks for the Long Run,* Siegel calculates the real return for U.S. government bonds during the same period to be 3.5%, while U.S. Treasuries have produced an average annual real return of only 2.9%. Perhaps Siegel's most important finding is that one has to go back to the period between 1831 and 1861 to find a 30-year period when the returns on either long or short bonds exceeded returns on U.S. equities. *For investors with long-term horizons, stocks have clearly been a far superior investment than fixed income securities.*

It is interesting to note that returns since 1982 have been noticeably higher than in previous periods. Is this because a "New Era" has arrived where equity valuations have finally come into their own? Or is it because equities have been bid up to greatly inflated prices? These questions are, of course, the substance of the great debate currently going on between the bulls and bears. From our perspective, there are a number of reasons for these remarkable returns: An important one is the unprecedented conditions which we have enjoyed over the previous several decades. These conditions include robust corporate earnings growth, low rates of inflation, correspondingly low interest rates, unprecedented productivity growth, sound fiscal policies, strong and expanding global trade, and the absence of major wars. A second reason is the U.S. tax code which treats capital gains more favorably than interest or dividend income. This has caused an increase in demand for equities. Investor sentiment has been very positive due to the significant flow of retirement funds into equities, which many believe will continue for the coming decade as well as the continuing flow of foreign capital into U.S. equities. Finally, it is likely that investors have come to realize that U.S. equities over the long term are less risky than was previously thought. Whether investors will act on this conviction in the face of a major, multi-year bear market or succumb to short term panic and sell their equity holding remains to be seen.

The Near Term View

For those whose time frame is somewhat shorter than thirty years or even a decade, the question naturally comes to mind, “Where is the market headed this year?” And as we have said many times before, “We don’t know.” While certain excesses in the market continue to worry us, we believe that there are grounds for optimism for the remainder of the year. The most important of these reasons is the strong outlook for corporate earnings growth this year and in 2001. While many observers believe that the economy has started to slow somewhat, these observers also see S&P 500 operating earnings up 15% this year and 8% next year. The second key reason for optimism is that inflation seems to be accelerating only grudgingly. At this point, it seems unlikely that inflation will breach the 4% level. If this is the case, most of the Federal Reserve Bank’s work in raising interest rates is done. Perhaps there will be one last interest rate increase on August 22 when the Fed next meets. Historically, the stock market does not advance much when the Federal Reserve is increasing rates, but it does quite well when the Fed stops raising them (or lowers rates). Finally investors are generally optimistic during a Presidential election year, as they believe that the Federal Reserve will make adequate levels of liquidity available to the stock market so as not to be accused of playing politics. There have been very few cases when the stock market has dropped during the last six months of a presidential election year.

Stocks for the Long Haul

While no one can be sure of what the next six months will bring for investors, the “long view” of equities in the U.S. stock market is very encouraging. Over the past 197 years, in spite of wars, both civil and foreign, bouts of inflation and deflation, and the Great Depression, equity returns have been astonishingly good. This is not to say that all stocks, or even the majority of stocks, do well over the long term. But an actively managed, diversified portfolio of high quality growth stocks is likely to produce superior inflation-adjusted rates of return. At this juncture in the U.S. economy, this means a strong weighting in technology-related stocks with strong growth characteristics, and it also means a healthy weighting of consumer-related, financial and health care companies with good growth characteristics. As the protagonist in the newly released movie on the Revolutionary war, *The Patriot*, says to his sons when the going gets tough, “Don’t give up; stay the course!” The same is true of the stock market. Those who stay the course will be rewarded.