

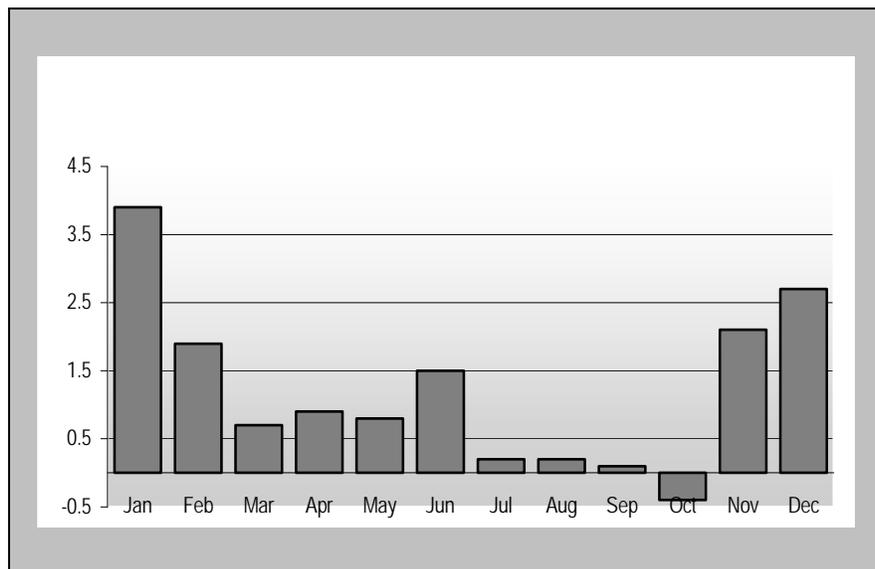
Revenge of the Nerds

October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February.

Mark Twain, *The Tragedy of Pudd'nhead Wilson*

We trust that you will forgive us for quoting the same aphorism by Mark Twain twelve months after we last used it in this publication, but he did get two things right in this famous line: October is a bad month for the stock market, and speculation is dangerous at any time of the year. The table below shows the average monthly percentage changes in the NASDAQ since 1971. October is the only month which shows a negative return on average for the entire period. Why? There are many theories, but two of the most likely are the following: For mutual funds, the taxable year ends October 31, which can stimulate significant tax loss selling in September and October and depress the whole market. The other theory is that it takes investors several months to regain an optimistic frame of mind after the end of summer vacations.

NASDAQ's Average Monthly Percentage Changes March 1971 - June 2000



Source: Hirsch Organization

The S&P 500 Index peaked at 1530 at the end of August and fell 11.5% in steady and unremitting selling to 1330 on October 12. As of that date, it was off 9.5% for the year. After reaching its peak in mid-March at 5045 and tumbling 39.7% to 3043 in May, the NASDAQ recovered much lost ground this summer reaching 4260 in late August. But the September/October sell-off brought the NASDAQ Composite back near its earlier low to 3075 - off 24.4% for the year-to-date. The Dow Jones is down 12.7% for the year through October 12. On the other hand, high-grade corporate bonds were up 6.36% for the first nine months of the year, and the return on T-bills of 5.45% topped all the equity indices.

Revenge of the Nerdy Stocks

The stocks which did the best so far in 2000 were those unloved, boring utility stocks and REITs. These dull and out-of-favor stocks have finally gotten their revenge over the “hot” favorites in the internet, media and telecommunications sectors. This reminded us of the 1984 movie, *Revenge of the Nerds*, in which the nerds and geeks, who are looked down upon by the athletes and fast crowd, finally get their revenge. There are only two good things that can be said about this sophomoric movie: It makes the movie *Animal House* look elegant and refined, and it must have been movies like this which caused college administrations across the U.S. to try to clean up fraternities. It is a dreadful movie, but the parallels in the U.S. stock market this year are striking. The “hot” new issues index is down 47% so far this year, and the internet index is down 76%. Yet the Dow Jones Utility Index is up 36.5%, while REITs are up approximately 17%. Over the past two years, many investors have been drawn into the highly speculative concept stocks with rapid revenue growth but no earnings. For most of the year, insiders have been selling these momentum stocks, while institutions and retail investors have been drawn into them, many of which have now fallen 50-90%. Even the highest quality companies in the technology sector like Microsoft, Cisco, Nokia and Intel have been savaged with declines of 35-60% this year. Meanwhile the utility, insurance, energy and REIT sectors, which were the “dogs” of the market during 1998 and 1999, have come roaring back. What’s going on?

Overvaluation in “New Economy” Stocks

As we have written before, stocks in many of the leading sectors of the market have been priced for perfection over the past several years. The following list of leading stocks shows the high valuations of these market favorites as of the end of August, 2000:

Stock	Market (\$B) Capitalization	2000E P/E	Price/Sales
Cisco	\$444	137	27
Intel	\$433	52	14
Oracle	\$208	102	20
Sun Microsystems	\$164	110	12
Ericsson	\$142	106	6
Dell	\$108	57	4
JDS Uniphase	\$ 87	N/A	21
Amgen	\$ 71	64	21
Yahoo	\$ 69	344	81
Qualcomm	\$ 47	56	12

Source: The Leuthold Group

These “New Economy” stocks, which are representative of the overvaluation in the technology, internet and telecommunications sectors, have suffered a major sell-off this year. On the other hand, many of the “Old Economy” stocks, which endured a stealth bear market during 1998-1999, have had an easier time this year with many sectors

showing positive returns thus far this year. The price/earnings ratio on the major stock market indices based on 2001 estimated earnings show the continuing valuation gap between the “New Economy” stocks and the “Old Economy” stocks:

Index	Price 10/12/00	Estimated Operating Earnings (2001)	P/E Ratio
Dow Jones Industrial	10,034	\$625	16.0
Standards & Poor 500	1,330	\$ 63	21.1
NASDAQ Composite	3,075	\$29.85	103.0

The above valuations, which reflect the last six weeks of selling pressure, indicate that NASDAQ Composite, even at this depressed level, is still priced for perfection. While many of the Internet stocks have been crushed, there are still many technology and biotechnology companies with no earnings, which sell at very large market caps. On the other hand, the Dow Jones is now priced at roughly the average P/E for the stock market over the past century. The S&P 500 has come from its high point of 27 times forward earnings in 1999 to a more reasonable P/E of 21 currently. What has caused this revaluation?

The Four Es

Over the past few months, a number of market strategists such as Ed Kerschner of Paine Webber have pointed to the four Es as the cause for the P/E compression which has taken place since March. The case for the four Es is as follows:

- Euro weakness: The Euro was launched last year with great fanfare. Since then, the currency has steadily weakened against the dollar, falling more than 20%. While having many ramifications, the most important one for U.S. companies is that European sales and earnings are translated into dollars at rates which understate these revenues and earnings, making it harder for U.S. companies to show yearly growth.
- Energy prices: Energy prices have increased significantly over the past year. Currently oil is at \$33 a barrel. Gas prices, at more than \$4 per mcf, have also gone up dramatically. Tensions in the Middle East and predictions for a cold winter in the U.S. offer little hope for relief in the short term. Higher energy prices mean lower margins and reduced earnings, as most companies cannot increase prices. Higher energy prices also mean less discretionary funds for the consumer, which will lower retail sales.
- Earnings deceleration: Corporate earnings in the U.S. are decelerating. After enjoying an increase of 14-15% in 2000 compared with 1999, investors are predicting S&P 500 earnings growth of only 6-8% in 2001. This kind of deceleration usually causes a multiple contraction. Third quarter earnings disappointments and predictions of lower growth in the 4th quarter by some bellwether firms like Intel and Yahoo have also helped deflate P/E ratios.

- Election Fears: Since the end of 1994 when the Republicans won control of Congress, the stock market has had the five best consecutive years in its history. Some observers believe that political gridlock is benign for business and the nation's economy. With some polls showing a chance that the liberal wing of the Democratic Party might capture both Congress and the Presidency, some investors are anxious - especially after the anti-business, populist rhetoric at the Democratic convention. Other investors believe that if the Republicans control both the legislative and executive branches, large tax cuts might be inflationary.

A Hard Landing?

Six interest rate hikes by the Federal Reserve Bank during 1999-2000, tighter money, higher energy prices, a weak euro and more normal capital equipment investment have caused the U.S. economy to slow. Quality spreads in the bond market suggest that the Federal Reserve went too far and that GDP growth will slow to a crawl - perhaps even causing a recession. After market bellwether Intel announced that its third quarter revenues would fall short of expectations and banks began to evidence higher credit losses, investors worried that what seemed to be a normal correction in the stock market was turning into a "hard landing".

Although the evidence for a hard landing - perhaps even a recession - is growing, we believe that this is still the minority case. Technology spending, though lower than the Y2K spending boom of last year, is still robust. Productivity growth remains high. Banks seem to be taking early action to nip credit problems, and the Fed appears more likely to ease interest rates and provide adequate liquidity for the market than to tighten. Accordingly, we believe that the odds are good for a soft landing, which would bring the U.S. economy from a supercharged 5%+ growth rate to a 3% rate. This would also help contain inflationary pressures.

Summary

The fundamental determinants of stock prices are earnings, interest rates and liquidity/monetary policy. In our view, earnings growth will slow but still show positive gains in 2001, while the trend of interest rates is probably flat to down. With much of the Internet "bubble" burst, the Fed will probably be more generous with liquidity. While we do not anticipate committing significant reserves to the stock market until the results of the election are clear, we do believe that there are a number of sectors of the stock market where there are currently good buying opportunities. The stock market's recent extreme volatility proves once again the value of a well-diversified portfolio. We will continue to practice our investment philosophy, which is to own quality growth companies at reasonable prices - even the "nerdy" stocks, which provide balance, income and growth to a portfolio.