3RD QUARTER 2001 MARKET COMMENTARY

It is difficult to go back to business as usual after experiencing the almost unimaginable horror of the September 11 tragedies. As have so many, we lost friends in the collapse of the World Trade Center towers. Thankfully, we also celebrated news of one of our clients who escaped from a lower floor and of a good friend who that day was away from his office near the top of One World Trade Center.

Mission was directly affected by the terrorism. Our partner in securities lending is Cantor Fitzgerald, which lost over 700 employees on that horrible morning. In April 1999, our clients enjoyed an insightful and entertaining presentation to our annual investment conference by Bill Meehan, Cantor's Chief Equity Strategist. Bill recently transferred from his Cos Cob, Connecticut office to the World Trade Center. He is among the missing.

On a more hopeful note, as an example of the ongoing cycle of death and renewal, there appears to be much good arising from the ashes of one of history's quintessential acts of evil. Throughout much of the world, society has spent the lion's share of the past two decades evolving toward ever increasing levels of self-absorption and self-gratification. The diabolical acts of terrorism have forced us to face our fragility and have led many to a reevaluation of those targets for which we should all be striving. There is reason to hope that this will be more than an ephemeral change of attitude. Humans are cyclical beings, and we have strong reason to believe that we may be reentering a period in which spiritual goals and a genuine care for the well being of others will replace the insatiable quest for more material goods and personal power.

The cyclical nature of so much around us is certainly evident in the securities markets as well. Over the entire history of our nation, we have experienced lengthy periods in which common stocks have provided bountiful returns followed by equally lengthy periods in which real, after-inflation returns are virtually negligible. (See the following table profiling the weak and strong cycles over the past two centuries.) While there are always opponents ready to debunk the conclusions drawn by cycle advocates, there can be no argument about the historical existence of the cycles outlined in the table. The only argument can be about whether these data tell us anything about the years ahead.

LONG-TERM U.S. STOCK MARKET CYCLES
Inflation Adjusted Total Returns

WEAK CYCLES		
Time Period	**Real Annual Total Return**	**Duration**
1802 – 15	+2.7%	13 years
1835 – 43	-0.6%	8 years
1853 – 61	-3.0%	8 years
1881 – 97	+3.9%	16 years
1902 – 21	+0.0%	19 years
1929 – 49	+0.8%	20 years
1966 – 82	-1.4%	16 years
STRONG CYCLES		
Time Period	**Real Annual Total Return**	**Duration**
1815 – 35	+10.0%	20 years
1843 – 53	+13.7%	10 years
1861 – 81	+12.0%	20 years
1897 – 02	+15.2%	5 years
1921 – 29	+25.2%	8 years
1949 – 66	+14.0%	17 years
1982 – 99	+14.9%	17 years

Since 1802, the inflation adjusted total return has averaged 7.08%.
Source: Robert Powers

It is worth noting that there have been only two weak and two strong cycles in the last 70 years of the twentieth century. Each of the four cycles was long enough to convince investors of the day that current conditions were likely to continue into the indefinite future. They were also long enough to wash out many investors and advisors with practical experience of a different market environment. As a result, at the end of the strong cycles in 1966 and 1999, investors were rampantly bullish. Conversely, as major weak cycles were ending in 1949 and 1982, it was very difficult to convince investors that common stocks were worth holding.

Perhaps not surprisingly, at the end of the weak periods investors could buy stocks at valuations far below historically normal levels. No one wanted them. On the flip side, at the end of the strong cycles, valuations were hysterically excessive. Everyone wanted to own stocks, and "new era" stories provided logical rationales for disregarding historical valuation guidelines that have always ultimately proved right in the long run.

We have argued strongly for the past several years that stock market valuations made no sense. We argued that, as has always been the case, markets will once again, sooner or later, revert to their long-term valuation means. This has not been an environment in which to own an aggressive allocation to equities.

Most common stock indexes have now retreated to their 1998 levels. Only a passing glance at the many financial TV shows is needed to enlist the opinion of a market "expert" that there are great bargains available in today's market. After all, look how far prices have declined. Other than on a short-term trading basis, that comparison with previous prices is relevant only if those earlier prices made sense. As we argued over and over while market indexes were skyrocketing, prices for virtually all stocks, not just the Internet darlings, had no basis in fundamentals. The late 1990s provided the most egregious example in U.S. history of mass investor hysteria. This was momentum investment run rampant. Almost any semi-plausible story justified a higher stock price.

Such an attitude of investor confidence dies slowly. The Dow Jones Industrial Average and the S&P 500 have each fallen over 30% from high to low over the past year and a half. The more technology-laden NASDAQ Composite has declined by more than 70%. Such losses have marked the full extent of many bear markets, and most of today's investment professionals have never before experienced such declines. Every market decline in their pasts has been quickly erased, and a new upward market leg has always rewarded their bullishness. Why would they expect anything different today?

Instead of comparing today's stock prices with those of the past few years, it would be prudent to evaluate them in relation to their underlying earnings. Using trailing 12-month earnings through June 30, the latest released by Standard & Poor's, the S&P 500 is currently selling for just a fraction below 30 times earnings. Last week the *New York Times* factored in third-quarter earnings for S&P companies that have already reported and came up with a price-to-earnings multiple over 35 times earnings, the highest in history. At the same time the NASDAQ Composite multiple remains above 100. It is universally acknowledged that both third and fourth quarter earnings will be lower year over year. If stock prices remain unchanged, price-to-earnings multiples will rise still higher.

Many argue that the P/E multiples are artificially too high because we're comparing prices to depressed earnings. That might be a fair objection of this were the first time corporate earnings had ever declined. The U.S. economy has, however, experienced numerous recessions, even a depression, throughout our history. That notwithstanding, we have never experienced price-to-earnings multiples like today's. Investors remain remarkably bullish.

Typically markets sell at above-average P/E multiples when economic growth and corporate profits look ready to grow significantly and steadily for many years to come. Despite repeated forecasts that the economy and earnings are on the verge of turning up, the rebound continues to be pushed farther and farther out. The reality is that no one can know how deep this recession may turn out to be nor when or how strongly we will recover. We cannot know the course of the war on terrorism nor whether we will yet experience more episodes of terrorist violence. How these factors will affect consumer confidence is unknowable. Such uncertainties are the ingredients for below average P/E multiples. It is inconceivable that rational investors would maintain that these conditions justify the highest P/E multiples in U.S. history. The most plausible explanation is that a vast majority of today's investors and portfolio managers have, until early last year, known only the bull market environment of the most recent 17-year strong cycle. The ingrained bullish enthusiasm, born of ever-higher prices, has not yet been extinguished, despite the serious deterioration of stock market

fundamentals. The most serious overvaluation in U.S. history doesn't faze those investors and managers because they know little about the history of valuation and because they paid little attention to price when the market was going up. Momentum was important, not valuation levels. Momentum can be sufficient in a bull market, not so in a bear market. Bear markets typically do not end until stock prices decline to levels of very attractive valuation.

The feeling of complacency, even confidence, evidenced by most institutional investors has been significantly buttressed by their consultants. Over the past decade these consultants have presided over investment programs that increasingly ratcheted up their allocations to equities as the bull market climbed to ever higher levels. This is the same error investors made on their own in past strong cycles. Support from their consultants has emboldened investment plan sponsors to raise their portfolio equity levels to the highest in history, a classic mistake at the end of extended bull markets.

To put the quality of consultants' advice into perspective, it is instructive to note that the investment consulting industry was virtually non-existent before the mid-1970's. It has only become widely popular within the last 20 years. The entire securities market experience of almost all consultants is that of the recently concluded 17-year strong cycle. Little surprise that their advice reflects what works well in an extended bull market. What they can't fully appreciate is how the dynamics change in a bear market. Most importantly, trustees and other investment decision-makers become increasingly fearful and defensive the longer a bear market drags on. This is not something a consultant will understand well unless he/she has experienced it. Consultants saw a touch of this attitude shift in 1987, but the last serious pressure on trustees came in the latter stages of the 1973-74 bear market. There were virtually no consultants then. If we are, in fact, in the early years of the next lengthy weak cycle, the bull market posture of most investment plans may be costly for a decade or more.

Contrasted with the advice of most consultants is that offered by some of the modern market's most successful investors. For the past few years Warren Buffett, the most successful investor in history, has repeated his admonition that he can find virtually nothing to buy at these levels of valuation. In a TV interview in late September, legendary investor Sir John Templeton declared firmly that we are "nowhere near the end of the bear market yet."

While reversion to the historic valuation means is an unbroken phenomenon, how it happens varies from one instance to the next. From levels of serious overvaluation, markets have eliminated the excesses rapidly in two years or so (1929-32) or over nearly a decade with a series of mini-bull and mini-bear markets (1966-74). Recoveries to earlier highs took well over a decade in each case.

Even after a year and a half of price declines, today's stock valuations are still more excessive than those prior to either of this century's two most serious extended bear markets. While rallies to even greater levels of overvaluation are possible at any time, the probabilities lie heavily on the side of continued price erosion until we again reach attractive levels of valuation.

Despite the trauma our country and the markets have experienced so far this year, we are pleased that all of our clients' portfolios where we have full investment discretion are up for the first three quarters with the S&P 500 down by 20.4%. Even more important, every portfolio that has been with us for at least three years has performed better than both stocks and bonds over that critical time period. While we remain equity oriented over the long run, we are patient and look forward to becoming more aggressive stock buyers at far more attractive levels of valuation.

Thomas J. Feeney
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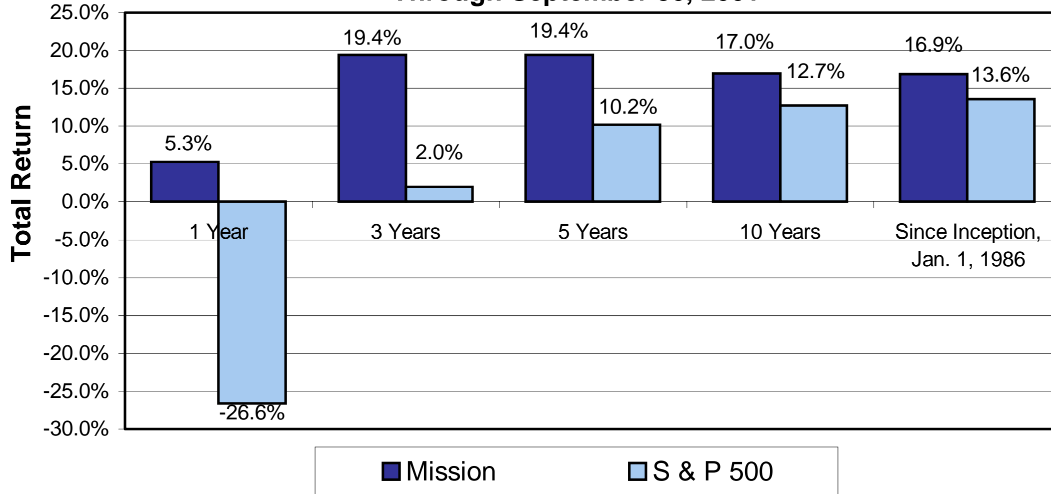

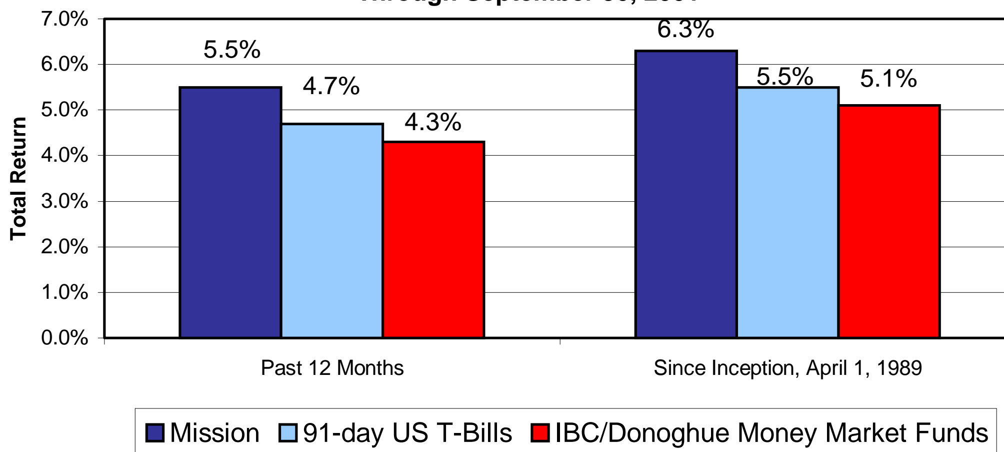

Past Performance May Not Be Predictive of Future Performance