



## **QUARTERLY REPORT**

**Third Quarter 2003  
October 17, 2003**

The investment landscape has changed dramatically over the past twelve months, and investors' attitudes have changed even faster. In an environment of rampant bullishness toward stocks, this may be the most important letter we've written since late 1999 and early 2000.

The third quarter of 2003 was noteworthy for both positive and negative events. The stock market rally completed a full year in the wake of stocks' worst decline since the Great Depression of the 1930's. On the bond side investors endured the worst month (July) in U.S. history. Because bonds rallied over the last two months of the quarter, July's destructive results were somewhat muted, and the general public took little notice of what may prove to be a landmark turn in the prospect for bonds.

What has captured public opinion and has reanimated investors' spirits is more than a 30% rise in the S&P 500 and a 70% rise in the NASDAQ Composite. Fueled by daily doses of bullish sentiment from TV commentators and brokerage house analysts and strategists, individual investors now express bullish sentiments by an extremely high three to one ratio. Contrast that optimism, which is typically wrong when it reaches such an extreme, to the actions of corporate insiders, who are more often right. Corporate directors and senior executives have been selling 4.5 shares of their companies' stocks for every share they have purchased, a 17-year high. One investment letter writer posed the question: "Would you rather be on the side of the smart money or the dumb money?"

Clearly the "dumb money" has been right over the past seven months, but it will ultimately prove to have been foresighted for other than short-term traders only if these gains are retained. Should stock prices resume the decline that began in 2000, the rally for long-term investors will ultimately be chronicled as an excitement producer but not a wealth producer. To the extent that investors are lured into larger equity positions late in the rally, they will be far worse off than if they had simply sat out this year's excitement.

In a recent interim client letter, we cited the investment outlooks of the two most noteworthy investment masters of the past half-century. Warren Buffett this past quarter made the point that common stocks were not worth buying at current prices. Sir John Templeton has been bearish on U.S. stocks for several years. In views reported this week in the International Herald Tribune, Templeton urged listeners to sell U.S. stocks and excess residential real estate, warning about probable serious potential pullbacks in both areas. We agree.

While it is comforting to be in concert with the views of such acknowledged experts, our convictions are based on a significant number of indicators that have excellent predictive history.

Over the past several weeks, we've been asked many times why the market rally accompanied by low interest rates, growing corporate profits, an accommodative Federal Reserve Board and an improving economy shouldn't justify a more aggressive equity stance.

First, only momentum investors should be encouraged to buy more by the simple act of a market rising. All else equal, we prefer to buy stocks when prices decline, not to chase them when prices rise. It's important to recognize that major market moves in either direction are frequently interrupted by shorter countertrend moves. The current rally in the United States is the fifth since March 2000 that has risen by at least 20%. We know that the first four rallies ultimately failed and penalized all but successful short-term traders. That, however, has not discouraged the investment analysts and individual investors whose optimism was noted earlier. We are always leery of sharing extreme optimism with the small investor. Similarly, we are loath to be very optimistic when corporate insiders are exiting their stock positions in record numbers.

Admittedly, much of what happens in markets over one- and two-year periods is random and in response to shifting investor sentiment. Longer moves, typically over a decade in length, demonstrate much greater symmetry. When one examines the lengthy weak and strong market performance cycles in the nineteenth and twentieth centuries, the odds look slight that a two-decade long bull market in stocks will be fully corrected in just three years. It would contradict two centuries of repetitive precedent.

Let's look at some of the factors encouraging today's equity investors. Corporate profits have been growing consistently over the past several quarters. Trailing twelve-months' profits for the companies in the S&P 500 were more than cut in half in 2001 and early 2002. The past year and a half have seen those profits grow by about 40% from the depressed base. That still leaves profit levels about 35% below their peak levels of almost three years ago. We hear a lot about the profit gains coming from increased productivity. With revenue growth far below profit growth, much of the productivity gain has apparently resulted from lay offs. When well-educated foreign workers are willing to work for far less pay than our domestic workers, it is unlikely that we will soon experience an employment resurgence. That may ultimately weigh heavily on consumer sentiment, which has remained buoyant despite an anemic employment picture. These factors may soon slow corporate earnings growth.

Even if corporate earnings should continue to grow, the effect on equity market prices should be limited. We studied year-over-year corporate earnings growth back to 1950 to determine what effect such growth has had on subsequent market performance. Surprisingly, even in the first year after earnings changes, the effects are not substantial. On average, over the past half century, the S&P 500 did only about 2% better when corporate earnings grew by 10% year over year than when they declined by 10% year over year.

We regularly hear investment analysts and commentators encourage greater equity involvement because they foresee a growing economy. Although that seems to make complete good sense, their conclusion is not borne out by the facts. Our recent study back to 1947 of Gross Domestic Product (GDP) growth and subsequent stock market performance revealed no positive correlation between greater GDP growth and greater stock market performance. Strange, but true.

The most widely discussed reason for not worrying about apparent equity overvaluation is the historically low level of interest rates. The logic of low interest rates justifying higher price-to-earnings ratios for stocks seems unassailable. Nonetheless, in one of a series of studies, we examined the effect of interest rates on subsequent stock market performance. There was no clear correlation between the level of interest rates and stock market performance over the subsequent twelve months. There was a nearly even split between above average and below average returns all the way across the interest rate spectrum. Counterintuitively, as we examined performance over periods beyond one year, the probability of better stock market returns was greater at higher interest rates than at lower rates. There were far more examples of below average returns at low interest rates. Apparently it's more important to know what has really happened than to accept the common wisdom fed to investors by TV's experts.

How about an accommodative Federal Reserve Board? Certainly that must logically lead to stock market growth. A study of market history does indicate that an accommodative Fed usually leads to market growth. Unfortunately, there are some disastrous exceptions. The Fed was aggressively accommodative through the two worst stock market declines in U.S. history, 1929-32 and 2000-02. In neither instance were the Fed's actions able to halt huge stock market losses. The Fed today has essentially run out of its interest rate ammunition, although it could yet continue to grow the money supply. That, in fact, has probably been the single most important contributor to the current stock market rally. The Fed does not act in a vacuum, however. There are international checks and balances in the world monetary system, and the other players on the world scene appear increasingly impatient with a persistently weak U.S. dollar. More about that later.

The one measure of stock market valuation that has been highly predictive - especially over a multi-year time frame - of subsequent stock market performance has been the price-to-earnings multiple of the market. At today's close, the S&P 500 was selling at 30.1 times its trailing twelve-months' earnings, as reported by the Standard and Poor's Corporation. Only in the last half decade has our market ever reached a 30 PE multiple. In all of U.S. market history since 1926 there have been only 14 monthly observations of an S&P 500 PE multiple of 28 or higher after which we have four years of market performance to analyze. The four-year performance following each of those 14 observations was negative. Our study of performance following the whole range of market PE multiples from 1926 to present over time frames from one to twenty years demonstrates an obvious conclusion. Over every time period the average market performance is well above average when starting from low PE multiples. Conversely, the average market performance is well below average when starting from high PE multiples. The market today is at one of the highest PE multiples in history. The stock market's long-term prospects from this level are not attractive. The risk of serious decline from current levels in the short run is significant.

Turning our attention to bonds, we are facing a very possible turn in bond yields after more than two decades of decline. As noted earlier, July was the worst month in U.S. bond market history. That rapid increase in bond yields (decrease in prices) provided several technical indications that the downward trend in bond yields since 1981 may well be turning.

Interestingly, there have been only three major trends in bond yields in the past 80 years. In the 1920's and 1930's yields were basically declining. For the next four decades rates were rising.

Since 1981 rates again have been declining. In the decades of declining yields, money was easy to make in bonds. The exact opposite was true for the four-decade long increase in bond yields from 1941 to 1981. Over that period of four decades the total return on bonds averaged less than the total return on risk-free, short-term treasury bills. Bond returns were also below the average inflation rate. Over that four-decade period, bondholders lost purchasing power. The lesson is clear: you don't want to be a bondholder in a rising interest rate environment.

Our biggest concern regarding bonds has been the persistent weakness in the U.S. dollar over the past two years. U.S. Treasury Secretary John Snow has recently announced his lack of discomfort with the prospects of a still weaker dollar. Last month's meeting of the G-7 monetary leaders released a call for more flexible currency exchange rates, which was widely interpreted as a call for a weaker U.S. dollar. Outgoing European Central Bank head Wim Duisenberg called further decline in the value of the dollar "inevitable." Now comes John Templeton's warning of a further 40% decline in the value of the dollar leading to aggressive selling of dollar-denominated stocks and bonds by foreign investors, especially the Japanese and Chinese.

Sir John encouraged U.S. investors to sell U.S. stocks and excess residential real estate. He urged his listeners to buy bonds, not U.S. bonds but bonds from Canada, Australia and New Zealand.

It is always flattering to have a world recognized investment expert bless your chosen course of action. We have long shared Sir John's concern with the senseless level of U.S. stock valuations. We spoke at some length in this year's April client conference about our concern with the weakening U.S. dollar and the damage it was likely to do to domestic investment. We voiced our suspicion that the next major interest rate move would be to higher rates, except for very short maturities. We began early this year to buy Canadian government bonds and some short maturity Australian dollar-based securities. We have been exploring New Zealand bonds over the past few weeks. The earliest Canadian and Australian purchases are already up over 10% because of the U.S. dollar weakness.

We would far prefer to be offering a glowingly optimistic outlook. That time will come, but the far greater danger today is of a serious loss of wealth in stocks and a possible loss in total return on intermediate- and long-term U.S. bonds. Clearly the administration will bend all efforts to defer any problems until after next year's election. All administrations do that. And they could prove successful. The risks of serious loss of wealth, however, are far greater than the potential for further gains in an already extended stock market and in a bond market that may have made a major change in direction.

We are putting some assets in very secure short-term foreign bonds and are holding most in reserve in short-term cash equivalents so that we are poised to take full advantage of lower future prices in both stocks and bonds. Fortunately our relatively few common stock holdings have done quite well.

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