MARATHON

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Dear Plan Sponsors and Friends:

Stock prices pressed persistently higher in the third quarter, completing five years without so much as a ten percent pullback, the longest such period in the U.S. stock market's entire history. Stock markets typically have at least ten percent corrections every year. This lack of any significant downward price movement has created a fear of cash in institutional portfolio managers. To the extent that they have held any risk free securities over the past half decade, their returns have been hurt. With the tendency among investors to move toward managers with the strongest recent records (a proven recipe for future disappointment) few managers dare to be out of synch with their peers. As a result, investment managers as a group are holding less cash today than at any point since such records have been kept starting several decades ago.

So strong and unrelenting has the stock market advance been that the general public has joined investment professionals in gobbling up stock even at record high prices. That nobody has been hurt for years has led many investors to ignore the time-tested measures of value that have differentiated reasonably priced from overpriced stocks for decades. And now we hear that the often derided individual investor has learned not to "panic" when markets decline. That investor now proclaims that he/she is in for the long run and will simply continue to buy more stock when prices decline. Many argue that regular inflows to 401(k) and other employee controlled retirement programs will provide a permanent support to the securities markets, rendering major bear markets things of the past. With all these factors going for stocks why not just jump on board and enjoy the ride?

The overriding reason for not abandoning historically sound standards and buying heavily where we are now is that people who have done that in somewhat similar circumstances in the past have lost money. Of course there is no way to know where the ultimate top to this great bull market lies, and the path of least resistance remains upward in the short run. As we have pointed out in the past, the higher prices go and the longer it takes, the greater will be the pressure to move more heavily into stocks regardless of price. Long term we want to own far more equities than we have recently owned, but we want to buy those stocks at historically sound value levels.

In recent quarters we have highlighted stocks' all time levels of overvaluation. By most measures that overvaluation remains just as severe today. Obviously that has not impacted the markets, but these value measures are not designed to be good timing indicators. They have <u>always</u>, however, been good stock price direction indicators, and there is no reason to expect that they will be less accurate in the 1990's. They point to lower stock prices in the years ahead.

The enthusiasm of investors discussed earlier is also a mixed blessing. While the new money is pouring in, it provides great upside impetus to stock prices as investment managers use it to buy more stock. That is what we have been experiencing for the past few years. So aggressive has institutional stock buying been that portfolio cash holdings are at all time lows. Historically, cash holdings of the investment universe have, however, been a very good contrary indicator. Markets traditionally begin major rises when cash holdings are very high. Conversely, low cash levels typically precede significant declines. We are in the latter condition today.

The confidence many have gained from the persistent buying by individual investors should also be examined in the light of history. Individual investors as a group have always bought stocks most heavily near market highs and have been net sellers when markets are near their bottoms. This is also not the first era in which individual investors have professed their long term orientation. I entered the investment business in the 1960's. Mutual funds were the chosen vehicle of the period, and large numbers of individual investors were committed, like 401(k) investors today, to monthly or quarterly investments. They professed a lack of concern for market fluctuations because they were investing for the long run. That resolve lasted only until the first major market decline, the 45% drop in 1973-74. By the end of 1974 huge numbers of investors had sold their stocks and their funds. A great many stayed away for more than a decade and a half. The public didn't want anything to do with stocks when they were cheap. They have only regained their confidence in the past five years with stocks at much higher prices. Once again history will prove them to be too late to the party. Whenever the next bear market pushes prices down, the public will sell again, as it always has, and will probably stay away from stocks for many years into the future. When the crowd is moving strongly in one direction, as now, the end of a market move is inevitably in sight.

For those who are getting tired of waiting for stocks to return to historically normal valuations, we continue to counsel patience. Those who attended Marathon's investment conferences in the late 1980's probably remember my comments about the Japanese market. For several years that market had been rising at rates above 20% per year. Professional commentators were urging institutional and individual investors alike to put money into Japan. They made the case that the old valuation standards no longer applied to Japanese stocks for a variety of reasons. At our conference in early 1987 I made the point that this was a market that had severed its ties to normal valuations and inevitably would break to much lower levels. The market went higher. I repeated that caution at our 1988 conference. The Japanese market went higher still. Once again in early 1989 I repeated that warning that despite the persistent rise in Japanese stocks, no one can repeal the forces of underlying value, and that the Nikkei average would certainly fall precipitously. The market continued to rise. On the final trading day of 1989 that average reached the 39,000 level. Finally the upward thrust ended, and prices in the next year and a half fell to 14,000, a 64% decline. This decline wiped out all of the dramatic gains of the prior years. Even today, at about 18,000, that average is about 54% below its peak, and anyone who invested in the late 1980's has net losses even now in the mid 1990's.

The Japanese stock market remained extremely overvalued for several years, but anyone who succumbed to the pressure to get on board has lost money for almost a decade. In the United States we have also remained extremely overvalued for a few years. No one can know exactly where this top will be. We can, however, know with considerable certainty that valuation criteria that have applied for a century or more will ultimately assert themselves and lead stocks to much lower levels, even if they should go higher first. We are in a period in which the long term risk/reward ratio for stocks is highly unfavorable.

In a recent client meeting I was asked what could lead to such a major market decline. I made the point that markets rarely make tops when problems are evident. Markets typically top out when prospects are rosy. The problems become evident after stocks begin to fall. Nonetheless, I would offer the following as areas from which a negative surprise could arise: fourth quarter and 1996 corporate earnings, value of the dollar, interest rates, a Japanese banking crisis, cumulative national debt, weak household liquidity and a low savings rate.

On the fixed income side we still see no reason to extend bond maturities. Thirty year treasury bonds yield only about .6% more than high quality short term securities, not enough in our opinion to take the additional risk.

We would welcome the opportunity to assist you in the management of your investment assets.

Sincerely,

Tom Feeney

Thomas J. Feeney
President