Q&A by the Bay

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On a recent January afternoon, Clara Basile, Dave Rahn, and Bill Oberman gathered around the conference table at their offices in the Port of Redwood City to consider some of the pressing questions they've been hearing from their clients over the last few months.

Here are composites of questions clients have posed and a synopsis of their discussion.

Q: **I am still in shock from three years of negative stock market returns. What went wrong and why should this year be different?**

A: The question sums it up well. We think that 2003 will feel a lot better than 2002. Despite the underlying improvement in the economy that began after Sept 11, 2001, the post-bubble hangover in equities persisted. Last year we had economic growth, estimated to be +2.6%, rising corporate operating earnings and cash flow, low inflation, declining interest rates, and 3 quarters of improving IT spending, yet the stock market tanked.

In hindsight, investors' appetite for risk (perceived as reward) went from nearly insatiable in March, 2000, to an equally insatiable hunger for safety by September, 2002. The worm had turned and fear supplanted greed. Investors were bombarded with disclosures of fraudulent accounting practices by major corporations, a wave of bankruptcies that were among some of the largest in US history, and several high-profile insider-trading violations. Geopolitical tensions also ran high, moving from Al Qaeda and terrorism to Iraq and then more recently to North Korea. That's a large wall of worry to climb in a short time and many said, "Enough is enough."

Last year was indeed brutal. Yet we believe the market has already discounted many of these negative psychological events and is now focusing on the quantifiable economic positives that began emerging in 2002.

Q: **Okay, you are telling me I have not assessed the positive improvements because I am dwelling on the negatives**. **Just what are these positives that I am missing?**

A: We have already mentioned the economy, profits, and the improvement in spending. There were also cushioning effects from the Federal Reserve's work in 2002: Housing performed near record levels with low interest rates and perpetual refinancing. In turn, consumers continued to buy.

Now we deduce that we are in a **normal economic and stock market recovery.** However, since it has been so long since we have lived with "normal" ups and downs in the market, no one recognizes that this may be the best characterization of the current environment. The world has to let go of the "Goldie Locks" standards of the 90's and the go-go returns that accompanied them. In their place will be returns more reflective of underlying realities.

Going forward, if the economy grows 3.5-4% this year, inflation and interest rates stay low, corporate operating profits and cash flow continue to increase, then over time these realities will swamp the negative perceptions dogging the market and prices will rise.

Q: **The above may be your opinion but it is not what I read in the papers and watch on television every day. I read and hear that consumer's are running out of steam and increasing their overall debt through refinancing their homes, and that corporate America is laying off people and not spending on business equipment and facilities**.

A: What you read and hear today is mostly about the past. Since the market is a discounting mechanism, you need to envision what you think the headlines might be saying six to nine months from now. For example, with business inventories and net investment as a % of GDP at 40-year lows, we should begin to read about how companies are moving to replenish their capital stock. Lay-offs today will necessitate hiring tomorrow once demand picks up.

And Washington is highly motivated to deliver the favorable headlines of tomorrow. The current administration does not want to risk re-election due to ongoing weakness in the job sector or a poor stock market. Fiscal activism has moved to the front burner once again. It is too soon to say in which form it will pass but some kind of tax cut is nearly certain. For his part, Federal Reserve Chairman Greenspan is making sure there is plenty of money around and that it is cheap.

For the first time in a long time, the government is on the side of the investor who is being paid to take on riskier assets for potentially higher returns. It seems unlikely that these stimulative policies will change anytime soon. In a sense, the government is making "safe" investments like fixed income that yield 1%- 4% unattractive relative to the potential returns from stocks and other "risky" assets.

Q: **OK. Maybe I can buy it that the government is pulling out all the stops to reflate the economy. But what does that mean for returns and how long should I expect a rally to last?**

A: Forecasting returns is never easy and anything but exact. Still we can set some parameters for the next year. Last quarter we wrote a detailed analysis of how markets had performed historically after the four-year cycle bottomed. Since 1960, on average the S&P500 was 23.5% higher six months after the bottom and 32.8% higher twelve months later.

That would equate to an S&P500 of 950 and 1021. From current levels (S&P500 902) that is not a staggering gain, but including dividends a return of 7-15% is far more attractive than the 0.8% available in cash. And after the negative returns of the last three years, it would be a turn in the right direction. However, we cannot predict what the market will actually do and there is always the possibility that the market might decline.

Q: **Even if what you say is true, look what happened to the market when war with Iraq became a perceived reality. What happens when the fighting begins?**

A: We do not know. We do know that many investors who have that fear have abandoned the market. Unless there is an unexpectedly bad turn of events, the effects on the stock market should be temporary. If there is unexpectedly good news, the market could rally as it did in 1991.

What we do know is that the market will continue to react to war rumors and news. You should expect increased rockiness over the next couple of months until more of the uncertainties present today are resolved.

There are no guarantees and we cannot predict market performance, but the stock market has generally been higher over the next 12 and 18 months following the outbreak of hostilities:

	M+12	M+18
Pearl Harbor	-.8	+22.8
Korean War	+10.5	+18.7
Vietnam War	+6.1	+18.4
Persian Gulf War	+4.9	+12.5

Source: Markethistory.com

Q: **You have done a good job describing the background, but where should I be investing?**

A: We are constructive on our outlook for the economy and stock market this year. However we do recognize that war jitters over the near-term should be accommodated in our asset allocation.

Thus we think you should be at your benchmark weight in cash so that you feel comfortable in riding through the rocky Iraqi situation. It is important for you that you are in an investment position that will allow you to get through this period without being forced into panic selling. At the same time you should maintain positions that can take advantage of the upturn when things settle down.

We are under-weighting bonds and real estate investment trusts. Corporate bonds are preferable to treasuries. With yield spreads trading at wide levels and credit quality likely to improve, many of the same factors that favor equities will support corporate over treasury and municipal bonds.

We are over-weighting U.S. and International Equities and the Resource area. Energy stocks remain attractive and have yet to perform during the recent rise in oil and gas prices. At the same time, U.S. oil inventories have reached their lowest level since 1975. As the global expansion improves, pressure on oil prices will increase. In the U.S., we like high technology, telecommunications, and biotech. We are less enthusiastic about the consumer and finance sectors.

Internationally, we are emphasizing the Far East and Emerging Markets. Valuations for emerging markets are at historic lows, with forward P/Es at less than 10, while growth prospects, particularly in China, far exceed the U.S.

Of course, these are our general investment recommendations and are not intended to be individual investment recommendations. Each investor must take into account his or her own individual investment objectives and risk tolerance levels, among other factors.

Q: **If this is going to be a bull market year it sure feels different to me!**

A: And it will probably continue to feel unfamiliar. The straight-line up markets of the 90's are gone. Investors will continue to see more volatility than they are used to and we believe the markets will be in a broad trading range over many years. Think of it as a bull market similar to the late 60's and 70's. While we believe there will be opportunities, permanent buy and hold investments will be rare.

Q: **Taking everything you've said into account, what can I do this year to help me keep my investment perspective?**

A: These are uncertain times and it is natural to feel disconcerted. History has shown that during periods of high volatility it is important to resist the urge to make impulsive decisions. The market will not be accommodative so that you get back what you have lost all at once. After three horrible years, we believe gains will come grudgingly.

Studies have also shown that during turbulent times broad diversification is your safety net. There will likely be few home run investments in 2003 so avoiding concentrated positions will help you maintain your perspective.

Significant market bottoms have always been characterized by the media concentrating on the negatives and dismissing the positives. In our view, your investment perspective will be aided to the extent you can stay above the fray and focus on the potential news six to nine months from the present.

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