

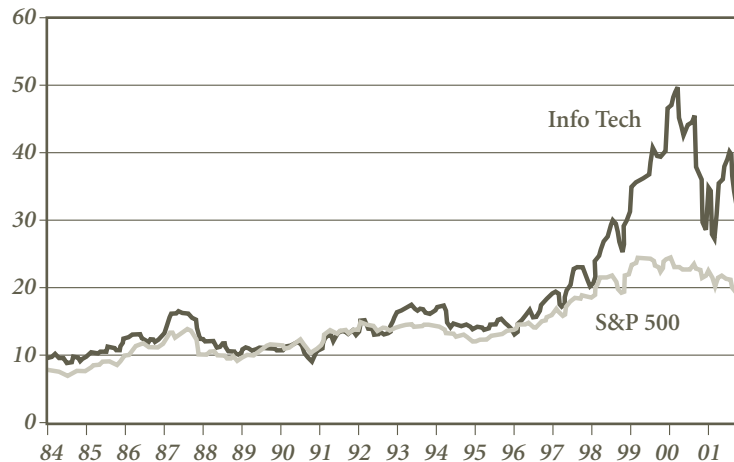
# FOCUS

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## *Treacherous tech?*

The rally in technology stocks since their September lows has many convinced that the long bear market in technology stocks is over. We're not convinced. Consider the chart below, reprinted from the TrendMacro website:

**FORWARD P/E MULTIPLES: S&P 500 AND S&P INFORMATION TECHNOLOGY SECTOR, *Monthly through 11/2001***



Courtesy: Donald Luskin, TrendMacro.com

What this chart shows is that the price/earnings ratio of the information technology sector is actually higher now than it was at the market peak in 2000 despite using next year's projected higher earnings, not this year's depressed ones. This sector includes Internet software and services, software, communications equipment, computers and peripherals, electronic equipment, semiconductors, and IT consulting services. In other words, technology writ large.

There are three ways for this divergence to be resolved: earnings will have to beat the analysts' already optimistic forecasts by huge margins, or the prices for these stocks will have to come back to earth, or they will have to stay relatively flat for a number of years to allow earnings to catch up. The

messages conveyed by corporate managements of late suggest that while things are looking “better,” we should not expect a return to 50%+ earnings growth, thus rendering the first outcome unlikely. Therefore, we believe that we are likely to see either a resumption of the bear market in technology stocks or a “long dry spell” during which these issues bounce up and down in a trading range, making no real progress and disappointing a lot of investors.

We don’t make predictions, so we have no opinion as to which of these scenarios is more likely. We will, however, continue to underweight this sector until we see some evidence that valuations are grounded in reality.

*[As an aside, we have found the articles on the TrendMacro website to be very informative and very provocative (www.trendmacro.com). Some require a subscription, but there are many available to the public as well. Highly recommended.]*

### ***Safety in bonds?***

In the same article at TrendMacro.com, Donald Luskin presents another chart that compares the earnings yield of the S&P 500 (the earnings-to-price ratio, expressed as a percent) compared to that of the long-term Treasury bond. His observation: by this measure, the S&P is not as badly overvalued as it was in March, 2000, but is about where it was briefly in 1987 just before the crash. With long-term Treasury bonds yielding 5.5% and equity valuations still through the stratosphere, Luskin argues that stocks will have a hard time competing with bonds until the valuation excesses are eliminated.

Does that mean you should rush out and sell your stocks in favor of long-term bonds? We don’t think so. First, the Treasury has stopped issuing the 30-year bond, so those still trading are in high demand (and thus probably overvalued). But there is more to the story, namely the risk component in long-term bonds.

Remember that over the last 20 years or so, long-term bond yields have dropped from the mid-teens to nearly 5%.

With short term rates hovering around 2%, the steep, positive slope of the yield curve, a reliable leading indicator in the past, suggests that an economic recovery is imminent. Generally, renewed economic activity brings higher rates. The following table shows what would happen to the price of a bond purchased today for \$1,000 as interest rates rise:

RATES INCREASE FROM 5.2% TO:	3-YR. NOTE	5-YR. NOTE	10-YR. BOND	30-YR. BOND
6%	984	972	940	890
7%	966	938	873	778
8%	948	906	811	687

As you can see, the longer the maturity of the bond, the more significant the drop in price as rates rise. Remember that rates were above 6% only 18 months ago; an increase to that level would drop the price the 30-year bond by 11%, albeit mitigated by the 5.2% coupon.

What if we are wrong and we are heading into a deflationary period, as some believe? If rates drop to 5%, the 30-year bond would increase in price to \$1,030. A drop to 4% would raise the price to \$1,209. At 3%, the price would be \$1,427, and at 2% it would be a whopping \$1,709, a 71% gain! Exciting returns, but with a commensurate level of risk should rates go the other way.

Therefore, while long-term bonds may look very attractive relative to equities in the short-term, they are not without risk. Caveat emptor!

**Other equity musings**

Concern about the state of the equity markets beyond the technology sector is spreading. Professional investors from the famous–Warren Buffet–to the not-so-famous–Larry Swedroe of Buckingham Asset Management–have been arguing of late that the returns we have enjoyed over the last two decades are unsustainable. Even if the economy recovers and resumes its 3-4% annual growth, which appears to be likely, they project

that returns to equity holders will be below, and perhaps well below, 10%, for perhaps as long as a decade.

Others with similar concerns include Richard Bernstein, Chief U.S. Strategist for Merrill Lynch, and Randy Lert, Chief Investment Officer of the Frank Russell Company. Bernstein echoes the P/E concern voiced above but goes on to add two more. First, the variability in the S&P 500's earnings is the highest since 1947, suggesting that investors are placing a very high valuation on a very uncertain earnings stream. Second, they are further mispricing risky assets, as evidenced by the fact that high-volatility stocks are currently very expensive relative to low-volatility stocks, just the opposite of what investment theory would dictate.

Lert makes two key points. First, looking at the last bubble, the famous Nifty Fifty craze of the late 1960s and early 1970s, many of the darlings of the time that crashed in the '73-'74 bear market—General Electric, Kodak, Xerox, Coca Cola, etc.—didn't regain their former highs for ten to fifteen years. Some never have. Thus, investors thinking that the recent technology darlings—Cisco, Intel, Yahoo, JDS Uniphase, etc.—will recover soon may be in for a huge disappointment. Second, he points out that for the NASDAQ to recover from its September lows of around 1,400 to its former high of just over 5,000 over a period of two years would require an annual growth rate of 89%. Five years would require 29%. At ten years, the required return is 13.6%. When you consider that since December 1987, a period of robust economic growth, declining interest rates and rising P/E ratios, its annualized total return actually was 13.6%, you may begin to see that even ten years may be optimistic.

Does this mean that there will be no opportunities for good returns in the U.S. equity markets? On the contrary, since many small- and mid-cap companies as well as many large non-technology companies never reached significant levels of overvaluation, we see plenty of opportunities. However, both

industry groups and individual securities must be selected with care, and success will depend heavily on proper industry weighting and corporate valuation.

### ***Fumbling Fed?***

A review of Alan Greenspan's press clippings over the last decade would have you believe that, except perhaps for sabotaging Bush Sr.'s reelection and overestimating the potential damage from Y2K by pumping too much money into the system in 1999, he has guided the domestic economy with great prescience and skill. A contrary view appeared in the December issue of Financial Planning magazine. David L. Smith, futurist, economist (Stanford-trained), and publisher of *Cyclical Investing Reports*, suggests that rather than benefiting the economy, Greenspan's efforts to stave off recessions have allowed debt excesses and other economic imbalances to accumulate. The money he pumped into the system as part of this process ultimately ended up in the stock market, which is what caused the bubble.

What the Fed needs to do, says Smith, is let the recession run its course. This will reduce the debt burden, allow weak companies to go bankrupt, allow companies to close factories and work off excess inventory, and eventually set the stage for the next wave of economic growth. Otherwise, we may be faced with an even longer, deeper and more damaging recession at the end of the next economic expansion.

So much for Goldilocks.

### ***REITs Come of Age***

REITs (Real Estate Investment Trusts) came into their own on October 9, 2001. For the first time, Standard and Poor's (S&P) added REITs to its indices. Equity Office Properties (a WAM holding) now has an official place in the S&P 500 Index. The S&P 400 Mid-cap Index added Hospitality Properties and New Plan Excel Realty Trust. Colonial Properties Trust, Kilroy Realty and Shurgard Storage moved into the S&P Small-cap 600 Index. S&P selected these companies because of their

liquidity, financial viability, market capitalization, ownership and industry and sector representation, the same criteria that are used for all companies considered for the indices.

The goal of S&P's indices is to reflect the performance of the U.S. equity markets and, through the equity markets, the U.S. economy. The inclusion of REITs furthers this goal. Because they were viewed as passive investment companies rather than as operating companies, REIT's were not eligible for the S&P indices under its guidelines for inclusion. In its recent review, S&P found that the majority of REITs now are operating companies that purchase, manage, invest in, maintain and market real estate.

We have invested in REITs for almost thirty years, and will continue to do so, because they provide diversification, relatively stable returns and a moderate to high level of current income. S&P's decision to include them in its indices is a long overdue recognition of the viability and attractiveness of these investment vehicles.

***Your mind on  
economics***

Sales and income figures show an easing up of the rate at which business is easing off. This can be taken as ample proof of the government's contention that there is a slowing-up of the slow-down. Now to clarify that, it should be noted that a slow-up of the slow-down is not as good as an up-turn in the down-turn. On the other hand, it's a good deal better than either a speed-up of the slow-down or a deepening of the down-turn. Also, it suggests that the climate is about right for an adjustment of the readjustment of the adjustment to rate structures.

Now turning specifically to rates, we find a very definite decrease in the rate of increase. This clearly shows there should be a letting up of the let-down. Of course, if the slow-down should speed-up, the decrease in the rate of increase of rates would turn into an increase in the rate of decrease. And finally, the inflation of the recession would turn the recession into a

depression, while a depletion in the rate of inflation would give the impression of a recession of the depression.  
Any questions?

*[Sent to us by our good friend, Milt Cummings,  
who gleaned it from the Internet (of course)]*

***The new  
investment  
lexicon***

*Momentum investing:* The fine art of buying high & selling low.

*Value investing:* The art of buying low & selling lower.

*Broker:* Poorer than you were in 1999.

*P/E ratio:* The percentage of investors wetting their pants as the market keeps crashing.

*Stock analyst:* Idiot who just downgraded your stock.

*Institutional investor:* Past-year investor who's now locked up in a nut house.

*Bull market:* A random market movement causing an investor to mistake himself for a financial genius.

*Bear market:* A 6- to 18-month period when the kids get no allowance, the wife gets no jewelry and the husband gets no sex.

*Market correction:* The day after you buy stocks.

*Cash flow:* The movement your money makes as it disappears down the toilet.

*Call option:* Something people used to do with a telephone in ancient times before e-mail.

*Yahoo:* What you yell after selling it to some poor sucker for \$540.00 per share.

*[Sent to us by our long-time friend and supporter,  
Jack Lingafelter (who also found it on the Internet)]*

***Inside Woodside***

First, we are saddened to report that Ted Heilman, CFA, who has served as our Director of Research for two years, has left the firm. We greatly appreciate Ted's contributions to our investment process, and we wish him the best of luck. Morgan

and Leslie will assume Ted's research responsibilities and will operate as a team much as Morgan and Chip did so successfully for many years.

Second, Bob Beim has been named Chairman of the Investment Committee of the U.C. Berkeley Foundation.


Third, in recognition of her rapid assimilation into the firm and her significant contributions to both client relations and research, we are pleased to announce that Leslie Beck, CFA, CFP has been promoted to Vice President.

Finally, for your planning purposes, our offices will be closed on Monday, February 18 in observance of Presidents' Day.

*And last, but not least,...*

...A happy, healthy and prosperous 2002 to all!

#### **WOODSIDE ASSET MANAGEMENT, INC.**

Woodside Asset Management, Inc. is an investment management and personal financial counseling firm. Our investment philosophy is based on a time-tested strategy of diversification across six principal asset classes: cash, bonds, domestic and foreign stocks, natural resources, and real estate. The firm is registered with the Securities and Exchange Commission. All services are provided on a fee-only basis. Questions, comments and inquiries, whether about *FOCUS* or about the firm, are invited. Also, please visit our web site at **[www.woodsideasset.com](http://www.woodsideasset.com)** for further information. 

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