

FOCUS

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***Crisis and
opportunity***

The tragic and shocking events of September 11th do not need belaboring. We are a strong nation that comes together in times of crisis. We have weathered other storms, and we will weather this one and emerge stronger for the experience, however painful and horrific. For those who have lost colleagues, friends or loved ones, we offer our heartfelt condolences.

At the time of this writing (the 14th), the equity markets are not open and will not be until the 17th. By the time you read this, whatever reaction will have taken place will be history. Because we have heard concerns expressed from friends and relatives (and a few clients) about possible longer-term negative ramifications of this crisis, we hereby provide you with some historical perspective.

Realty Stock Review just published a table showing the change in the Dow Jones Industrial Average for various periods after 28 different “crises” that occurred between 1940 and 1998. These included Pearl Harbor, the Cuban missile crisis, the JFK assassination, the Arab oil embargo, the 1987 financial panic, the Gulf War ultimatum, the World Trade Center bombing and the Russian “Long Term Capital Management” crisis. On average, the Dow dropped 7.1% immediately following these events, with the largest decline (by a factor of 2) occurring in 1987—a drop of 34%. (Keep in mind that this was a financial panic and not precipitated by external world events). The next largest was 18% at the time of the oil embargo in 1973.

What is interesting is that within 22 days of the event, on average the Dow had gained back over half of its original loss (3.8%), the largest gain being 17% at the time of the Gulf

War. After 122 days, the average loss was entirely recouped and then some, the average gain being almost 13%. In only a few instances—Pearl Harbor, the invasion of Grenada, and the bombing of Lybia—was the Dow still in negative territory four months after the event.

In other words, events such as occurred on September 11 should generally not be viewed in and of themselves as cause for serious concern about the financial markets. That being said, the current weakening economy could be dealt a blow by the disruptions to the transportation system and the delay in reopening the equity markets. We can only watch and wait. This is a time for grieving, healing, and rebuilding. Using history as a guide, we do not believe that this is a time for panic selling.

***Hedge fund
mania***

The term “hedge fund” sounds alluring to investors. The recent dismal performance in domestic and foreign equities has many investors and advisors looking at hedge funds as a source of better returns. After two years of losses, hedge funds outperformed the indices by wide margins in 2000. Also, hedge funds have little or no correlation with any of the traditional asset classes, and that characteristic paid off last year for investors who held them as part of a diversified portfolio.


Hedge funds come in many flavors: managed futures, convertible arbitrage, dedicated short sellers, event driven, fixed-income arbitrage, distressed debt, and the most popular, long-short strategies including margin leverage. Another type is the “fund of funds,” which offers diversification across several funds.

A hedge fund is usually structured as a limited partnership with up to 99 investors, the majority of whom have to be “accredited” (annual income of \$200,000 or more, or a net worth of more than \$1 million). Hedge fund managers typically charge 20-30% of the profits and a 2% annual

management fee. The sponsor of a fund-of-funds will charge an additional 1-2% management fee and sometimes an additional percentage of the profits. On top of all these expenses, most gains are short-term and thus taxed at ordinary income rates. Because of these costs, returns need to be extraordinary in order for the investor to realize returns in excess of what can be achieved with more traditional vehicles. In the August 6 “Hedge Fund Folly” issue, *Forbes* defined a hedge fund as “any investment company that is unregulated, has limited redemption privileges and charges outrageous fees.”

Obviously there are costs and risks, but hedge funds can provide significant contributions as an asset class. Ibbotson’s research using data from 1987 through 1997 shows positive returns from hedge funds, though not outperforming the S&P 500. However, the volatility was lower, and the returns had little correlation with other asset classes.

After seeing the technology bubble burst last year, it is alarming to watch perhaps another brewing. Institutional investors seem to be flocking to funds as a panacea to repair the damage of the last eighteen months. Our concern with hedge funds is that they are funneling enormous sums of money through relatively small spigots into markets where there may be limited liquidity. The encouraging news about this flood of institutional money is that these professional investors can only bring further scrutiny and accountability to the hedge fund industry.

We believe that hedge funds may be appropriate for a select group of clients, and we will continue to look for appropriate vehicles. For now, however, prudence dictates patience—we do not want to be trapped in a stampede. 

***The Congress
giveth, the
Congress taketh
away***

Given the complexity of the federal tax code, we were not surprised to learn recently of an unwelcome consequence of the Economic Growth and Tax Relief Reconciliation Act of 2001. An article entitled “Tax Relief: The New Act and What It Means for Individuals,” which appears in the August issue of *AII Journal*, explains it this way:

Without question, over the next 10 years more taxpayers will fall within the reach of the AMT [Alternative Minimum Tax]—unless Congress takes additional efforts to reform the AMT system. The drop in rates is expected to exacerbate the unintended reach of the AMT into the middle class. This is true because the AMT rates are *not* reduced from their level of 26% and 28%, while regular tax rates *are* reduced. However, the AMT exemption level is raised for years 2001 through 2004; it then drops back to current levels.

As more taxpayers find a substantial portion of their income taxed at 10%, 15%, and 25%, the risk increases that the 26% AMT rate will force them to pay additional tax.

Inquiring minds


Have any of you wondered how modern conventions and standards came to be, or why it is so difficult to change established habits? Well, the following “ride through history” just may shed some light on the topic.

The U.S. standard railroad gauge (the width between the two rails) is four feet, eight and one half inches. That is an exceedingly odd number. Why is this gauge used? Because that’s the way they were built in England, and most U.S. railroads were built by English expatriates. Why did the English build them according to this odd standard? Because the first rail lines were built by the same people who built the pre-railroad tramways, and that was the gauge they used. Why did “they” use that gauge? Because the people who built

the tramways used the same jigs and tools that they used for building wagons which used that same wheel gauge.

Of course, one is forced to ask, “Why did the wagons have that particularly odd wheel spacing?” Well, if they tried to use any other spacing, the wagon wheels would break on some of the old, long distance roads in England, because that’s the spacing of the wheel ruts. So, who built those old rutted roads? The first long distance roads in Europe (and England) were built by Imperial Rome for their legions, and have been used ever since. Roman war chariots first formed the initial ruts, which everyone else had to match for fear of destroying their wagon wheels. Since the chariots were made for or by Imperial Rome, they were all alike in the matter of wheel gauge.

The U.S. standard railroad gauge is derived from the original specification for an Imperial Roman war chariot. Ultimately, the reason Imperial Roman war chariots were designed with a gauge of four feet, eight and one half inches was that they were made just wide enough to accommodate the back ends of two war horses. So, the next time you are presented with a specification or standard that seems absurd, and you find yourself wondering which horse’s behind came up with this one, you may be exactly right!

There is a modern twist to the story. The space shuttle has two large booster rockets attached to the main fuel tank. The booster rockets are made by a firm called Thiokol at it’s factory in Utah. The engineers who designed them preferred to make them wider, but the rockets had to be shipped by train from the factory to the launch site. The railroad line from the factory had to run through a tunnel in the mountains. The rockets had to fit through that tunnel, which is about as wide as two horses’ behinds. So, the major design feature of what is arguably the world’s most advanced transportation system was determined over two thousand years ago to conform to the width of two horses’ behinds. 

**Who reads
what?**

You may have wondered about the hierarchy of newspapers in the US. Well, we have it on good authority that...

- The Wall Street Journal is read by the people who run the country.
- The New York Times is read by people who think they run the country.
- The Washington Post is read by people who think they ought to run the country.
- USA Today is read by people who think they ought to run the country but don't understand the Washington Post.
- The Los Angeles Times is read by people who wouldn't mind running the country if they could spare the time.
- The Boston Globe is read by people whose parents used to run the country.
- The New York Daily News is read by people who aren't too sure who's running the country.
- The New York Post is read by people who don't care who's running the country as long as they do something scandalous.
- The San Francisco Chronicle is read by people who aren't sure there is a country or that anyone is running it.
- The Miami Herald is read by people who are running another country.

**On an even
lighter note...**

Today's Market Report (courtesy of our long-time friend, Jack Lingafelter):

Helium was up.

Feathers were down.

Paper was stationary.

Fluorescent tubing was dimmed in light trading.


*Knives were up sharply.
Cows steered into a bull market.
Pencils lost a few points.
Hiking equipment was trailing.
Elevators rose, while escalators continued their slow decline.
Weights were up in heavy trading.
Light switches were off.
Mining equipment hit rock bottom.
Diapers remain unchanged.
Shipping lines stayed at an even keel.
The market for raisins dried up.
Coca Cola fizzled.
Caterpillar stock inched up a bit.
Sun peaked at midday.
Balloon prices were inflated.
And, lastly, Scott Tissue touched a new bottom.*

Inside Woodside


Hearty congratulations and best wishes are in order for our Director of Investments, Ted Heilman, who will be tying the knot with his childhood sweetheart Amy Dover in Sonoma on September 22nd. Yes, “childhood” is correct—they’ve known each other since second grade! They plan to honeymoon on Maui.

Congratulations as well to Tom Sedgwick, our trader, who passed the CFA Level I exam.

For your planning purposes, our offices will be closed as follows between now and year-end:

- October 31, Closed at 1:00 PM
- November 22-23
- December 24, Closed at 1:00 PM
- December 25-26 

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