WOODSIDE ASSET MANAGEMENT

Focus

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The blame game

It is very fashionable these days to talk about who, or what, is to blame for the technology stock bubble that has burst. Was it the venture capitalists, who funded dubious business models hoping for accelerated liquidation via the IPO route? Was it the investment banks, who were more than willing accomplices to the venture capitalists and stood to make a killing in underwriting fees from those IPOs? Was it the mutual fund complex, willing receptors and "flippers" who bought these IPOs, and perhaps worse, kept buying the same companies with the river of new cash pouring in from 401(k) plans instead of doing proper due diligence? Was it the day traders, who were pure momentum players, to whom the term "business plan" was just jargon that had no place in this brave new world of investing? Or, finally, was it Federal Reserve Chairman Alan Greenspan who created this mess, having decided that since he was the one who brought all the toys to the party (in the form of excess liquidity), he could take them home anytime he thought appropriate?

We believe that the events of the last twelve months or so can be explained as follows. It starts with the telecommunications industry. This includes the large long-distance carriers, the Baby Bells, the CLECS (competitive local exchange carriers, a fancy name for other local telephone companies), the ISPs, and the too-numerous-to-mention equipment and software providers.

The telecom sector can be simplistically separated into vendors (equipment and software providers) and customers (large long-distance carriers, Baby Bells, CLECS, and ISPs). Secular trends for the customer segment were grim. Exploding competition, declining prices and margins, and relentless pressure to upgrade their technology or be left behind, were the prevailing conditions. The customers had one thing going for them (temporarily, as it turned out): liquidity. They had seemingly endless access to cheap capital, allowing them to throw money at literally any business plan and upstart that might give them a tactical advantage in a highly competitive market. In addition, they were voracious customers of the established equipment firms (Cisco, Sun, Nortel, JDS Uniphase).

The vendors, of course, not only supplied all their customers, they also helped finance their purchases. In the case of customers such as the CLECs, this would prove to be disastrous. Internet and networking start-ups came public with business plans that assumed their customers would continue to spend and have access to cheap capital. The stage was now set.

The Federal Reserve began an aggressive tightening. Not only did it raise interest rates, but it also actually drained liquidity from the system. Access to cheap capital was now cut off. At about the same time, the first wave of Internet firms and networking start-ups began to miss business plan milestones. Now, instead of tying capital spending budgets to what competitors were doing, the customers were forced to reduce these budgets because anticipated revenues didn't materialize. Combine that with a few exogenous events such as saturation of the PC market and already record-high levels of consumer debt, and the unwinding process was unavoidable.

How does an investor survive such a process? By remaining diversified not only across various asset classes (stocks, bonds, real estate, etc.), but also within each class. Technology still has an important role to play in investment portfolios, as it will doubtless be an engine of growth in the future, but it should not be the sole focus of any portfolio. The bubble was created by an extreme overvaluation of an entire economic sector. To eliminate technology from one's portfolio now that the overvaluation has been corrected, or even worse, to liquidate an entire portfolio now in hopes of "getting back in at a more appropriate time," would be making the equally serious mistake of grossly undervaluing the future prospects of the market in general and the technology sector in particular. Our best advice, as always: stay invested, but stay well-diversified. *[See also the next article on the perils of market timing.]*

Timing is everything. NOT!

We and many others have long argued that market timing is a dangerous game. Some years ago, we noted in these pages that if an investor missed only the best 40 days out of some 1,200+ days during the bull market between 1982 and 1987, his or her portfolio would have underperformed Treasury bills.

In 1994, Towneley Capital Management, Inc. commissioned Dr. H. Nejat Seyhun, Professor of Finance and Chairman of the Finance Department at the University of Michigan, to perform a comprehensive study of the effect of daily and monthly market swings on a portfolio's performance. To measure the effect of those swings, Dr. Seyhun looked at two periods—1926-1993 and 1963-1993.

The results were startling. We know that the market is volatile. There are days and even months when the market soars or plunges. However, what was surprising was that only a tiny portion of those brief swings accounts for practically all of the market's gains or losses over decades. For example, 95% of the market gains between 1963 and 1993 stemmed from only the best 1.2% of the trading days!

The study also showed that for market timers, the windows of opportunities are very narrow. Between 1926 and 1993, more than 99% of the total dollar returns were "earned" during only 5.9% of the months. Identifying the 48 months out of the total of 816 months during which to be invested is clearly a daunting proposition.

The implications of this study could well be critical for the average investor. By being "out of the market" for as few as even one or two of the best performing months or days over several decades, a portfolio's return may be significantly diminished. For those tempted to run to cash during the current bear market, we say forewarned is forearmed. *(Courtesy* Towneley Capital Management, Inc.)

Diamonds, Spiders and Cubes

Jewels? Bugs? Art? No, these are the nicknames for an investment tool called exchange traded funds, or ETFs. An ETF is similar to an index or sector mutual fund except that it trades on an exchange and throughout the market day rather than just at the closing price at the end of the day and at a fixed price. "Diamonds" mimic the behavior of the Dow Jones Industrial Average of 30 stocks. "Spiders" track the S&P 500, and "Cubes" (so called because of their ticker symbol: QQQ) track the NASDAQ composite. These are just a few of the ETFs available. The American Stock Exchange sponsors the Spiders (Standard & Poors Depository Shares, or SPDRs) and the Diamonds. NASDAQ sponsors the Cubes.

Another type of ETF is the iShare, issued by Barclays Global Advisors. Originally created to track 16 foreign markets and called WEBS (World Equity Benchmark Shares), there are now 44 iShares in the United States and 50 in Canada, tracking not only foreign markets but also various sectors and indices. In addition to creating the original SPDR, the AMEX also offers a mid-cap SPDR for the S&P 400. State Street Global Advisors offers nine ETF sector funds that track selected industry sectors of the S&P 500 Index. Merrill Lynch offers its Holding Company Depository Receipts (HOLDERS) that track a special portfolio of 18-20 stocks within a specific segment of a particular industry. Vanguard plans to come out with VIPERS (Vanguard Participation Equity Receipts), and Nuveen is exploring new offerings as well.

Why all the excitement? For traders (and we are not), ETFs offer a vehicle to play the market intra-day. For long-term investors, ETFs offer the ability to control taxes: since they are in fact shares traded on the exchange, they do not have the problem of capital gain distributions associated with most actively-managed, open-end funds. But more importantly, for advisers like us, they afford us an easy way to put cash to work quickly in a diversified portfolio.

For example, we recently sold several issues to “harvest” tax losses. Rather than risk being out of the market, and having no immediate replacements available, we can buy SPDRs, for example, as a “placeholder” until we identify individual companies we want to own or until those we have identified reach a point at which we want to purchase them. Then, as these companies are added to the portfolio, we can peel off positions in the SPDRs. In this manner, we avoid trying to time entry points, and we increase the chances that we will be invested when the market recovery starts (which it will—someday!).

A tax-cut parable

[The next time you hear someone complain about how the Bush tax cut proposals favor the rich, tell them this story.–Ed.]

Every night, 10 men met at a restaurant for dinner. At the end of the meal, the bill would arrive. They owed $100 for the food that they shared. Every night they lined up in the same order at the cash register. The first four men paid nothing at all. The fifth, grumbling about the unfairness of the situation, paid $1. The sixth man, feeling very generous, paid $3. The next three men paid $7, $12 and $18, respectively. The last man was required to pay the remaining balance, $59. He realized that he was forced to pay for not only his own meal but the unpaid balance left by the first five men.

The 10 men were quite settled into their routine when the restaurant threw them into chaos by announcing that it was cutting its prices. Now dinner for the 10 men would only cost $80. This clearly would not affect the first four men. They still ate for free. The fifth and sixth men both claimed their piece of the $20 right away. The fifth decided to forego his $1 contribution. The sixth pitched in $2. The seventh man deducted $2 from his usual payment and paid $5. The eighth man paid $9. The ninth man paid $12, leaving the last man with a bill of $52.

Outside of the restaurant, the men began to compare their savings, and angry outbursts began to erupt. The sixth man yelled, "I only got $1 out of the $20, and he got $7, "pointing at the last man. The fifth man joined in. "Yeah! I only got $1 too. It is unfair that he got seven times more than me." The seventh man cried, "Why should he get $7 back when I only got $2?"

The nine men formed an outraged mob, surrounding the 10th man. The first four men followed the lead of the others: "We didn't get any of the $20. Where is our share?" The nine angry men carried the 10th man up to the top of a hill and lynched him. The next night, the nine remaining men met at the restaurant for dinner. But when the bill came, there was no one to pay it.

Chicago Tribune, 3/4/2001

Signs of the times

On a plumber's truck: *"We repair what your husband fixed."*

On another plumber's truck: *"A flush beats a full house."*

On the trucks of a local plumbing company: *"Don't sleep with a drip. Call your plumber."*

At a towing company: *"We don't charge an arm and a leg. We want tows."*

On an electrician's truck: *"Let us remove your shorts."*

On a taxidermist's window: *"We really know our stuff."*

In a podiatrist's office: *"Time wounds all heels."*

At a car dealership: *"The best way to get back on your feet–miss a car payment."*

In a veterinarian's office: *"Be back in 5 minutes. Sit! Stay!"*

In a restaurant window: *"Don't stand there and be hungry. Come on in and get fed up."*

In the front yard of a funeral home: *"Drive carefully. We'll wait."*

Inside Woodside

First, we are pleased to welcome Kathie Albert to the company. Kathie joins us as a Client Relationship Manager, supporting both Leslie and Morgan. Prior to joining Woodside, she worked for Weathergauge Advisory, an investment firm located in Lafayette, CA, where she provided client service to individual investors, executed securities trades, and handled all aspects of account administration. Kathie's addition brings our staffing level back to the levels of a year ago (remember–both Zoilita and Shannon left us last year).

Also, please be advised that during the second quarter our offices will be closed as follows:

- Friday, April 13, Closed at 1:00 PM for Good Friday
- Friday, May 25, Closed at 1:00 PM for Memorial Day weekend
- Monday, May 28, Memorial Day

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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.

FOCUS is written and edited by Leslie H. Beck, CFA, CFP; Robert B. Beim; Ted A Heilman, CFA; and Morgan W. White. Questions, comments and inquiries, whether about *FOCUS* or about the firm, are invited. Also, please visit our web site at www.woodsideasset.com for further information.

WOODSIDE ASSET MANAGEMENT, INC.
3000 Sand Hill Road 2/160
Menlo Park, California 94025 (650) 854-5100

www.woodsideasset.com