WOODSIDE ASSET MANAGEMENT

Focus

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Polarized politics

What did we learn from the election of 2000? For our part, we were shocked at the level of division and polarization that seems to have become entrenched in our society. On the surface, we can point to the media's frenzied attempts to pair off spinmeisters and so-called experts in intellectual jousting matches for the sake of ratings, a trend which began with the Bork and Thomas hearings and continued with Whitewater, the O.J. trial, Monica, and into the elections.

Another factor was eloquently described in an op-ed piece in *The Wall Street Journal* in late November. The author pointed out that the core of the Democratic party is made up of government workers at all levels (Federal, state and local), workers in certain other industries tied to government spending, and welfare and some Social Security recipients whose livelihoods are tied directly to the continuation of the government's largesse. Many of these people live in fear that the Republicans will take control, cut spending, and thus jeopardize their income streams. For balance, we would add that Republicans, on the other hand, are largely middle and upper income voters who feel taxed to death and want to see spending and taxes lowered. They fear that a Democratic President and Congress would allow spending to balloon out of control, to be followed by tax increases (or at least no reduction or reform).

In other words, the bottom line is all about money, no matter what your political leanings. As the saying goes, if you rob Peter to pay Paul, you will get Paul's vote.

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Evolving benefits of international diversification

With stock market volatility at an all-time high, it is more essential than ever to maintain a well-diversified approach to portfolio management. Prudent diversification means the inclusion of several different asset categories, one of which should be international equities.

The benefits of including international equities have been well documented throughout the past thirty years. However, what many investors have not grasped is that the manner in which one diversifies internationally is in itself very important. In particular, diversifying across global industry sectors, as opposed to across countries and regions, has now become essential. Global industry sector influence on individual share prices has increased substantially over the last couple of years. In fact, as recently as 1998, country effects accounted for an average of 32% of the variation in stock prices, while sector affects accounted for only 12%. Today, the tables are turned, with sectors on average accounting for 18% and countries accounting for less than 15%.

What has caused the shift away from country-dominated to industry-dominated return factors? The primary reason has to do with the pace of globalization of the economies of the world's developed countries. Economic ties across national boundaries are becoming tighter. At the same time, factors that affect a particular industry in one country are spilling over to affect the same industry in other countries.

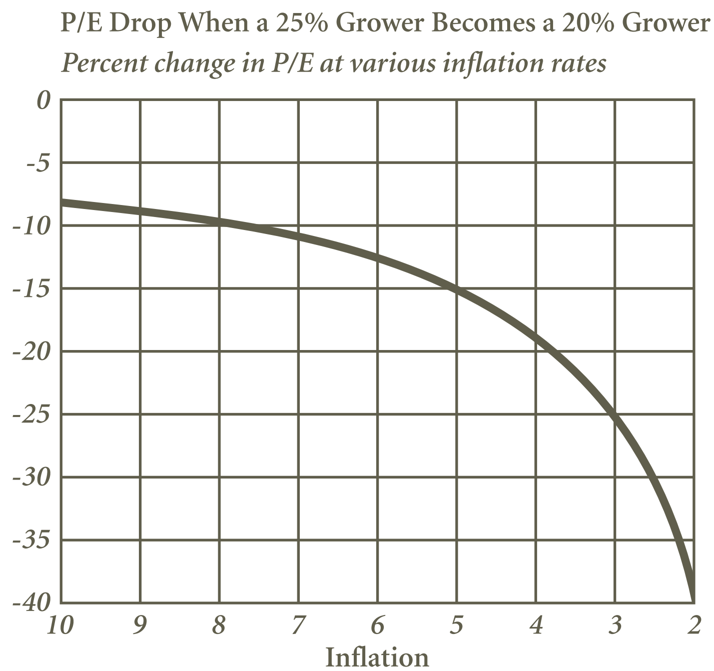
A specific case in point highlights this structural evolution. Economists and market participants alike have been surprised at the rapidity and synchronization of the slowdown now occurring in the developed world's economies. Increasingly, earnings disappointments are accompanied by a statement like, "...due to decreased foreign sales, we will not achieve our projections." For many U.S. and foreign firms, the pressing problem may not be the depth of the global downturn but rather its width, a reflection of the increasing ties across global markets.

So how does one capture and maintain the benefits of global diversification? By applying the same principles used here in the U.S. to determine which industries will benefit at a particular point in the business cycle. However, instead of restricting the analysis to U.S. economic sectors, one must also include major companies across the globe. For example, if the economy is slowing down, historically it has been profitable to invest in the consumer staples industry (Sara Lee, Kimberly Clark, Gillette, Safeway, etc.). Potential candidates should also include Nestle (Switzerland), and Ahold (Netherlands). The fact that the economies of Switzerland and the Netherlands are correlated with ours should make this a successful tactical move. Woodside Asset Management will be steadily evolving our investment process going forward to capture these benefits.

Performance problems

2000 witnessed a fall (and in some cases collapse) in the prices for many if not most "growth" companies. Why are the prices of growth companies so volatile? The main reason has to do with the market's discounting mechanism. Remember that growth companies are valued based on expectations about their future earnings (rather than on current earnings or asset values). Therefore, when those expectations are reduced, prices fall.

Consider the chart on the next page, which plots the drop in the price/earnings (P/E) ratio that occurs when the expected growth rate drops from 25% to 20% at different levels of inflation. Today, for example, inflation is running (according to the government) at around 3%. So, a company whose growth expectation drops from 25% to 20% can expect its shares to drop by about 25%. You can imagine how steep this curve is for companies whose expected growth drops from say 100% to 15%.



The implication of this analysis is that companies who disappoint the market will continue to see their shares pummeled. Therefore, we should not expect to see a reduction in market volatility any time soon, particularly in light of the apparent economic slowdown which can only impair companies' earnings further.
[Chart and concept courtesy PaineWebber]

Funding college expenses

We recently became aware of a tax-advantaged program for funding college and even post-graduate expenses for family members. The so-called 529 program is a significant improvement over the "Education IRA." It has much higher contribution limits, allows the donor to maintain some level of control, has no income limits on who can contribute, and not only gets the assets out of the donor's estate but also taxes the benefits at the student's tax rate when withdrawn. Each state can set up its own guidelines, and many have. Interestingly, you do not have to be a resident of the state to use that state's programs, and you can use the benefits in any state.

Even more interesting, you can roll over education IRAs as well as custodial accounts into these programs.

We think the 529 program can be a very useful tool. Heretofore, parents and grandparents seeking to set up college expense funding programs were limited to either paying the expenses as they occurred, setting up a custodial account, or establishing trusts. The pay-as-you-go alternative is very tax-inefficient because the expenses are paid with after-tax dollars. The custodial account carries with it certain risks: once the child turns 18, or in some cases 21, the money is his (or hers), and he (she) can take it and run with no assurances that it will be used for educational expenses. Therefore, these plans may be a good choice for those wishing to terminate a custodial account by rolling it into a 529 plan. Setting up a trust (usually a Crummey trust) is expensive and requires administrative effort (as well as a willing trustee). There are estate planning advantages in some cases to using Crummey trusts, but if the sole purpose is college funding, the 529 plan may be a better alternative.

We have located several web sites which offer guidance on how to evaluate and choose a plan. The most frequently-visited is www.savingforcollege.com, but there are numerous others. A simple search using Google (www.google.com—highly recommended as a search engine) turned up a huge number of links. Schwab has set up a program with American Century Funds, and TIAA has also set one up. We are still in the early phases of our evaluation of these programs and are not making any recommendations or endorsements of any particular plan. However, we would be happy to discuss with any of our clients whether such programs make sense in their particular case.

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A Mother's Dictionary

Having just spent the holidays with children and grandchildren, we thought the following definitions would be appropriate to the season (with thanks to our loyal travel agent *par excellence*, Jean Harman, who sent them to us):

Dumbwaiter: One who asks if the kids would care to order dessert.

Family Planning: The art of spacing your children the proper distance apart to keep you on the edge of financial disaster.

Feedback: The inevitable result when your baby doesn't appreciate the strained carrots.

Full Name: What you call your child when you're mad at him.

Grandparents: The people who think your children are wonderful even though they're sure you're not raising them right.

Hearsay: What toddlers do when anyone mutters a dirty word.

Independent: How we want our children to be as long as they do everything we say.

OW: The first word spoken by children with older siblings.

Puddle: A small body of water that draws other small bodies wearing dry shoes into it.

Show Off: A child who is more talented than yours.

Sterilize: What you do to your first baby's pacifier by boiling it and to your last baby's pacifier by blowing on it.

Top Bunk: Where you should never put a child wearing Superman pajamas.

Two Minute Warning: When the baby's face turns red and she begins to make those familiar grunting noises.

Inside Woodside

It is with great pleasure that we announce that Leslie Beck has joined the firm as a Client Relationship Officer. Leslie comes to us (after a brief hiatus to raise her daughter) following a seven-year career at Chemical Bank (Texas Commerce Investment Management) in Houston, Texas, where she was a Vice President and Senior Portfolio Manager. She also spent two years as a Director at Commonwealth Savings Financial Planning and five years at Prudential-Bache Securities as a retail broker. Leslie holds a Bachelor of Arts in Economics from Trinity College in Connecticut and is both a Chartered Financial Analyst (CFA) and a Certified Financial Planner (CFP). We are excited about the experience and expertise Leslie brings to the firm, and we look forward to introducing her both to our clients and to our valued professional partners.

On a somewhat sadder note, Bob's assistant Zoilita McKeon will not be returning to the firm. Therefore, we have launched a search for her replacement, and Wendy will continue to assist Bob with his clients until that search is successful.

And finally...

...A healthy, happy and prosperous 2001 to one and all.

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WOODSIDE ASSET MANAGEMENT, INC.

Woodside Asset Management, Inc. is an investment management and 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 Robert B. Beim, Ted A Heilman, CFA, and Morgan W. White, the three principals of the firm. Questions, comments and inquiries, whether about *FOCUS* or about the firm, are invited.

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