

## Market Commentary – Monday, July 15, 2002

### Enough!

*If I listened long enough to you, I'd find a way to believe that it's all true.*

*Knowing that you lied – straight-faced while I cried.*

*Still I look to find a reason to believe ...*

Tim Hardin – Rod Stewart's *Reason to Believe*

Fear has definitely set in as the Dow<sup>1</sup> experienced multiple triple digit daily losses last week and continued the sell-off this morning. Pundits are rampant calling for meaningful declines from here. The calls from last quarter and last year for a second-half of 2002 market rally have been met with a monstrous smack in the face. We keep listening to “gurus” prognosticate – looking for a *reason to believe* – trying to latch on to straws of hope. I say Enough! Face it, we're still in a bear market. No amount of wishful thinking will change the fact that the three major domestic equity indices are down significantly on a year-to-date basis. A good question to bring up right about now is why the reminder and clarification of such a painful reality. Simple, by the same rationale that gurus can't will the market up, they can't will it down either.

In fact, I think it was this bad habit of listening to what we wanted to hear that got us into the problem we are in now. It wasn't that long ago that “earnings didn't matter” and “it's different this time” were the chants of the New Economists. Now, we look to someone to tell us a new story that will bring back “confidence” to the market. We all know that market timing is a sucker's bet. However, the market does give clues. Coupled with economic data and other macro forces, one can come to conclusions that gives one confidence to act. I think the writing is on the wall for the markets to respond favorably from here. I'm not looking for a straight up recovery but a see-saw upward trend.

Here are my arguments that the worst is behind us:

1. When WorldCom announced its accounting discrepancies, the market sold off broadly. As discovery of other potential accounting problems emerged (e.g., Merck), the market sold off again. Add in last week's heavy sell-off and it seems clear that the market is discounting the potential for future discoveries. As the new accounting firms take over former Arthur Anderson clients, more accounting issues will be disclosed as the new auditing firms scrub the books and heap blame on Anderson. Given the broad sell-off that has already taken place, much of these future discoveries will be a non-event from a stock price point of view. The “market” knows which firms were aggressive with their accounting practices – firms that were aggressive acquirers, firms with opaque financing arrangements, firms with substantial self-dealings, etc. Clearly, fear of the unknown is a risk of investing. True professionals weigh the probabilities of likely risks against likely rewards. It looks to me that the market has priced in the risk of accounting irregularities.
2. I agree with the popular opinion that capital spending is the next indicator of the reemergence of the economy and the stock market. Companies have cut back, trimmed fat, deferred major expenditures, and managed earnings from the middle line now for over a year. We are at a point where companies need to honestly evaluate whether or not they expect to survive and

thrive this trough. If so, continuing to sit pat will only lead to irreversible atrophy. Our next growth spurt will come in the form of old fashion top line growth – i.e., new sales. These new sales will result from shifting from defense to offense – aggressive capital spending coupled with aggressive marketing campaigns to beat their competition to the punch and capture meaningful market share. Much like the airlines’ fare wars, someone will start and others will have to follow. The courageous, but smart competitors will win and their investors will be richly rewarded. The “dot com” era has become the target of many jokes, but the Information Age is here to stay. Capital spending is necessary because the Information Age is expensive.

3. Capitalism remains the most productive system in the world. While its distribution can get out of balance, capital has always flowed to opportunity. In a low interest rate environment, the more the equity markets sell off, the more attractive they become. What’s different this time is that equity investors will not be looking for triple digit returns on each stock pick. Expectations will likely be not only rational, but even low. It will be okay for a company that looks to grow earnings at 15% to sell for 20 times to 25 times earnings. So, when that company is selling at 17X or 18X, some rational investors will buy it.

I see two major market risks that are not being priced into the market. The first is geopolitical which is ever-present, but tensions seem to grow each day. The second is the under-funded corporate pension plans. This is a double-edged sword. Not only are those liabilities real, a company’s inability to pay beneficiaries will send Enron-like pain through the markets. The former risk is one with which we will have to live. The latter is one that will, at the very least, dampen earnings if companies seek to remedy such problems.

So, what does all of this mean? I see the potential for more discovery of accounting irregularities as favoring investments in small- to mid-cap companies. They are less prone to acquiring other companies and more prone to being acquired for cash (instead of stock) due to changes in accounting rules. Their businesses tend to be less complex, making them easier to audit. I see increased capital spending favoring stocks of all cap sizes. Increased technology spending will be a stimulus to the entire economy. Capitalism with rational expectations will also favor all cap sizes. The ability of companies to attract capital (debt or equity) will require clean financial statements, a profitable business plan, and an accountable board of directors. Further, the power of capitalism leads me to expect opportunities abroad to be at least as attractive as domestically.

Instead of looking for turning points, I’m looking for probabilities. Instead of hoping for hope, I’m looking for opportunities. Instead of relying on someone else to save me, I’m reinforcing my own strategy. With rational expectations and expectations for manageable levels of inflation, I see now as an excellent time to regain confidence in equities. Market-like returns will be achievable by taking market levels of risk. Excess returns will require taking excess risk. Active asset management should have a clear advantage over indexing as yesterday’s high fliers fail to adjust to a rational world of investors. I expect the market to surge and pull back, then surge and pull back, then do it again and again. However, I see it setting higher lows with historical rolling three-, five-, and ten-year returns and standard deviations being reasonable guidelines. In any short time frame, *stuff* will happen and the market will quickly react or overreact. That’s why true market timing remains a sucker’s bet.

It has been said that one saves for the short-term and invests for the long-term. What's missing in this adage is that "long-term" is not a strategy. Discipline and diversification are strategies. Given the beating we've taken over the past two-plus years, here's my strategy – I will prepare for the worst and plan for probable. I will check my allocations to cash, fixed income, and equities – they are the primary drivers of my portfolio's volatility. I will check my investments within each of those three asset classes – they are the bass and treble knobs for my expected returns. With interest rates at relatively low levels, it's back to basics – it's back to working on the things I control. So, to those gurus who keep trying to give me a *reason to believe* that they know when the stock market will turn, I simply say Enough! – I'll take my life back.

<sup>1</sup> "Dow" alludes to the Dow Jones Industrial Average index.

*The views are those of Marc Kawakami, Senior Vice President/Product Research & Support, and should not be construed as investment advice. All information is believed to be from reliable sources, however, we make no representation as to its completeness or accuracy. All economic and performance information is historical and not indicative of future results. Please consult your financial advisor for more information.*

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