

“The Long and Short of It”

Quarterly Newsletter from
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Third Quarter, 1998

A Difficult Quarter

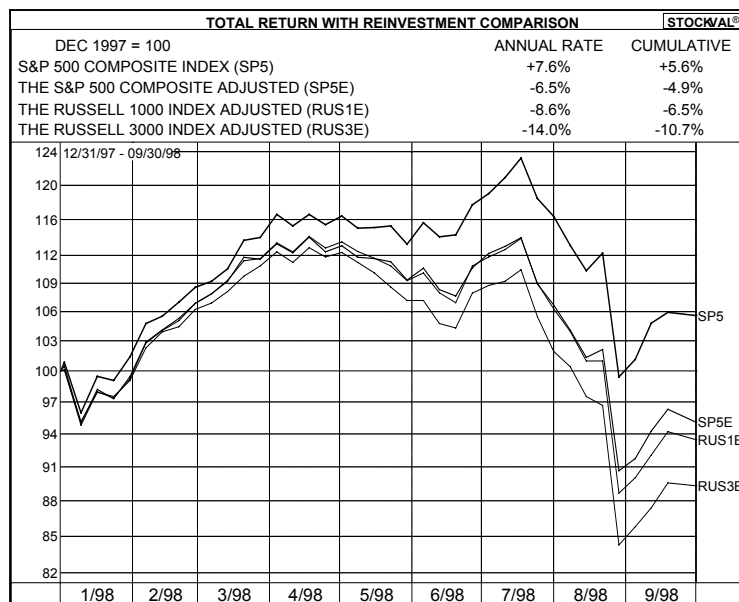
The Third Quarter of 1998 was very difficult for the equity markets. The S&P 500 lost 9.9% for its investors, turning in its worst quarterly performance since the Third Quarter of 1990. It was significantly worse for the vast majority of stocks. The Russell Value Index declined 12.08%, the Russell Midcap Index declined 15.26% and the Russell 2000 Small Cap Index declined 20.51%. It was only a handful of large-cap, growth-oriented issues that kept the returns of the market-weighted indices, like the S&P 500, relatively high. This “Nifty-Fifty” type of bias conceals the fact that most stocks are in a bear market. A few statistics graphically demonstrate this reality.

As of August 31, 1998, the S&P 500 Index closed down 19.6% from its 1998 high. Looking at the broader market, 82% of all NYSE listed stocks, and 95% of all NASDAQ listed stocks, were down 20% or more from their 1997-1998 highs. Further, 62% of NYSE listed stocks, and 88% of all NASDAQ listed stocks, were down more than 30% from their highs.

This discrepancy is possible because the indices are calculated on a market capitalization weighted basis, which favors the returns of the largest stocks. And the largest stocks in the S&P 500 Index account for a lot.

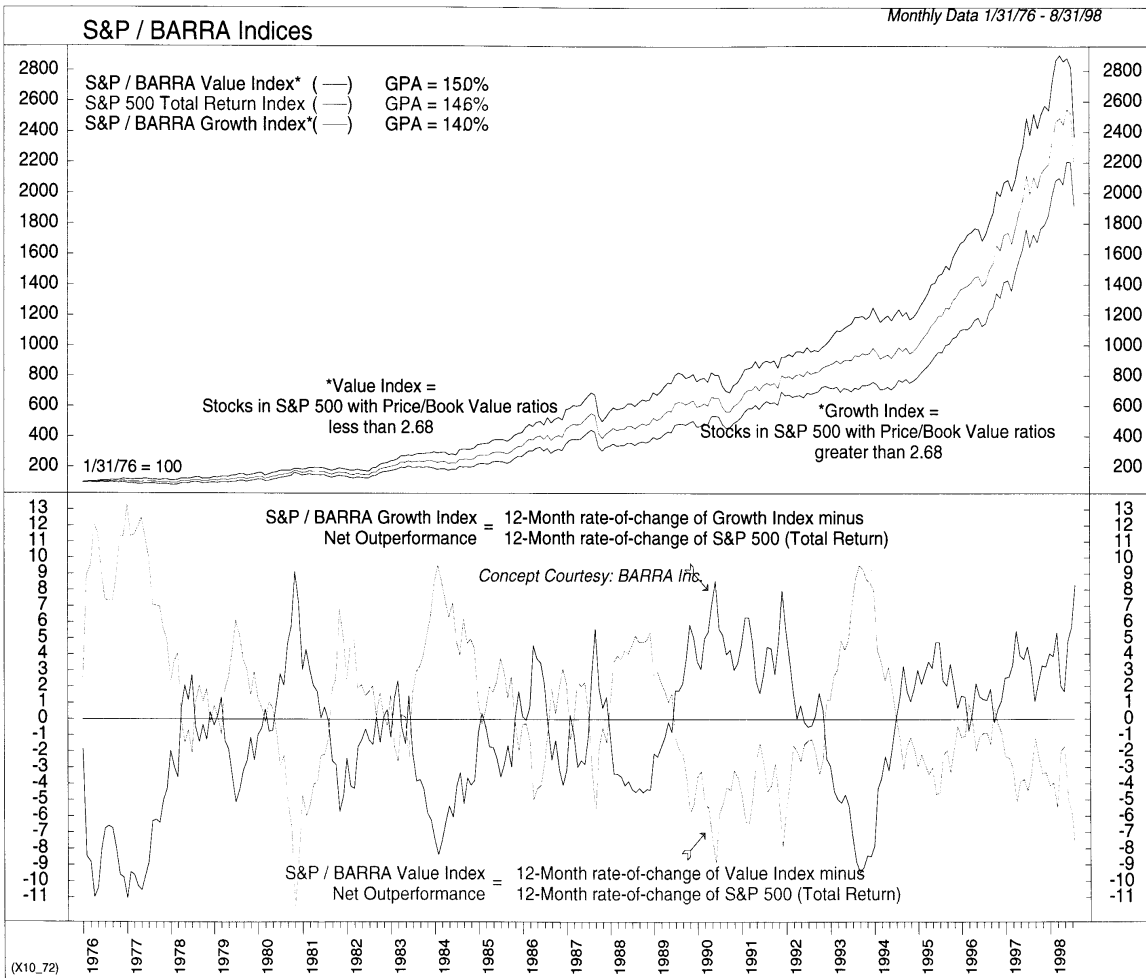
As of September 30, 1998, the top 30 stocks in the S&P500 represented 41% of the index’s total market capitalization, up from 36% at the start of the year. Microsoft is now the largest (ahead of General Electric); and Dell Computer, having only been added to the S&P 500 in 1996, is in the top 20.

As of September 30, 1998, year-to-date return of the S&P 500 Index was about +6%. The top 30 largest companies –measured by market capitalization- had a return of +21%, while the other 470 stocks had a return of -5%. As you move to stocks of companies with even smaller



market capitalization, it gets worse. The chart shows the year-to-date performance of the S&P 500 Index (SP5) -which is market weighted, favoring the large companies- in comparison to the equal-weighted calculation of the S&P 500 (SP5E), Russell 1000 (RUS1E), and Russell 3000 (RUS3E) Indices. The calculation of these indices gives each company equal weight. Each index sequentially includes more, smaller companies.

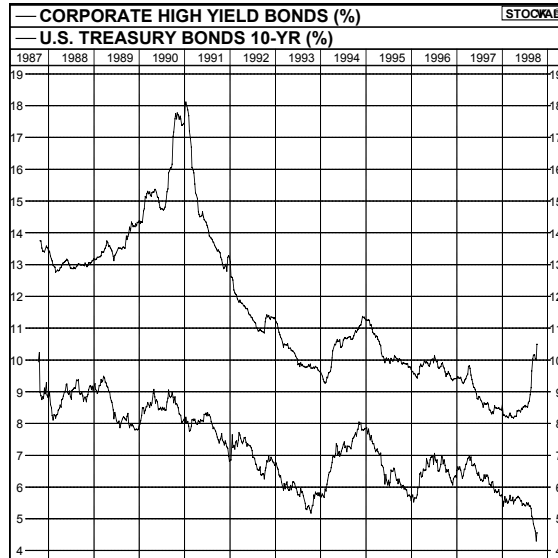
Growth stocks have also outperformed value stocks. The S&P Barra Growth Index (SGXA) had a return of +14.3% year-to-date compared to the S&P Barra Value Index (SVXA), which had a return of -3.5%. These market capitalization weighted indices also significantly outperformed the equal-weighted calculation of the same indices.



In addition, after trailing most major European indexes in the first half of the year, the U.S. market's decline of 9.9% in the Third Quarter outperformed Germany's DAX which was down 24%, France's CAC 40 which declined 24%, and the London FTSE 100 which fell 13% in the same period.

Recession Concerns

Clearly there is growing concern about the possibility of a deflationary recession, which is reflected in the spread between the yields of high yield corporate bonds and high quality U. S. Treasury bonds. When there is rising fear of recession, low financial quality corporate debt issuers bond yields increase as investors require a greater return on investment to compensate for the added risk of default. U.S. Treasury obligations, on the other hand are perceived to have little risk of default. Note that the spread has widened quickly, but has yet to approach the width seen in the 1990-1991 recession.



We do not believe all the troubles are behind us. There should be continued adjustments as the financial markets digest all of the ramifications of slower long-term economic growth. Most of these adjustments should continue to be negative for low quality issues, namely those who carry large debt exposure. As Lester Thurow said, “In times of inflation it is just a matter of who gets rich quickest. During deflation, somebody goes broke.” As a result, we are favoring high quality stocks and bonds.

What debt holders need is liquidity, which is currently very dear. Between the needs of Asia, Russia, and Latin America, the world’s economies may have difficulty generating enough liquidity to generate any irrational exuberance on Wall Street for some time. In this kind of market, a little bad news goes a long way and, as a result, several good companies have been indiscriminately thrown on the trash heap.

It is in this type of setting that we are beginning to find some reasons for optimism about certain individual issues. In fact, we are cautiously beginning to deploy some cash into equity positions, where we have been hesitant to do so over the last several months.

Values in Individual Issues

As an investor in individual issues, we try to assess values of individual issues, not the overall value of the market. Recently we have noticed that, as a result of the unusual nature of this bear market, the 30 largest companies are still expensive by our measures. Nevertheless, we are finding some companies whose stock is selling at prices that represent exceptional values. These stocks should outperform over the long run, but if the negative economic news continues, it may be difficult to see significantly positive returns for a bit longer.

Do you remember playing or hearing about a game called “Kill the Man with the Ball?” As a child, we played this game where one child was given the ball and his job was to run and duck for as long as possible until some one else in the group caught up with him.

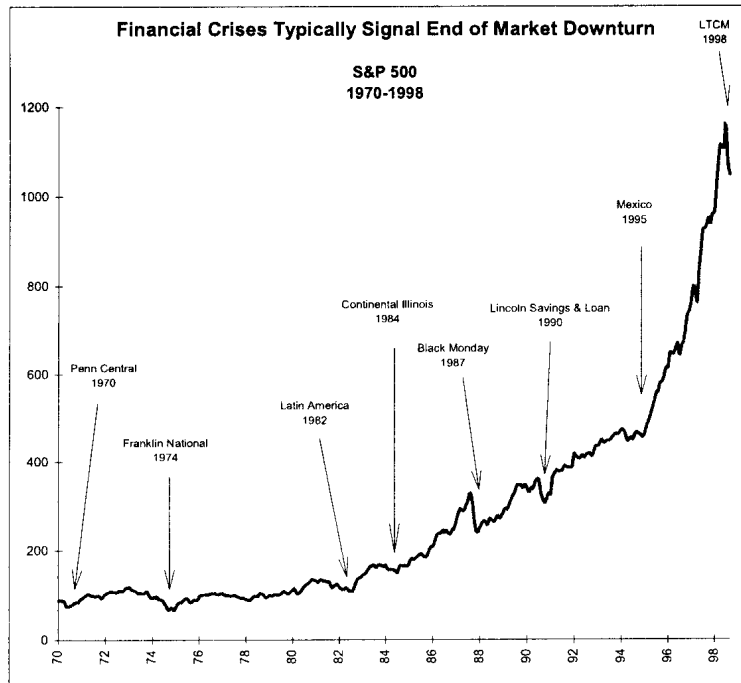
Once caught, he was unceremoniously tackled and everyone would pile on, as if each child would then get credit for the tackle.

This market currently has much the same psychology. Once a stock begins to drop, all the analysts and investors join in the selling, without regard for the underlying value of the company, perhaps to get credit for exiting an issue that is either under-performing or associated with bad news. In many circumstances we are seeing recommendations by analysts that in essence say to sell a stock because it is down and buy another stock because it is up.

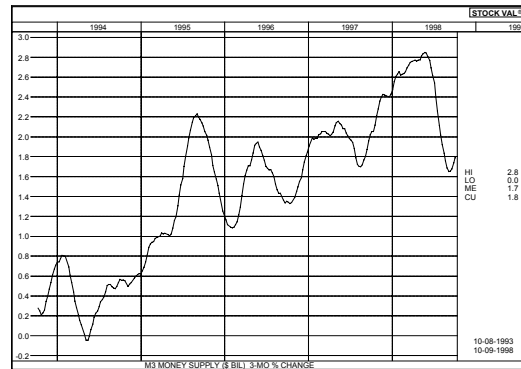
We do not rely on analysts, but on our own research. Surely this type of environment must lead to the excellent values we are beginning to find. We will continue to hold out until we find opportunities that we feel will excel over the long run and then try to take full positions after most of the “piling on” is over.

Monetary Stimulus

While we were right about slowing money supply growth earlier this year, the Federal Reserve finally provided some added liquidity through the recent rate reduction. This move may have been prompted, in part, by Long Term Capital Management’s (LTCM) joining the long line of financial disaster stories. They include Lincoln Savings & Loan, Continental Illinois, Penn Square, Franklin National, and Penn Central – each of which masterminded its own demise.



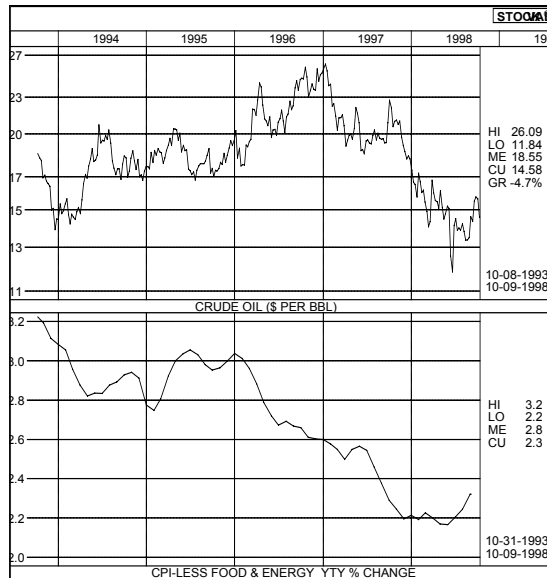
Monetary easing by the Fed accompanied each of the previously mentioned disasters, which led to a market bottom and ultimately great buying opportunities for patient investors. While we may not have seen the end of LTCM or other hedge fund failures, we do find it significant that the Fed stepped in to orchestrate a bailout in order to avert larger global problems that would have resulted from liquidation of LTCM’s very large positions.



The Third Quarter began with investors worried about a potential Federal Reserve tightening. Ironically, as the Quarter ended, many were complaining that the 25 basis point easing was not enough. We believe it is prudent for the Fed to begin with small steps. We also find it comforting that, with real rates very high, the Fed can provide plenty of liquidity if needed.

Fiscal Stimulus

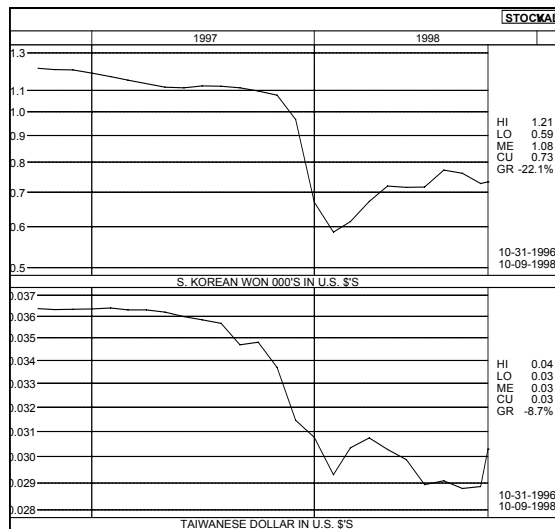
In addition to the ability to deploy a stimulative monetary policy, the government may embark upon fiscal stimuli given the recent improvements in the budget. All politicians took personal credit for the United States Government running a budget surplus for the first time in 30 years. Yet the surplus also means that the Federal Government is in a position to stimulate the economy with a tax cut or other fiscal policy should the economy slow enough to raise the political willpower. The Republicans are working on a small tax cut at this time. It is thought likely to be vetoed. We will see what an election year can do to improve the chances of its passage.



Signs of Prices Stabilizing

Another somewhat comforting indication of an improving environment is stabilizing prices and foreign currencies. While disinflation (declining inflation) has clearly arrived, it is hard to believe that broad-based deflation (negative inflation) is around the corner. Energy prices have risen 27% since the quarterly low level of \$12.73/barrell paid on August 12, and manufacturing and other inventories are being reduced in the United States.

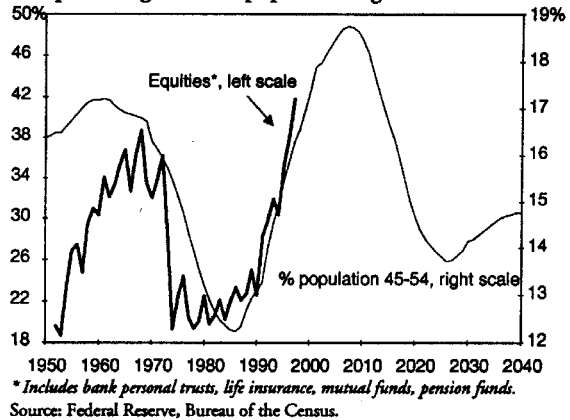
Asia could bring another ugly surprise from a country like Hong Kong, Malaysia, or China. Still, other Asian countries, like Korea, have recently been able to lower interest rates without provoking a further flight of capital out of their countries or decline in their currencies. This is the first sign that an end to the difficulties in the “Pacific Grim” may be forthcoming.



Continued Favorable Demographics

While the best of times for the U.S. equity markets may have taken place over the last three years, there is still a strong case for continued upward performance over the long term. Although it is unprecedented, equities should continue to grow to an even larger percentage of household assets over the next ten years. As baby boomers continue with increasingly productive employment and greater desire and ability to save for retirement, the equity markets are the most likely places for them to put their savings.

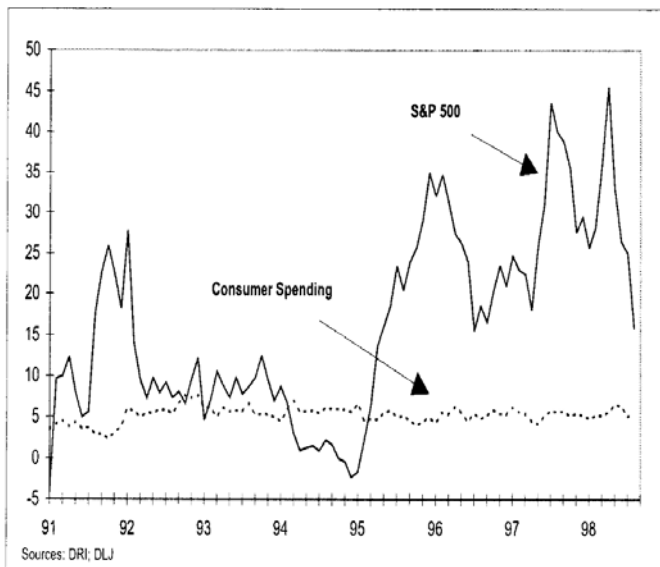
Stocks as a percentage of household financial assets, and percentage of U.S. population aged 45-54



Finally, one popular theory floating around is the “Wealth Effect.” It postulates that consumer spending rises and falls in response to the market, thereby magnifying the strength and duration of bull and bear markets. As the market rises, people feel wealthier. They consume more goods, which leads to stronger corporate earnings and generally good times for everyone. Alternatively, when the market turns down people see less wealth on their brokerage statements. They consume less, which leads to further reductions in corporate earnings, thus extending the bear market. The Wealth Effect has great appeal because it makes common sense.

But what do the facts say? Apparently the answer may be “Not much.” It does not appear that consumer spending was dramatically effected by the weak or strong markets since 1991. Although we do not yet have data from the 1970’s, we do know the equity markets languished for years, yet there was tremendous growth in consumer spending.

S&P 500 versus Consumer Spending
(Percent Change from Year Ago Month)



So perhaps the Wealth Effect does not hold much promise as a reliable indicator. For us, this highlights the difficulty in trying to time the market. We have found much more success in buying shares in quality companies that, for one reason or another, are under-valued and holding those investments until they find favor in the eyes of Wall Street once again.

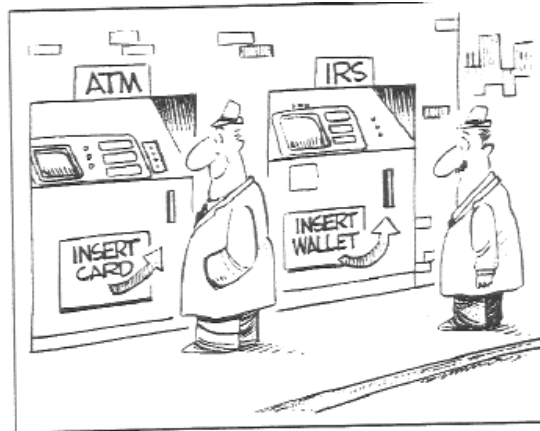
In summary, the recent decline in our equity markets appears to be the result of a disinflation induced slowdown in corporate earnings. The cause appears to be slowing demand, which is arriving after years of growth in productive capacity. Though the damage to the broader market appears to have taken place without inflicting much damage to the widely followed indices, the difficult environment of adjusting to slower growth is not over. We expect the large companies that seem unaffected by recent problems may eventually have their stock prices decline in response to expectations of slower growth. There will always be bad news. At this point it seems much of it may already be reflected in the prices of certain issues. We are seeing some nice values in certain issues and will continue to deploy funds into the stock of these companies as opportunities arise.

TAXING THOUGHTS...

Accessing your IRA

Generally, it is to the taxpayer's advantage to leave investments in an IRA to grow tax-deferred. Nevertheless, it is sometimes necessary or advisable for financial or tax reasons to make withdrawals from an IRA before reaching retirement age.

Distributions from an IRA are includable in gross income as provided in section 72 of the Internal Revenue Code and, if the owner is under age 59 ½, a 10% penalty tax applies to any distribution that fails to satisfy one of the exceptions for premature distributions. Several exceptions exist, including substantially equal periodic payments and distributions attributable to disability, medical expenses, health insurance premiums for the unemployed, higher education expenses, and "qualified acquisition costs" of first-time homebuyers.



A series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary, is one of the exceptions to the 10% penalty listed above. As one of the exceptions not requiring the existence of specified circumstances, it has been growing in popularity as a way to access one's IRA early. However, it can be an expensive way if the owner forgets the requirements and makes an extra withdrawal. As the taxpayer in *Arnold v. Comr.* discovered, if a series of substantially equal periodic payments is subsequently modified (other than by reason of death or disability) within five years of the first distribution, the 10% penalty is imposed retroactively on distributions made before the taxpayer attains age 59 ½, plus interest.

IRS Drops the Ball

In late September, the IRS released its revised mission statement. According to the new statement, which the IRS was required to revise under the reform bill, the mission of the IRS is to “provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax laws with integrity and fairness to all.” IRS Commissioner Charles O. Rossotti said, “This mission statement reflects the new attitude at the IRS... Our top priority is putting the interests of taxpayers first, and this is spelled out simply and clearly.”

After Mark McGuire tied Roger Maris’ home run record at 61, IRS spokesman Steven Pyrek said that a baseball is owned by major league baseball until it leaves the field, after which time it is owned by the fan who comes up with it... Even if the fan was to return the ball, “the giver is responsible for paying any applicable tax on any large gift.”

Serious income and gift tax issues thus confronted baseball fans trying to snag McGuire’s 62nd home run ball as it was speculated to have a \$1,000,000 value. Income taxes on the fan, at approximately 39.6%, would have been \$396,000. Gift taxes for returning the ball to McGuire, at approximately 40% of the value in excess of the \$625,000 exemption equivalent, would have been \$150,000. According to Pyrek, the noble fan returning McGuire’s 62nd home run ball to McGuire owed the IRS at least \$546,000.

Public and congressional outcry came quickly, forcing the agency to reverse its position. Maybe the IRS needs to circulate its mission statement among the employees!

Convert? Unconvert?

December 31, 1998, is your last chance to convert a regular IRA to a Roth IRA and spread the tax bill over four years. You are eligible to make the conversion if your 1998 adjusted gross income is \$100,000 or less on a single or joint return. If you have already converted to a Roth IRA and its investments have participated in the market drop, consider converting back to a regular IRA and then reconverting.

Why? If you converted a \$100,000 regular IRA to a Roth IRA before the stock market tumbled and the investments inside your account are worth only \$75,000, you still must report the full \$100,000 as taxable income. But if you convert the account back to a regular IRA and then reconvert the \$75,000 to a Roth, you cut your taxable income by 25%. So far, such maneuvering is legal, but there is some confusion over how often investors can use this tactic to reduce their tax bills. If this move would save you money, check with your IRA custodian for the latest rules.

Dear IRS,

I would like to cancel my subscription. Please remove my name from your mailing list.

