

DÉJÀ VU!

JUNE 2002

"It's déjà vu all over again." Yogi said it, and he couldn't be more right!

Last month we saw the stock market take off like a rocket after Cisco systems announced earnings. Wall Street and many investors perceived these numbers to be outstanding. Analysts across the land were crying out "Hear Ye, Hear Ye, The bull is back!"

They were wrong. Since May 8th we have seen the Dow backtrack from 10100 to as low as 9474.

There was this great movie that came out back in 1981, it was called Dragonslayer. This movie took place back in the 6th century British countryside. It was about this fire-breathing dragon that terrorized everyone and everything. To make a long story short, the Dragon was reportedly slain and the people went on living carefree once again. Unfortunately, reports of the dragon's death were greatly exaggerated. Then things got quite tough in merry old England. This past week we have seen another powerful rally with the Dow rising over 200 points. Once again pundits across the land found their way on to CNBC and the Wall Street Journal proclaiming like fairy tale knights that the bear has been slain. It is now safe for all the villagers to come out and buy stocks haphazardly again.

I hate to break it to everyone but the bear is still on the prowl. The markets have a great many problems to deal with. Starting first with the tremendous threat of more terror attacks here in the United States and abroad. Israel just had its most horrific attack in 6 years. We reportedly have 40 Al Qaeda terrorists trying to sneak into California and we have arrested a man that was trying to build a radiological bomb. Just so everyone understands, a "dirty bomb" detonated in Manhattan would leave most of the island uninhabitable for about 50 years.

Currently, our account deficit is at 4% of GDP and growing. Foreign investors are starting to bail out on the United States. This in turn is putting great pressure on the dollar. We are at 17-month lows against the Euro. If the dollar continues to fall, confidence in U.S. equities could erode very quickly.

Retail sales fell 0.9% in May. Consumers pulled back on spending at retailers last month, reflecting the tenuousness of the economic recovery. Consumer confidence had its biggest drop in June since the terrorist attacks, and industrial production slowed in May as the economic recovery faltered in many different areas.

In the first quarter of this year a whopping 379,012 consumers and businesses declared bankruptcy. That is the second worst quarterly tally ever. In 2001, bankruptcy filings set an annual record of 1.49 million. We are on pace to surpass that dubious record. Banks charged off \$38.8 billion worth of bad commercial and consumer loans in 2001. That according to Weiss Ratings is the highest ever. Charge-offs may be even worse in 2002. Currently, delinquency rates, which are loan payments that are more than 30 days outstanding, are nearing record highs.

The business pages continue to disappoint the American people and the world as we continue to embarrass ourselves with one corporate scandal after another. Many people are waiting and wondering to see when the next shoe is going to drop. There has been a fundamental breakdown in capitalism. Too many CEO's are on "Ego trips" feeling that they are above the laws of the land and have army's of lawyers looking for loopholes and gray areas to perpetrate their schemes. Some of them are downright evil. Take for instance Sam Waksal from Imclone, not only did he hurt investors in his company by lying about his wonder drug, he unjustly raised the

hopes for cancer victims and their families all over the world. Scum like this need the medieval going over as far as I am concerned.

The markets still have a valuation problem. Investors must come to grips with what a P/E ratio (price to earnings) is and what it means. A P/E ratio shows the multiple of earnings at which a stock sells. Determined by dividing current stock price by current earnings per share (adjusted for stock splits). Earnings per share for the P/E ratio are determined by dividing earnings for the past 12 months by the number of common shares outstanding. Higher multiple means investors have higher expectations for future growth, and have bid up the stock's price. It is also a means for judging how expensive a stock is. The average P/E level for stocks is 15. It is currently at 26. Sounds expensive right? Wait a second there is more. If you add in exceptional expenses, the P/E level is 41. Now if you add in the cost of stock options, the P/E level is at 50. Ouch! I thought coffee at \$4 a cup was expensive but this is ridiculous.

Let me make this very clear to everyone, I am not advocating selling all your stocks and investing in frozen concentrated orange juice or baseball cards or stamps. The market without a doubt has been very tricky for the untrained eye. However, if you know where to look...

Did you know that almost half of the stocks on the New York Stock Exchange and the Nasdaq Stock Market have gained ground since late March 2000? Many of the stocks that have been making investors money were looked at as lepers during the whole tech run. These companies that pay dividends, have excellent valuations, and positive cash flow are the path to turning a broken portfolio around.

There is a new sheriff in town as far as the markets are concerned. These stocks with the strongest gains since the market turned down come from a number of different categories. But they all have one thing in common: All of them avoided getting caught up in the excesses of the late 1990s, they generally are smaller and less complex than the old leaders, and they trade at a lower price, compared to their earnings. As well, foreign markets have done very well, actually outperforming the U.S. market.

The Dow Jones Industrial Average and the Nasdaq Composite Index are both dominated by the bigger, better-known or more "popular" stocks. Therefore the declines statistically outweigh the gains of the generally smaller, "less popular" companies that are doing well. Most investors own the big "popular" stocks that have under performed than own the smaller, more obscure stocks that have been gaining. E.S. Browning of the Wall Street Journal articulates this point.

The shift to a new breed of winners is the latest example of a longstanding historical trend. When one group of stocks declines, it doesn't tend to bounce back and take over leadership again. A different group tends to emerge in that role.

In the 1970s, oil stocks dominated. By the 1980s, that group was fizzling, replaced by fast-growing consumer-product multinationals such as Coca-Cola Co. and McDonald's Corp. The 1990s saw tech stocks taking the lead, producing one of history's biggest stock bubbles.

So far this year, the big gainers cross a wide range of groups, including homebuilders, health-care providers, steel companies, clothing manufacturers and restaurants. It is hard to believe that nearly 300 stocks have more than doubled in price in the past 12 months. During the boom, investors didn't worry much about a stock's price. If it traded at 100 times its projected earnings, that didn't matter as long as it was thought to be a stock of the future. Dozens of stocks traded at lofty triple-digit multiples of their earnings. Today, that fascination is gone: The stocks doing the best are "value" stocks, those that are trading at a relatively low price compared with earnings.

One of the best places to be during the late 1990s was in super-size stocks, companies such as Cisco, Sun Microsystems and AOL Time Warner Inc. that dominated their markets and were diversified enough to offer investors several ways to win.

Now, with many big companies having trouble boosting sales, dealing with excess inventory and adjusting their accounting to the new post-Enron conservatism, investors are looking to companies that didn't get caught up in the earlier euphoria. Small and midsize stocks, which often out-gained big stocks during the 1970s and 1980s, once again are performing better than big ones. Especially popular are small and midsize stocks in mundane businesses. Today they look both inexpensive and easy to understand. Of the nearly 300 stocks that have doubled in price during the past year, all but 17 have market values below \$1 billion, according to Baseline, which tracks stock prices.

It is not a matter of luck. It is a matter of intelligence. Just because the major market indices are down and out does not mean that there is extraordinary opportunity abound. Do not repeat the same mistakes over and over again looking for different results. For many investors that have lost a great deal of wealth in the stock market, that feeling of déjà vu is not a welcome one.