

## THE PERFECT STORM

*By Bruce White*

In 2000, we saw the first year of negative equity-index returns in a decade. It is important to understand the forces behind this dramatic market reversal. To begin with, recall the investing public's mind-set a year ago. We had just escaped being bitten by the mythological Y2K bug. Technology stocks and any company associated with the Internet had overtaken the weather and politics as the primary topic of every conversation.

Then, near the end of the first quarter, technology stock prices fell steeply and continued to decline through year end, taking the major indexes with them into negative territory. The Standard & Poor's (S&P) Technology Index ended the year down -40%, after gaining 75% in 1999, for a two-year annualized return of 3%. With easy equity capital drying up, the dot.coms began merging or disappearing.

Unfortunately, investors tended to treat all technology companies the same. Many quality firms, with positive fundamentals that have performed well for several years, were lumped in with the rest of the sector and their stock prices were driven down.

### Why Did Prices Rise?

To understand what happened, we need to know what initially brought about the higher-than-sustainable stock prices in the technology sector. We believe there were several interrelated causes. First, after several years of extraordinary stock market returns, investors had high return expectations. This led to money flowing into the markets with more concern for return than risk. Stock prices, like all prices, are set by supply and demand. So with greater demand, stock prices rose.

Many mutual funds and institutional investment managers answered their customers' expectations of high returns by overweighting their portfolios in aggressive technology stocks and new or recently-issued Internet stocks, where very high returns were hypothetically possible.

Why did technology stock prices continue to rise, even after they became unrealistically high? Two reasons: momentum investing and mutual fund indexing.

Momentum investing has been around for a long time, but in the last few years has become all too



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prevalent. This strategy is easily defined as buying a stock because its price has been going up, and selling it as soon as its price falters. It may work in the short term, but not when there are too many people playing the same game. Buyers buy because others are buying, which causes the price to rise—a self-fulfilling prophecy. This tactic can cause rapid price movements, both up and down, without regard to the fundamental qualities of the underlying company. (Please see the chart, below.)

The other factor, mutual fund indexing, is a relatively new practice. Index funds must replicate an equity index benchmark. We have observed that many actively-managed (non-index) mutual funds also build portfolios that are close facsimiles of the indexes. They do this so their returns will approximate those of the benchmark. (See "Lost Sheep" in our Summer 2000 newsletter.)

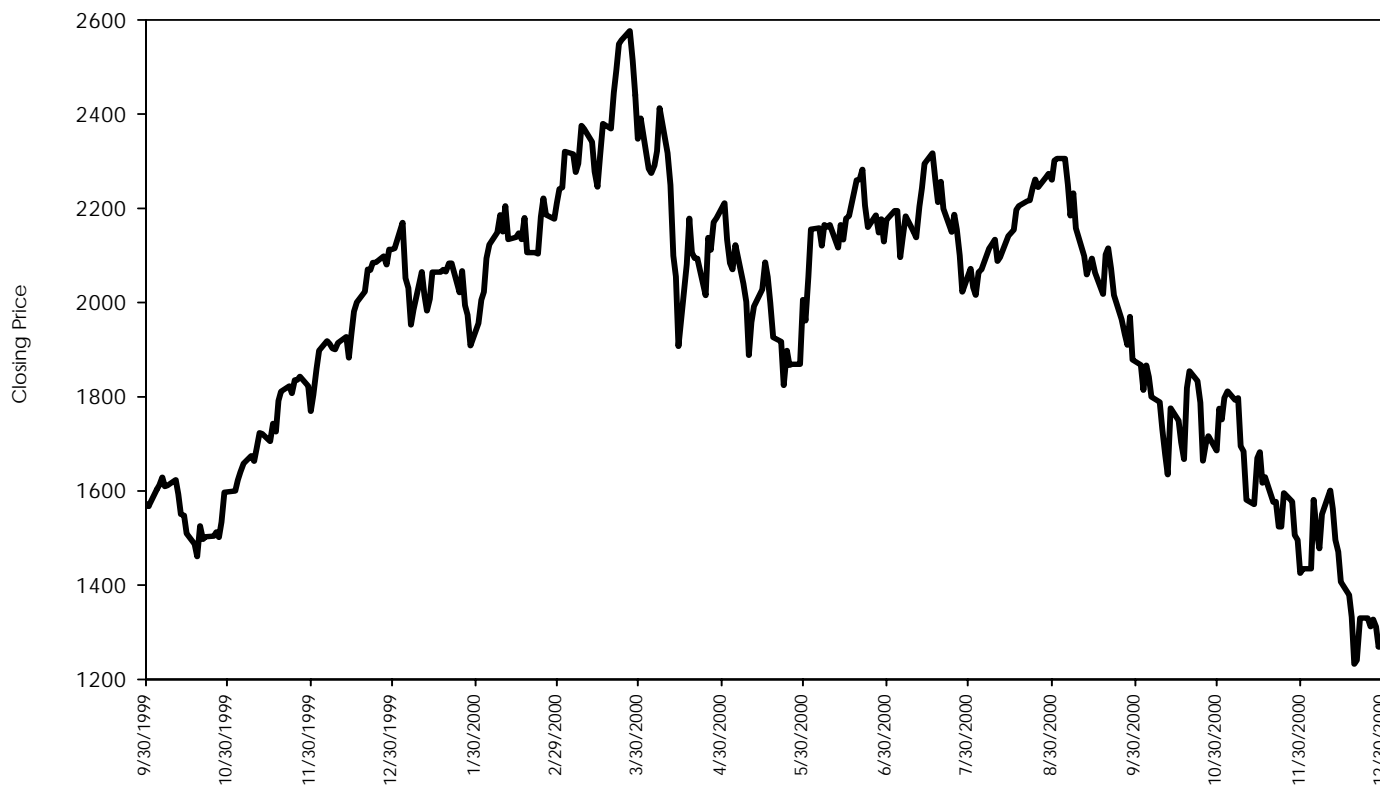
Because the broad indexes like the S&P 500 are capital weighted, the percentage of the indexes in the technology sector increased as the prices for technology stocks rose. The need to match the benchmark forced mutual fund managers to buy more and more technology stocks in order to equal the percentage of this sector in the indexes.

### **Why Did Prices Fall?**

What triggered the end of rising technology stock prices? Again, several interrelated factors: the Federal Reserve, interest rates, and energy prices, all of which has caused a slowing economy. The sector began its retreat out of concern about this slowing.

As we predicted at year-end 1999, long-term interest rates declined in 2000, as the federal government balanced its budget and fewer

Standard & Poor's Technology Index



This chart shows the dramatic price movements of technology stocks from the last quarter of 1999 through the year 2000. The Standard & Poor's Technology Index is a capitalization-weighted index of all stocks designed to measure the performance of the technology sector of the Standard & Poor's 500 Index.

long-term government bonds were issued. The Federal Reserve maintained a “tight” monetary policy, however, which kept short-term rates very high and slowed the economy.

Higher energy prices also had a negative impact, as individuals and companies spent more than anticipated for energy. Our European and Asian trading partners suffered even more than our domestic economy, because the energy price increases were amplified by their falling currencies and high fuel taxes. Technology companies sell their products around the globe and their overseas sales were lower than anticipated, as our trading partners cut back on technology purchases.

Tight money and high energy costs also led to a slowing U.S. economy, which caused the earnings of many companies to fall short of Wall Street’s forecasts. These earnings disappointments led to a sudden realization that many of the technology and Internet companies’ fundamentals couldn’t sustain their stock prices. When technology stock prices faltered, momentum buyers became momentum sellers, accelerating the decrease in stock prices. At the same time, indexers had to reduce the percentage of their holdings in this sector to match the benchmark. Then, as the year closed, tax-loss selling no doubt exacerbated the price declines.

This is a pattern we have seen before and will see again. Last year we highlighted these irrational price movements. We used Amazon.com (AMZN) as an example of a company with fundamentals that couldn’t sustain its stock price. (See “Two Tales and Holy Grails” in Spring 2000 newsletter.) These periodic episodes of irrational market action, caused by emotion-driven human behavior, can create opportunities for long-term investors.

### **What Now?**

We expect positive returns for the year 2001 for both equity and fixed income markets. Our optimism is based on two factors: a stronger econo-

my in the second half of the year with lower interest rates, and a return to more rational, traditional valuation of companies by the market.

Certainly the first half of the year will be focused on the health of the U.S. economy to determine when strong corporate profit growth will resume. Interest rates, inflation, energy prices, the health of our trading partners and U.S. productivity will need to be monitored closely. The uncertainty of the last quarter of 2000 may continue, but we expect the calendar year 2001 will be profitable. In the past, when the Fed has moved to cut interest rates, there has been a positive reward for investors. According to Merrill Lynch, “Historically, within three months after an initial rate cut the S&P 500 has generally traded up around 10%, within six months the index has generally advanced 19% and by 12 months it has generally returned 23.6%.”

### **A Return to Basics**

We believe that the end of the year 2000 marked a return to traditional fundamental investing for most investors. Return expectations have moderated, mutual fund indexing has failed to perform, and momentum buying based on rising prices is dying. While the equity indexes have declined, the excesses of last year in technology and Internet stocks should have only a narrow effect on the economy because few of these companies were leveraged with much debt.

**Our optimism is based on two factors: a stronger economy in the second half of the year with lower interest rates, and a return to more rational, traditional valuation of companies by the market.**

### **Our Approach**

Clifford Associates continues our long-standing disciplined approach to investing, seeking predictable growth with reasonable stock valuations. We focus on the growth of internal measurements of sales, profitability, cash flow, and other fundamentals of our companies. This analysis allows us to determine a reasonable value for a company. We can then take advantage of market prices, when they don’t reflect this value, by buying or selling the stock. Bargains in quality companies are starting to appear, which makes us optimistic for a good year.



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## Reduced Capital Gains Rates, Yes. Simplification, No!

*By Peter Boyle*

**A**s a result of tax legislation passed in 2000, beginning with the 2001 tax year, a lower capital gain rate of 18% (8% for individuals in the 15% tax bracket) may be applied for assets held more than five years. Simple enough, but that would be too easy. The twist is at what point the asset needs to have been purchased to qualify for these reduced rates. For those in the 15% bracket, there is no restriction. However, for those above the 15% bracket, this new rate only applies to assets purchased or "elected" to have been purchased after De-

cember 31, 2000. What makes the law especially complex is that it allows the taxpayer to elect to treat pre-January 1, 2001 assets as if they had been purchased on January 1, 2001 and therefore eligible for the five-year holding period. If this election is made, it is assumed the asset is sold and repurchased on January 1, 2001, therefore making the taxpayer liable for any capital gain taxes created by the "transaction". Because of the law's enormous complexity, please consult us or your tax professional to see if this election may be appropriate. 

## Welcome Randy Zaharia

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**P**lease join us in welcoming Randall Zaharia, CFA, to Clifford Associates. Randy joined us in November 2000 as a principal. He brings 19 years of investment and financial experience to our firm. Before joining Clifford Associates, he was a senior portfolio manager for First American Capital Management, where he managed over \$300 million in assets for individuals, employee benefit accounts, corporate accounts, mutual funds, and charitable trusts, as well as providing substantial equity and fixed-income research support to the company. Prior to First American, Randy was a portfolio manager and investment analyst for the Los Angeles County MTA Treasurer's office where he managed internal fixed-income portfolios and provided

analytical support to the authority's pension and defined contribution plans.

Randy received his Masters of Public Administration (MPA) degree from California State University, Long Beach in 1995, and his Bachelors of Science degree in Business Administration (finance and economics) from the University of Arizona in 1981. He is a Chartered Financial Analyst, a member of the Los Angeles Society of Financial Analysts, and the Association for Investment Management and Research (AIMR).

We are enjoying working with Randy and anticipate that he will continue to make valuable contributions to our portfolio management team. 