



# Sigma Summaries

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## There Has Never Been a Bear Market that Didn't End

*"The Commerce Department said yesterday that sales at the retail, wholesale, and manufacturing levels dropped \$419.1 billion in June after a four-tenths of one percent increase in May."*

*"Private analysts predicted that the economy will be plagued in coming months from this drag of slumping sales and unwanted inventory build-up."*

These two quotes are from the August 14, 1984 issue of the New York Times. They appeared at a time when the Dow stood near 1200 and the S&P 500 was around 165 versus 9800 and 1150, respectively, as of March 30, 2001. These indexes had been declining for eight months and were about to reverse their downward trajectory in less than a month's time.

Further, according to George Gilder, a modern day technology analyst and researcher, "The mood of the time was grim. (Technology) Industry keynoters bemoaned a glut of wafer fab capacity and memory chips and prophesied the end of the golden era of silicon, the move of the industry overseas, and its emergence as a mere cyclical part of the national economy. Intel (INTC) founder and Moore's law author Gordon Moore inquired morosely, 'What could we ever do with millions of additional transistors on microchips?'...Semiconductor stock prices retreated below the levels last reached in the midst of the catastrophic recession year of 1982...The U.S. storage industry was kaput, with 'floppy' disk drives entirely dominated by Japan and an obvious wretched excess of venture money pouring in multiple floppy hard disk companies...Spurred by somber complaints from Sanders (of Advanced Micro Devices) and from Andrew Grove and Robert Noyce of Intel, the press sagged with articles predicting the death of the U.S. semiconductor industry at the hands of Japanese keiretsus...The shares of U.S. microchip and computer companies went into free fall."

From history we know that not only was the semiconductor industry revived, the personal computer era had just begun and was about to ignite a decade of economic and stock market boom. Further, existing U.S. firms such as Intel, Applied Materials, Microsoft, Oracle, Peoplesoft and others were about to restore their lead in virtually every area of technology. And scores of new firms gave the U.S. the lead in services, design tools, capital equipment and high-end manufacturing.

History is repeating itself today. Optical equipment companies bemoan inventory buildup. There are talks of a "bandwidth glut". The recent collapse of dot-coms is reminiscent of the earlier collapse of computer startups. Faced with the current financial plunge, panicky investors are now questioning whether there is such a thing as a "New Economy".

For perspective, it may be interesting to retrace the steps of how we arrived at this current period when the U.S. dynamo, technology, which has powered world economic progress for two decades, is now impeding it. With that insight, perhaps we can also gain some vision of how we can eventually emerge from this long dark tunnel.

The embryonic years of the new economy can actually be traced back to the Sputnik years. In reaction to Russia's leap ahead in technology, President Eisenhower and the Pentagon

developed a new agency called ARPA. Developed by a small Massachusetts company BB&N, ARPAnet was created to connect computer researchers at universities across the nation. Within nine months the technology was invented, built and installed to connect all of these researchers. However, it wasn't until 1995 that the Internet's growth inflection period began. Microsoft, in particular, introduced software that made using the World Wide Web a friendlier experience. Microsoft introduced Windows 95 with Internet Explorer. With lightning speed, the Internet became a 24-hour medium where people could do business, chat, and go shopping. Tens of millions of computers are now connected in the world and billions of dollars of business have shifted to the net.

The advent of the Y2K bug, or the fear that our computers would crash on January 1, 2000, was another major stimulus to computer and software demand. As a result, we witnessed an unprecedented upgrade cycle of PC's, servers, mainframes, and software applications, worldwide.

Given the substantial upgrade of computer systems and networks, and the growing use of the Internet, more information began to pass through telephone wires. Simultaneously, service providers such as America Online (now AOL-Time Warner) began to offer flat rates for their consumer Internet access businesses. People started tying up phone lines for hours at a time and installing additional lines in their homes. The phone system, however, was designed and optimized for voice traffic for which the average call lasts a few minutes. Moreover, telephone systems are typically designed to provide a dedicated line for this two-way communication, which represents a waste of space on that line and is highly inefficient. While this didn't matter when we operated in an all voice world, as data has become an increasingly greater proportion of the telephone network traffic (think of e-mails, web pages and photographs), it matters a great deal now. As a result, new systems were invented to maximize the use of these wires but our need for speed and bandwidth cannot be satisfied using the legacy infrastructure.

Moreover, we witnessed a massive transformation of the telecommunications industry. Governments worldwide deregulated and privatized telecom services. Hundreds of new companies sprang up and they built dozens of new phone networks: local phone systems, urban fiber rings, high-speed long-distance networks, wireless systems and transoceanic data pipelines. This all began an unprecedented spending spree on telecommunications gear. But even though the telecom industry was expanding at a healthy rate, there were too many carriers chasing the same customers, thus creating an oversupply of both carriers and equipment. Now the inevitable is happening. Demand for equipment has slowed dramatically. Many of the carriers that never achieved profitability are going bankrupt. The low cost producers and those with the best balance sheets and proprietary products and services among both the carriers and equipment makers will ultimately survive. In the interim, it will take time for supply and demand to come back in balance.

Three more factors exacerbated the excesses we have seen in the supply of computer and telecommunication equipment. First in 1999, "momentum" investing (buying only shares of companies that are going up) had become all the rage with even some seasoned pros abandoning their valuation disciplines and defecting to the "growth at any price" party. CNBC featured stories about the double and triple digit returns achieved by teenagers in their "weekly" stock market derbies. Instant wealth was created by investors who bid up the prices of any "dot-com" start-up on its first day of trading as a publicly traded company to levels that had no association to economic value.

The second factor was the overabundance of capital through the proliferation of venture capital funds and a roaring initial public offering (IPO) market. With too many companies competing in the same "space", competition and pricing wars have resulted in slowing and, in some cases, declining revenues and profits. Finally, as we approached the year 2000, the Federal Reserve flooded the market with liquidity given a fear of serious disruptions from the Y2K bug. As we celebrated the New Year with the lights still on and flush with extra cash, we pushed stock prices up further, for by then everyone and his brother knew how to make money in the stock market.

So where are we today? How long will it take to work off all the excesses? How low can the stock market go? Is there really a "New Economy?"

What we can say is that the Fed is moving in the right direction, inventories are being worked off, and most of the excesses in valuations have been corrected. It may take awhile before the imbalances are completely adjusted. However, the stock market is a predictive medium and it is likely that stock prices will begin to appreciate before corporate earnings expectations begin to rise once again. Also, we can take solace in the fact that this downturn in the market has cleared out the weaker companies so the stronger ones can grow and proliferate. They will have better access to resources, both financial and people, and less clutter and competition to deter their growth prospects.

Further, according to Alvin and Heidi Toffler, co-authors of "Future Shock", "The Third Wave", and other books about the future, "The notion that the new economy never existed is ludicrous if we look at how deeply it has already restructured even the biggest and least Internet-dependent corporations. Their hierarchies are more flat, their products more customized. Their skill requirements have changed as muscle-work declined and mind-work increased... There are today more than three million digital switches for every being alive on the planet. They are not going to go away. There are nearly half a billion PCs on the planet-one for every 13 human beings. They are not going to go away, either, unless they are replaced by even more advanced networks and technologies...To imagine the new economy is over is the equivalent of thinking, in the early 1800s, that the industrial revolution was over because textile manufactures were going broke in Manchester."

In fact, the digital revolution is stimulating fundamental change in a multitude of industries including genetics, biotechnology, composite materials, energy, cloning, supra-molecular chemistry, optics, memory research and many other fields.

While it is difficult to gauge the length and depth of the current slowdown and when stock prices will bottom, one day, this too shall pass. Just as some people may have been fooled into thinking that stocks can rise 20% plus per year ad nauseum, many individuals are now concerned that stocks will falter for an extended period of time despite a likely turnaround in economic activity. The Dow, S&P 500, and the Nasdaq fell 8.4%, 11.9%, and 25.5%, respectively, for the quarter ending March 30, 2001. Even though the Dow and the S&P 500 were down less than the technology dominated Nasdaq, the first two averages reflect the fact that the rest of the economy has not been immune to the woes experienced in the technology and telecommunication sectors. Although it is no consolation, there have been other quarters throughout history where all of the major stock indices posted negative double-digit returns. In most instances, the equity markets staged meaningful rallies 6 to 12 months following these periods of poor performance, although we are aware that past may not be prologue.

Clearly, these are difficult times for equity investors. We remain confident, however, that stocks have the potential for providing superior returns versus cash and fixed income securities over a multi-year holding period. Moreover, your portfolio is well diversified among sectors and industries, and is comprised of some of the financially strongest and best-positioned companies in their respective industries.

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