Sigma Investment Counselors

Sigma Summaries

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Be an Owner - Not Just an Investor

All three of the major stock market indices staged rebounds in the second quarter after a dismal first quarter of this year. Year-to-date returns are still in negative territory, with the Dow, S&P 500, and NASDAQ down 0.06%, 6.72%, and 12.55%, respectively. However, this reflects some encouraging improvement from the figures of minus 8.4%, 11.9%, and 25.5%, respectively, reported at the end of the first quarter.

Some market strategists argue that the recent strength in the market represents a bear market trap. Others contend it is the beginning of a new bull market.

The bears maintain there is no earnings visibility. In fact, they look for corporate profits to be depressed the rest of this year and then down again in 2002. They claim that CEOs have lost credibility. One day these leaders could not meet demand and the next day there was no demand. Further, aggressive easing by the Fed may lessen the pain, but cannot 1) offset weakening demand from Europe as European economies stall or 2) cure the horrendous excesses in the technology industry. In addition, the gloom and doom seers look for more corporate layoffs. Debt-laden consumers and consumers impacted by the negative wealth effect of lower stock prices are expected to pull in their horns over the next few quarters. The bears conclude that market valuations are still high despite the ravages undergone by all the stock market indices over the last year.

The bulls, on the other hand, rebut that bull markets begin when there is little, if any, earnings visibility. They chide that there was plenty of visibility in March of 2000 when the market peaked well before the fog rolled in with the onslaught of earnings disappointments. They acknowledge that it may take time to work off the bloated inventories in the telecommunications segment of the technology sector. However, the same bullish advisors remind us that Fed easing has always led to improvement in profits within 9-15 months of its inception. That would mean a recovery would begin between the fourth quarter of 2001 and the second quarter of 2002. As the market usually turns up about six months before earnings, the market upturn so far might be slightly premature but not severely. These forecasters maintain that the rapidity of the retrenchment among telecommunications firms means that the catalyst for recovery may come sooner rather than later. While they grant that growth in consumer demand may slow, they point out that corporations have been reliquifying.

Indeed, **Sigma's** Director of Information Technology, Ken Bernard, pointed out at **Sigma's** recent weekly Investment Committee meeting that 2001 appears to be the year of the Triumph of the Chief Financial Officer (CFO) over the Chief Information Officer (CIO). Historically, the CIO reported to the CFO. In recent years, the CIO has been elevated to the same level as the CFO in most organizations. In 2001, it appears that the CFO has regained his/her prior status. However, this resumption of their previous status is not just over the CIO but over the heads of most cost centers. Not only has capital spending been reeled in but companies have suspended or cut back all other costs as well. If history is any guide, swelling cash coffers may vindicate upbeat strategists. Usually such balance sheet improvements are the precursor to stronger spending on tangible assets since companies do not earn a decent return from holding cash. Finally, these strategists contend that though valuations may look high historically, lower inflation and higher long-term growth rates are the reasons market valuations should command higher levels than they have experienced on average in the past.

While the bulls and the bears discuss and debate what will happen in the short run, **Sigma** continues to invest its clients' assets with a long-term time horizon. **Sigma** is not a hedge fund that sells short. As indicated in many previous **Sigma Summaries,** we have never felt comfortable timing the market. Further, there is a cyclical pattern to the economy and stock market over time. Some business cycles are longer than others, but they are all similar. Excess inventories need to be worked off and new investment and consumption are required to get the economy going. Fiscal and monetary policy may be used to accelerate the process, as is currently the case. But the economy always comes back. Unless this time is unlike any other in history, it is a question of *when* profits turn up, not whether.

And even if this is correct, the odds favor the market will not head straight up. When investors have been bruised badly, they typically take time to recover. Meanwhile, investors still face months of relatively glum earnings reports. So fluctuations, including some intermittently scary sell offs, are probably on the horizon. But the key point to remember is that bull markets do not wait for all the good news to arrive. In fact, bull markets have one thing in common; they all climb a wall of worry.

Perhaps, the important message for investors today is to vigorously review existing holdings and to search for new investments that will prosper when conditions brighten. **Sigma's** review process is ongoing. However, those stocks, many of which are in the telecommunications sector, that have come under the severest pressure, are receiving additional scrutiny.

Sigma believes there will be ultimate winners as well as losers in this sector. For companies too early in their growth path, too indebted, and with insufficient near term liquidity, defaults are already occurring and more are in the offing. Other companies will be shoring up their existing base of business, eliminating low return businesses and slashing costs. Surviving companies will be in a better competitive position, as marginal players will be forced to liquidate or sell out assuming they can find a buyer. Further, surviving companies will benefit from demand exceeding GDP growth longer-term as there are still productivity and efficiency improvements to be gained by employing more sophisticated communication networks. **Sigma** believes the stocks of companies in our clients' portfolios are among the survivors and, in some cases, the market has been overly punitive in its assessment of their business prospects.

Clearly, only time will tell whether there are better times ahead near term for the market as a whole and for the holdings in the portfolios of **Sigma's** clients. **Sigma** continues to emphasize companies that have a strong competitive franchise. Over time, these stocks hopefully should reward investors that have had the tenacity to stay the course through this recent difficult stock market environment. **Sigma** encourages its clients to think of themselves not just as investors, but owners. Decisions about investments in equities, just like home buying decisions, should be made keeping a long-term view in mind.

Written by: Ann J. Conrad, CFA