

Rebuilding Confidence

As I write this, investors in common stocks have been through two years of the equivalent of Chinese water torture as the market indices slowly but steadily declined interspersed with brief rallies, which buoyed spirits before the decline resumed. To assess the likelihood of a change in market direction, one has to understand how we got where we are and what factors are delaying a recovery.

Much has been written about the stock market "bubble" of the several years leading to the peak in April 2000. Economic bubbles have been around for centuries, going back at least to the Holland tulip mania of the seventeenth century. The unique aspect of the recent bubble was its extension to the world of corporate finance and the adoption of a get-rich-quick mentality by too many in the investment community.

A recent New York Times story featured Toby Lenk, the founder of eToys, a dot.com company with a concept that actually worked – for a while. The company sold toys on the Internet, competing with Toys

"R" Us and others. The company enjoyed some success until it was pushed into over expansion by its outside investors and imploded. The difference from so many other dot.coms was that Lenk sold virtually none of his ten million shares, thereby not reaping the rewards enjoyed by his outside investors during the bubble period. As the Times said, "He was always more interested in building a company than in getting rich, and in the end he did neither."

"Building a company!" That describes the missing link in too many companies in recent years. As one who has been there, after fifty years in business including twenty-five years as chief financial officer of a thriving company, I know that building a company is slow, painstaking, hard work. Innovation and acquisitions can help, but in the end it all comes down to the pitching, fielding, and hitting, i.e. strong management in the marketing, operations, and finance arenas. Unfortunately, the overextension of the Las Vegas mentality in too many

companies did not leave time for such mundane activities!

As the desire for instant wealth proliferated, a number of companies resorted to unsavory business practices to "make their numbers" as forecast by Wall Street and thereby pump up their stock prices. The process of inflating sales and/or deferring costs can work wonders to the bottom line of income statements and was exacerbated in some cases by self-dealing on the part of management. In too many instances, the auditors in these situations were either careless or not diligent and the accounting transgressions went undetected until the damage was done. Now the bankruptcy of Enron has led many companies to review their own practices, and over 100 companies are in the process of restating prior periods' earnings, a serious blot on U.S. companies' record of honesty and transparency in reporting.

Although the Internet bubble and the false promise of a "new" economy propelled the market to its new high in 2000, the price gains were

exaggerated by aggressive accounting and the accompanying Wall Street hoopla. What we have been experiencing is a return to a more normal price level for common stocks that, unfortunately, only becomes apparent in retrospect.

When the threat of terrorism, Middle East violence, escalating India-Pakistan conflicts, and a host of other political problems are added to this series of events, is it any wonder that common stock investors are nervous? But, as investors, all of us want some insight as to what happens next.

We believe it is encouraging that the Securities and Exchange Commission is aggressively seeking solutions to the recent accounting and corporate governance problems. In addition, the chairman of the investment bank Goldman Sachs recently bit the hand that feeds him by calling for changes in how public companies are run,

audited, and regulated in order to restore investor confidence. Although there may continue to be sensationalist headlines in the near term, we believe the direction of corporate governance is positive.

In addition we think our economy is in a recovery mode that over time will bode well for common stocks. In support of that opinion, we refer to a commentary in the Wall Street Journal editorial page by David Malpass, chief global economist of the Wall Street firm Bear Stearns. He thinks that the recovery is global in nature and that our economy is well positioned to benefit. Notably, we have “a growing labor force employed mostly in the private-sector, flexible jobs. This has massive positive implications for the U.S. and for the wide and widening U.S. advantage over Europe, which has a shrinking labor force employed mostly in government and unionized jobs.” This quotation defines

our country’s competitive advantage. It is this advantage that has shaped Sigma’s investment decisions during the past decade.

The next time we encounter something like the dot.com bubble, we hope we have the wisdom to recognize it. It reminds me of what my German grandmother told me: “We get too soon old and too late smart.” As investors we all have suffered from the bursting of the bubble and have endured the after shock of bankruptcies and accounting mistakes, as well as increased security costs and political uncertainty. Although it may be many years before we again encounter the double-digit gains of most of the 90’s, we continue to believe that common stocks represent the best wealth enhancement tool available to most of us.

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