

## ***FINANCIAL MARKETS COMMENTARY***

***1<sup>st</sup> Quarter 2002***

### **Summary**

This past quarter was significant, not for its returns (neither stocks nor bonds moved all that much), but for the attention focused on such issues as corporate accounting and full disclosure. Investors discovered that they had been deceived (in some cases, quite badly), and corporations were astounded to find themselves suddenly punished for doing the same things for which they had been rewarded in the past. This took the luster off a quarter that was surprisingly strong for the economy as a whole. Though no official pronouncement has yet been made, it is highly likely that the recession is over.

The biggest beneficiaries of a strengthening economy are economically cyclical industries like autos, paper & forest products, chemicals, industrial metals, steel, and the like. Also, hotel & lodging and retailers do better as investors anticipate that workers will have more money to spend. Typically, interest rate-sensitive industries like homebuilders would be hurt because rising interest rates cut into home sales. However, this housing cycle is so strong that those stocks have held up. On the other hand, a rising economy should lead to a pickup in business spending, which would be favorable to the technology sector. Unfortunately, this capital spending cycle is unusually weak. The hoped for recovery in tech is not yet in evidence, so tech stocks have given back much of their November and December gains.

For the quarter, the S&P 500 index of the largest U.S. companies rose 0.23%. The Dow Jones Industrials (which has a greater weighting in those industrial stocks like Dupont and 3M which tended to do well) gained 4.29%, while the NASDAQ Composite, which is more heavily weighted in the laggard technology and communications industries, lost 5.4%. Smaller company stocks, whose operations are generally less complicated, continued to outperform larger companies.

Bonds were hurt by the surprisingly rapid recovery in the economy. Investors began to anticipate the Federal Reserve's switch to a less accommodative policy by pushing up interest rates. The sharp rise in energy prices late in the quarter tied to the Middle East conflict only made things worse. The Lehman Bros. Government/Credit Index declined 0.47% on the quarter. Normally, high-yield bonds would benefit from a strengthening economy. However, growing concerns about corporate balance sheet tactics largely killed any momentum in that sector. The only sector of the bond market that saw rising prices was emerging market debt. This risky sector continued to benefit from the rising fortunes of Russia and Brazil.

International markets performed slightly better than the U.S. in the first quarter. Foreign stocks are generally cheaper because world economies have been weaker, so a worldwide economic recovery would provide more leverage here than to the U.S. Emerging markets were once again the stars (as they tend to be early in the year) with a gain of more than 11%. As a whole, however, foreign markets gained just a little more than one percent.

## Outlook

A certain equilibrium seems to have been reached in the stock market. There is a rough consensus that prices are fair – not cheap or expensive as a whole – and that profit opportunities going forward will be modest by recent standards. As a result, trading activities have declined substantially. Stocks may continue to drift in a range, paying modest attention to economic reports and political matters in turn. Since 1994, stock prices rose several times faster than earnings. Therefore, it may take several months or even years for corporate earnings to rise enough relative to stock prices that above average profit opportunities will once again exist. It is very difficult to earn high returns now, because the sectors of the market that are strong right now – real estate, gold, and emerging markets – are not appropriate for large percentages of a portfolio.

## Commentary

Several years ago, the notion became accepted that it was better for a company to retain its extra profits rather than pay them out as dividends. Dividends are taxable, after all, and a company might grow those profits internally at a much higher rate than the investor could otherwise earn. For example, a company could pay its shareholders a dollar of dividends per share or retain that dollar and use it to improve its operations. The shareholder's dollar might be worth 64 cents to him after taxes. If the company were growing at 10% per year, the shareholder's dollar would earn 10 cents (the first year, and more thereafter) inside the company. On the other hand, if he took the dollar in dividends, the 64 cents he had left, invested at 6%, would grow by about 4 cents per year. Buying rapidly growing companies that retained their profits (versus buying slower growing companies that paid out excess profits) was an easy decision.

For the better part of the 1990s, this was the paradigm. Investors sought rapidly growing companies, and were more than willing to pay higher prices for that growth. Somewhere along the line, however, the process mutated. There is certain honesty to paying dividends, since you can't pay out money you didn't really earn. On the other hand, reported earnings growth is just that – reported. Investors had to take the company's word that they were indeed growing. Companies and their accounting firms became increasingly creative in terms of putting the company's operations in the most favorable light. Many accounting firms had consulting arms, so the consultants could help the company get around standard accounting procedures. Investors demanded consistent, rapid earnings growth (except, perhaps, an upside earning surprise), so companies became adept at setting expectations that they could beat - and making sure to beat expectations whatever that might require. The innovations in investor deception were truly breathtaking – recognizing revenue to be earned in future period as current earnings; stuffing distribution channels with product and claiming it as sales; taking the costs associated with research and development and assigning them to a separate company that was off your balance sheet – and so many more. My personal favorite was reporting earnings on a *pro forma* basis. This is where companies count and omit whatever they deem relevant. Warren Buffett, in Berkshire Hathaway's annual report, made a humorous analogy to *pro forma* golf, in which he chose to highlight the improvements in his iron game by not counting his putts.

Of course, a market built on such a foundation could not stand, and it didn't. We've gone through a two-year period where investors have realized that the companies that retained all their earnings did not necessarily compound them at higher rates. In fact, many didn't compound them at all! Conversely, investors now tend to favor dividend-paying industrial companies (once shunned because they are cyclical and tax-inefficient) because they are regarded as honest and easy to understand. This is a healthy process. As investors, we will be the better for honest, accurate accounting, and an investment climate that rewards telling the truth, even if the truth isn't pleasant.

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