



VALUE FINANCIAL ADVISERS, INC.

Investing after Y2K

December 27, 1999

As long as computers or obsessed humans don't create havoc, January 1, 2000 technically, is just another New Years Day. Still, it seems like a reasonable time to share our collective thoughts about investing in the upcoming New Year / Century / Millenium.

This letter will be longer than most you've received from us. It addresses 1999, the current trends, what we believe the future holds and finishes with recent insights from some of the world's most successful, long-term investors, Warren Buffett, Peter Lynch, Sir John Templeton and others. And while we understand there's no shortage of data and opinions available to consume, we hope you'll take the time to read this. Obviously, we believe the information below is valuable as you make financial plans for you and your family's future.

1999 - An UNUSUAL Year

As we write this, 1999 is not over. But unless some dramatic changes ensue, this year's U.S. financial markets can be called (searching for the correct word, we chose) 'unusual'. Out of the thousands of statistics available, the ones below, we believe, accurately summarize 1999.

The NASDAQ (dominated by Internet and technology stocks) will have the largest annual gain in its history.

Yet, for all NYSE companies, the stocks of those with no earnings gained an average of 52 %, while those with earnings lost 2 %.

Thirty IPOs (Initial Public Offerings, essentially new stocks in companies with no earnings) gained more than 1,000 % each.

Yet, Berkshire Hathaway stock (Warren Buffett's company) fell 23%.

A record \$69 billion was raised in IPOs.

Yet, the price of the average IPO with no earnings rose more than twice that of the average IPO with earnings..

More money was raised for new junk bonds than any year in history.

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Yet, judged by the 'long bond', bonds had their worst year since 1927.

Two Internet stocks, Amazon.com and Yahoo, have a combined market cap (shares of stock multiplied by the stock price) 25 times greater than Ford and GM.

Yet, Ford alone, has more profit than the combined revenues of Amazon and Yahoo!

As regards stocks, more than half of all U.S. stocks are down for the year! 2/3 of all stocks on the NYSE and NASDAQ are down at least 20% from their highs. From a prudent investor viewpoint, the problem with the stocks that are up, particularly those up a lot, is that they were priced way too high when the year began and simply went higher. The price / earnings ratio (P/E) for the NASDAQ Index, for example, is at 175. The P/E was over 100 on January 1st. For comparison, P/E ratios for U.S. stocks have averaged 15 during this century.

If you do the math, profits from businesses have to grow at extraordinary rates to support P/E ratios of 175. And if you look at history, P/E ratios have been high before (although never at this level) but profits have never grown fast enough to justify such prices. Consequently, stock prices have always collapsed from similar high levels.

And as the year is ending, rather than selling due to Y2K worries, investors are buying and driving Internet and technology stocks even higher!

We could go on and on, but, you get the picture. Unusual indeed!

The Internet

In simple terms, U.S. stocks in 1999 are divided into two tiers; those whose business is directly and substantially involved with the Internet and those that are not. The stocks with the largest percentage gains in 1999 are almost all Internet companies. The percentage returns of U.S. market indices are largely the result of Internet stocks. The more Internet stocks you own (NASDAQ, for example) the more you out-performed others (the DJIA, for example).

We see the Internet in two ways.

First, like the Agrarian and Industrial Revolutions before, the Internet (coupled with other 'chip' related technologies; computers, cell phones, fiber-optic cable, others too numerous to mention and all the ones not yet invented) has the power to improve efficiencies in so many widespread applications that it can properly be called Revolutionary. History hints that the current applications for Internet efficiencies are probably a small fraction of the ones that will emerge in the next 10, not to mention 100, years. The current rage, on-line consumer shopping, should rapidly be eclipsed in impact

by business-to-business and 'behind the scenes' efficiencies that will lower costs and improve standards of living for Americans and, more slowly, the rest of the world.

Second, however, as a sector to invest in, one needs to be extremely cautious. Investor excitement has created a huge influx of money to Internet enterprises. Thousands of new businesses have been created. Relative to the total monies invested, profits are essentially non-existent. In fact revenues, although growing for some, are historically well below a level that would predict a profitable venture over the long-term. Some futurists maintain that those companies directly involved in the Internet (compared to those utilizing it to improve their efficiencies) may never, in the aggregate, be profitable.

Warren Buffett, for example, suggests one look at the Airline Industry as a possible model for future Internet profitability. He suggests that few industries have had as definable an effect on the global economy and consumer's standard of living as have Airlines. Yet from the dawn of aviation through 1992, taking into account the total monies invested balanced against the numerous bankruptcies and successes, Buffett believes that total net profits for the commercial Airline industry were zero! Without predicting the future, it is possible that like the Airlines, Internet companies will continue to use lower prices to compete for market share. So while the consumer gets better service at lower prices, companies within the industry cannot sustain substantive profit margins. In fact, as of today, one could characterize the Internet as a 'profit-crushing' technology.

Even if the Airline model does not repeat itself exactly, investors should admit to themselves that IPOs and stocks trading at 1900 times earnings (Yahoo) are speculations, not quantifiable investments. Revolutionary ideas often occur in tandem with high investor expectations. This combination, however, rarely results in acceptable returns for those excited investors. One dollar invested, for example, in every computer stock in 1980 would have compounded at just 4% per year through December 1999, less than one would earn buying a federally insured certificate of deposit!

We suspect that a poll during most years, asking whether investors wanted to "invest their college or retirement funds in untested companies with no earnings and companies selling at hundreds or thousand of times current earnings" would bring laughter and a resounding no! Currently, however, Internet stocks have price momentum and new investors continue to pile in, blind to any mathematical logic or long-term business valuation.

Investing in .com and .net companies is like shooting craps; playing doesn't guarantee you'll lose, just that the odds are against you. With Internet stocks it's very difficult to know which ones will survive (we believe the majority will not). And even if you pick a survivor, the chances are slim that the price you pay today will result in a profitable investment. Like all craps games, prudent people either don't play at all, or play with money they absolutely don't mind losing.

On-line & Day Trading

There have always been day traders. In the past these were primarily quasi-professionals who did their own research because they wanted to or because they thought they were better than their adviser / broker. 1999 evidenced an increasing number of Americans who decided to bypass the traditional brokerage business to trade their portfolios directly, on-line, through computers. Some choose to buy and sell extensively, often closing out all positions at the end of the day; hence the term, day trading.

As with the Internet, we have two thoughts. First, on-line trading, for both professionals and consumers, is here to stay. We increasingly place trades on-line. Additionally, on-line research is more efficient than previous systems. These efficiencies are good for everyone, advisers and clients alike.

Second, day trading, however, is gambling. Think of it this way: the true, fundamental value of a company changes very slowly. Yes, the market price may fluctuate daily, but that evidences the flow of investor's money, not the real value of the enterprise. So, shortening the time horizon to a couple of hours is simply betting on the flow of money into or out of the security (caused by the short term behavior of other investors) and has absolutely nothing to do with the long term profits and prospects of the enterprise. In any other setting, most would agree this constitutes gambling.

A New Era ?

Over the last couple of years some have postulated that due to the Internet, computers and related chip technologies mankind has entered a New Era. Consequently, the old rules, including the old investing rules, are no longer valid. As regards money, this New Era theory maintains that Internet stocks can continue to sell at nearly astronomical multiples and the economy can grow forever with low inflation.

Of course this New Era theory is not new. The same words were used to describe the U.S. economy and financial markets in the 1920's. Similar logic explained away the risks in the bubble economy of Japan in the late 1980's. A study of history finds numerous similar circumstances that appeared, for awhile, to seem permanent only to 'fall back to earth' eventually.

Chip technologies have, and will continue, to change the world. But will this technological change invalidate the old rules of investing? We don't think so. Over the long-term, money is smart. On average, people who accumulate money are smarter (judged by financial definitions) and more productive than those who don't. These accumulators demand their money earn the highest return possible relative to the risks they are willing to take. Companies must make profits if, over the long-term, their stock price is to appreciate. In the short-term, money may be invested in assets based upon an

expected profit. Eventually, however, that profit must materialize or the 'smart money' will dump the stock.

Many of the hottest stocks today (Internet and technology) have no profits. As Buffett remarked, investors are buying these stocks only because the price is going up. We re-state the statistic from page 1: the stocks on the NYSE with no earnings appreciated 52% in 1999 vs. a 2% decline for companies with earnings. The history of investing shows numerous similar periods where money chased high expectations. Generally, the outcome is predictable. Most investors lose all or a significant portion of their capital. The insiders and investment bankers make a ton. And the occasional investor, lucky enough to buy and hold the correct securities, retires wealthy.

Just because the Internet is new and revolutionary does not predict to us that all the rules are new. Nor does it infer that money has now become stupid and will continue to buy investments which don't eventually show acceptable profits from each dollar invested. Warren Buffett counsels investors to learn "The inescapable fact is that the value of an asset, whatever its character, cannot over the long term grow faster than its earnings do".

To be clear, we have no prejudice against Internet or technology companies. We have purchased some in the past and will probably buy more in the future. Specifically we'd like to own industry leaders and companies who benefit directly (possibly in a 'mine-the-miners' role) from the industry. Our current aversion to most of these stocks takes two forms: prices are unrealistically high and profits are unbelievably low.

Value Investing vs the Rest

The facts are irrefutable. Over time, Value Investing has better average rates of return, with lessened risk, than any other known strategy. The facts also point out, however, that this out-performance is not an every year guarantee. Just as the last couple of years have shown, there have and will continue to be periods where Value Investors are out-performed by investors using some other system.

Value Investors believe that profits are important. In analyzing stocks, Value Investors attempt to purchase a future stream of income (profits) at a price that creates a mathematically attractive rate of return. This same math based analysis is used for bonds, cash and other investment vehicles. Generally, Value Investors are trying to achieve an attractive average rate of return while taking the lowest risk possible. This is what Ben Graham, the father of Value Investing, called a margin of safety.

We believe that the current under-performance of Value Investing will be followed by a period of over-performance. We are confident making this prediction for two reasons. First, we believe that Value-selected investments will, generally, produce profits that increase, relative to the price paid, at a much more attractive rate than the hot

growth / momentum stocks that are currently leading the rate of return race. Second, in every other instance throughout history, Value investments have re-gained their lead.

There is only one 'scientific fact' about investing. Most investors eventually come to understand it. That is: the current price of any security reflects the flow of money, not necessarily the true value. In the short-term, your stock or bond may be selling at a low price and have attractive earnings yet appreciate less than another stock or bond, priced high with no earnings. Fear and greed influence what many investors do with their money and this flow of money is the only direct way to affect the price of a security.

Well then, you might ask, if prices are random, isn't this just another form of gambling? Not really and here's why. While money flows influence prices, particularly in the short term, over the long haul prices of investments rise or fall almost exactly in line with their earnings. This is the 'hole card' of the Value Investor. By buying only those investments that are priced low relative to earnings, (and / or assets, cash flow etc.) eventually, the prices out-appreciate other systems because their underlying investments produce more profits from each dollar invested.

It's a simple, common sense system. Additionally, history indicates more money made this way than any other system. By the way, most of the great, long-term successful investors are Value Investors.

The Experts

One important component of our investment process is that we pay close attention to the opinions and actions of some of the worlds most successful, long-term investors. We weight these opinions and actions more than those from TV, radio, newspapers, magazines, etc. We believe that, since successful investing is best judged using long-term results, input from the most successful long-term investors can help us make prudent decisions for you, our valued clients. Its not necessary that any of us invest exactly as these fellows do; often their circumstances are different from ours. Their experience, however, is invaluable in locating opportunities and avoiding undue risk. Below we summarize recent investing thoughts from some of these tremendously successful sources:

Warren Buffett was recently voted the Top Money Manager of the 20th Century in a survey of over 300 investment professionals. His 34-year, 24% compound rate-of-return is phenomenal, particularly when you consider the extremely low risk taken. As evidence of the unusual state of the U.S financial markets in 1999, Buffett's Berkshire Hathaway stock is down over 23% y.t.d.

Buffett, due to the large amount of money he controls, is forced to buy stocks of very large companies. Currently he is 'sitting on' \$ 15 billion of cash because he cannot find large companies whose prices are low enough to warrant investing.

In a series of speeches this year Buffett discussed his opinion of the U.S. stock market. Based upon the math, i.e., stock prices at historically high multiples of earnings compared to a 'reasonable' expectation of earnings increases and a 'reasonable' expectation of growth of the U.S. economy, Buffett surmised that annual rates of return to investors in U.S. stocks "in the aggregate" (he repeated "in the aggregate") would be 6% over the next couple of decades.

This experience and math based prediction by one of the world's most successful investor is far lower than recent polls wherein the average investor with less than 5 years' experience expects 22% per year over that period. It is lower, too, than polls of investors with 20 years' experience who, on average, expect 12.9% per year returns.

Buffett makes clear his reason for differing with other investors' expectations; "The inescapable fact is that the value of an asset, whatever its character, cannot over the long term grow faster than its earnings do". This stance, of course, puts Buffett clearly on the opposite side from today's technologically absorbed stock market where Yahoo trades at 1900 times earnings and Internet IPOs, with no operating history, increase 1,000%.

This divergence brings to mind a Buffett quote from 1969; "I am out of step with present conditions. However, I will not abandon a previous approach whose logic I understand even though it may mean foregoing large, and apparently easy, profits to embrace an approach which I don't fully understand, have not practiced successfully, and which possibly could lead to substantial permanent loss of capital". Buffett, who had made millions in stocks over the previous 20 years, essentially stayed out of the U.S. market from 1969 until it crashed in 1973 / 74. At that time he re-entered, scooped up incredible bargains and made billions.

Peter Lynch, though retired as an active stock fund manager since 1990, his legendary 29.2% annual return over 13 years at Fidelity's Magellan Fund ranks as one of the greatest securities management records of all time. Lynch had a keen eye for small stocks and downtrodden value plays.

In November 1999 Lynch answered questions for Dow Jones Asset Management. Asked whether things were different now than 10 years ago Lynch stated "We haven't changed the rules of fear and risk. If earnings go down, stocks go down. My method of making money was to look for companies that were depressed or small companies that could grow into big companies".

In response to, "is there a theme to the investing you do these days?" He added "...big stocks, small stocks. Generally they're out of favor". Out of favor, in case you're wondering, translates into inexpensive. Lynch, like most successful investors, tries to buy when prices are low, not when they're high.

Regarding Internet stocks Lynch had a lot to say. "When a stock has a reasonable downside risk, you'd better make sure there's some upside potential. That's the problem with some of these Internet stocks. You can be right on the company and not make money because the market is already discounting 10 years worth of future earnings." Amazon has to make a lot of money in the next five years to justify its price. You can't just say, "They're going to make money in the future, it has to be a lot of money." At present, by the way, Amazon's losses grow larger with every new dollar of sales.

On day trading Lynch warned, "People are doing more gambling than investing. Some people think long-term investing is three weeks. That is not a way to make money. My best stocks have been the third, fourth, fifth year I've owned them, not the third, fourth, or fifth day."

Sir John Templeton, also retired from active management, has one of the longest, successful track records of this century. Called the Dean of Wall Street, Sir John is recognized for his ability to find bargains around the world.

Regarding investing in a Standard & Poors 500 Index fund Templeton cautioned, "There is a vast amount of new investment by people who don't know what they're doing, so the stocks of famous businesses have been bid up much more than unknown businesses or unknown nations. It would not be wise to invest in an index fund that specializes in big companies".

Asked how to determine where the worldwide bargains are, Templeton responded "...all freely traded markets have excesses in both directions. They go up too high, and they go down too low. They are subject to waves of excess optimism and excess pessimism. And we had excess optimism in Japan 15 years ago. It's been down, down, down (ever since) and I'm not sure it's at the bottom yet. And the same thing has happened in over half of the world's markets...though it has not happened in America. But that doesn't mean it won't. The U.S., for example, has had only minor bear markets for the last 17 years. The U.S. is roughly 50% of the world market, so you should have less than 50% in a market that has not had its bear market".

Ed Hyman, recognized for over 20 years as the Top Economist in the world by Institutional Investor Magazine, is one of the most widely read economists by professional investors and the only one Peter Lynch paid attention to. Ed's firm, ISI, actively manages several Bond Mutual Funds and is relied upon by many who manage Stocks.

Hyman feels strongly that current U.S. consumer spending is tied closely to stock market swings. If the market goes up, so does spending, and vice versa. Upward stock price moves, therefore, are positive for most Americans. Stocks rise, Americans spend more. More spending helps corporations who, ostensibly, make more profits. More profits influence stock prices to go higher.

As positive as this trend is, the reverse is powerfully negative. Once something (and since things always cycle, there will be a 'something') interrupts this virtuous circle it quickly becomes a vicious circle. Stock prices fall, spending slows. Corporate profits decline, workers are laid off. Fewer people working further reduces spending and so on.

Additionally, Hyman feels global economic growth may be peaking. A slower world economy makes it harder for U.S. corporations to increase profits.

Bill Gross. Not only does Gross manage more bonds (PIMCO) than anyone on earth, he's had the best total return of any quality bond manager over the last 10 years. Given his success, in spite of the enormous size of the portfolio, Gross has been on the mark as regards U.S. economic activity.

Gross agrees with Hyman's assessment that the U.S. economy needs higher stock prices to sustain current spending levels. He calls this 'Ponzi-like' (after the investment scoundrel Ponzi). Americans are, for the first time in over 50 years, spending more than they are making. In 1999 consumers will spend approximately 5% more than their income. This 'extra' money is coming from capital gains (stocks and real estate) and new borrowing.

Gross is worried that our current prosperity "depends on prosperity itself, and at least some of our prosperity depends upon a booming stock market". In November 1999 Gross stated "History shows that the current state of affairs cannot continue indefinitely" and that "Without a prosperous stock market, it all can come undone rather quickly".

Conclusion

We believe intelligent investors, with their serious money, want a statistically rigorous investment strategy that takes a minimum of risks. While all investors want high rates of return, intelligent investors are unwilling to chase high returns if the downside is permanent loss of capital.

Most successful investors follow the Value strategy. In addition to best answering the needs addressed in the paragraph above, Value Investing has produced the highest rates of return over the longest period of time. It makes sense that successful investors would embrace such a strategy.

Currently, however, we understand the enigmatic look of the U.S. financial markets. As referenced in statistics above, the high-risk-takers are currently making higher returns than Value Investors. The longer this occurs the more likely it is that investors wonder whether some New Era is in place and whether they should migrate to a New Era strategy. All that we wrote above was intended to present a logical, time-tested view of these current conditions to help you make prudent plans for the future.

As you might have concluded, the Value approach, coupled with continued input from the experts quoted above, is the strategy we plan to follow. We believe the disciplined buying of low-priced, high quality investments today, both domestic and foreign, will produce acceptably high rates of return in the future with little risk of permanent loss of capital. We don't buy the stock market, we buy individual stocks. We believe that staying less than fully invested at this time will enhance our long-term rate of return. The future is as bright as ever, we are confident, for investors who can exercise discipline and remain patient.


We appreciate you taking time to read our rather long treatise. Additionally, we very much appreciate your ongoing business and support. Please call us if you have questions about our writings. And don't hesitate to call on us if we can be of help in any way to you or your family.

Best wishes for a New Year / Century / Millenium


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