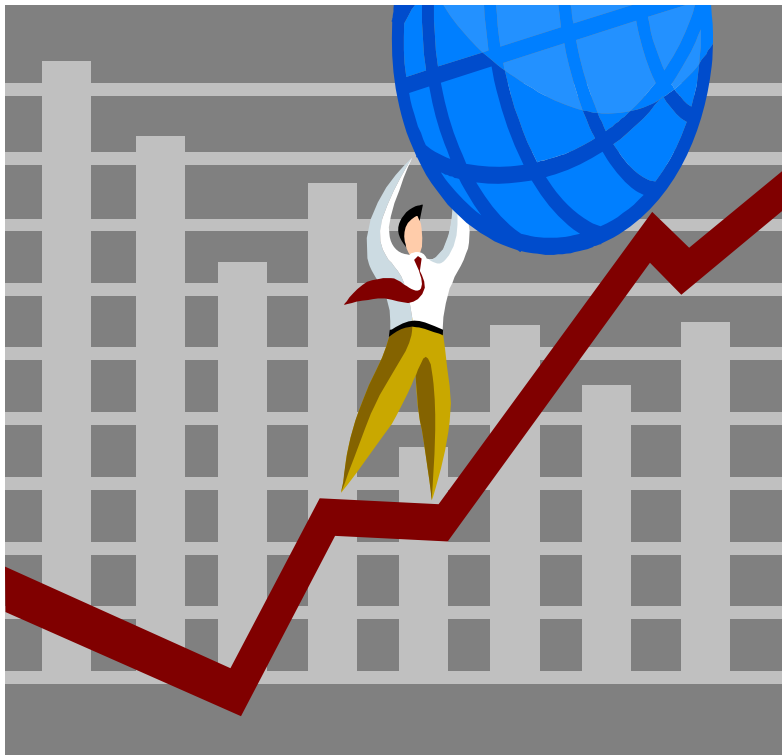


# Priced For Perfection

## 1999 Q1 Quarterly Commentary



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The panic of '98 seems like a distant memory. Over the past 100 days equity markets have rallied tremendously after central banks unleashed a torrent of liquidity in the form of interest rate cuts. This invites the question: was that the bear market and is the worst over? Our prediction is that we are in for a very volatile year in equity prices with a pretty good chance of another sizable correction before next January.

Some asset classes have rallied back to their old highs and have actually reached new highs: particularly large cap and technology stocks. Unfortunately, from a fundamental perspective these same stocks are looking exceedingly expensive when measured using valuation methods like price to earnings and price to book. In fact, they are even more expensive than they were during the summer, before the panic.

Investors bidding up these stocks must be expecting a perfect earnings and interest rate environment to justify the prices – priced for perfection. As we mentioned in our June '97 report, as inflation approaches zero and interest rates plummet, equity and long-term bond price appreciation might accelerate. We are experiencing that "zone" now. The downside to this scenario (also mentioned in '97) is the increased volatility that accompanies it. Going forward, healthy corporate earnings must be present for equity prices to continue their climb. Achieving them will be improbable however, if the global economy starts slowing down.

From our perspective, the risk is that equity markets remain very expensive while at the same time the global environment is problematic (not to mention the risk of Y2K): Asia is getting off the mat (but just barely); the "contagion" has crossed the Pacific to Brazil with the threat of spreading to Argentina and Mexico; at the same time, Europe is slowing down. Not a terrific scenario.

On the other hand, this may possibly be the bottom of the global economic cycle and the Y2K conversion may be as easy as the preliminary conversion to the Euro completed without incident this past January 1.

Another scary aspect to markets is how some sectors have totally disconnected from their underlying fundamental value and appear to be solely price-momentum driven. The epitome of this trend has been Internet stocks like Amazon.com and Yahoo. The valuations of these stocks are truly stratospheric: at one point in January, Yahoo's market capitalization (what the company is worth) was equal to Boeing and Texaco combined. If this trend does not abate and spreads to the whole market, equity prices may become hostage to a commodities-like spike with the potential of an aggressive sell-off... price-momentum works on the downside too.

Over the past couple years, a well-diversified portfolio has under-performed the S&P500. Of course, this is to be expected since a diversified portfolio will always trail the best performing asset class, particularly an equity asset class. Moreover, with valuations currently as high as they are in the S&P500, one may logically conclude that this under-performance is normal and makes sense. The mistake that many investors sometimes make, however, is to extrapolate a short-term trend over the long-term and then put all their eggs in one basket, often with debilitating financial results. We avoid this, and believe that over the next few years diversification will prove to be the optimal strategy as the valuation differences between various asset classes converge.

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# Disclaimer

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