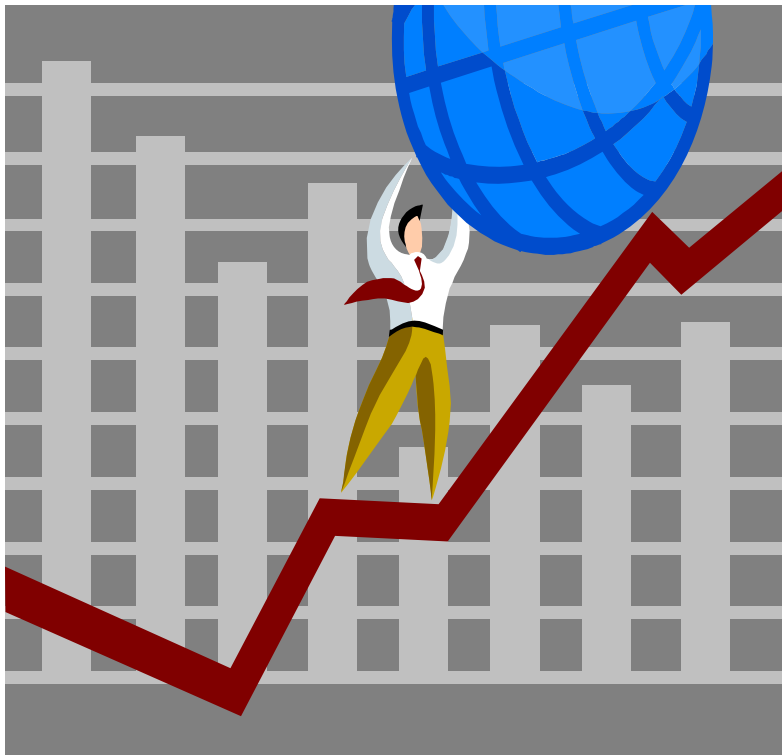


# Paradigm Surfing: When Models Break Down

2002 Q2 Quarterly Commentary



**Robert W. Henkel**  
Chief Investment Officer  
[bhenkel@weyland.com](mailto:bhenkel@weyland.com)

### Paradigm Surfing: When Models Break Down

You have to give the technical analysts their due. Technicians speak about 50% retracements in the markets, i.e. that markets tend to reverse course at the 50% level. Although fundamental analysts regularly deride these "technicians", one fact can't be disputed:

On January 11, 1973 the S&P 500 had an intra-day high of 121.74, an all-time high. Over the next 22 months, the S&P 500 experienced pretty much the worst bear market since the depression. It bottomed on October 4, 1974 with the S&P 500 reaching an intra-day low of 60.96, a 49.93% retracement.

On March 25, 2000 the S&P 500 had an intra-day high of 1552.87, an all-time high. As we well know, the past 28 months have been brutal. On July 24, the S&P 500 traded intra-day at 775.68 before recovering, a 50.05% retracement.

Score a big one for the technicians.

Only technical analysis seems to be working well right now. Fundamental, "interest rate" valuation models traditionally used to figure out the "fair value" of the market are greatly under stress, possibly on the verge of experiencing a discontinuity, on the verge of breaking. During the end of June and early July, they were flashing extraordinary "buy" signals. The market just cratered.

Enron, Adelphia and WorldCom have scared the markets horrifically, leading to an environment that is quite uncommon. P/E ratios that had been considered cheap by valuation models, all of a sudden seemed to "invert" becoming expensive given the perceived systemic risks of egregious accounting lapses and widespread corporate malfeasance. The models were, and are, creaking like the submarine in the movie "Das Boot." Creaking, but not broken, yet.

Some worry that the U.S. is entering a Japanese-like malaise that could last ten years. I think this outcome remains unlikely as we have already, collectively tackled key issues:

- Obfuscating accounting methods that have created distrust in our companies and our markets. (It even looks like option expensing will be somewhat broadly embraced; an issue I thought would hang over the market for years to come).
- Investment banking influence on compensation systems and stock rating systems used by Wall Street firms
- Misuse of privileged information and company assets by executives. (Opportunists like Bernie Ebbers, Dennis Kozlowski, Andrew Fastow and Martha Stewart are poised to share the Leona Helmsley Suite at the Sing Sing Resort. Hang 'Em High!)

Meanwhile Alan Greenspan and the Fed continue to recognize the threat of deflation. In my opinion, they have done their homework and have largely executed the correct policy. Furthermore, they will not hesitate to use, in a prudent way, all the tools at their disposal to avoid such a scenario. I believe that the Fed will be able to reflate the economy, but it may spawn an intermediate era of somewhat higher inflation.

Nevertheless, we are in a period of extreme volatility which has led us to temporarily reduce our clients' exposure to equities. Our strategy is to dollar average back to our normal allocations over the coming year or so. We may lose a little on the upside if the markets go straight up from here, but we feel right now that the emphasis should be, at the margin, on capital preservation.

One very good thing is that it won't take that much return for our portfolios to return to their old highs. Frankly, that's because we haven't lost that much. For example, if your portfolio has been reduced 15% from its high (a return which most clients have done better than), you would need a gain of 17.6% to equal your old high. Compare that to the S&P 500 or NASDAQ:

	S&P 500	NASDAQ
Apr '00 - Jul '02 Returns:	-37%	-71%
Returns Required to Reach Apr '00 Level:	60%	244%

So in a sense we are "spending" a small amount of the tremendous out-performance we have "accumulated" over the past two and half years by being a little cautious in this current extraordinary environment. If, as I hope, the models are battered but correct and this turns out to be a great buying opportunity, no matter, we're in - just not all the way in. On the other hand, if we enter a truly stressful time, we are committed to portfolio stability and to increased portfolio protection.

## The Morning After

Some investors, after having lost so much in the markets, are putting all their money into CDs, money market instruments or Treasury bills for the long haul. This is a typical, all or nothing, over-reaction. As the following chart shows, these asset classes are historically terrible performers compared to a diversified U.S. equity portfolio as the bear market ends:

### 10 Year Total Inflation Adjusted Returns:

	Treasury Bills	Diversified U.S. Equity
1933-1942	-21%	180%
1975-1984	14%	298%

Note: Diversified U.S. Equity Portfolio: 36% Large, 24% Large Value, 24% Small, 16% Small Value, Rebalanced Annually.

So if this time is not different (and it rarely is), then we will return to the "good old days." But until we get there, our objective is to balance the risks.

### Trust

We feel great pride at being able to serve as your advisor during these “interesting” times. Although sometime stressful, always challenging, it is what we enjoy. We’ve gotten most of it right, and that’s pretty good.

Regarding the future, we trust in it, as we believe in capitalism. We believe in the capital markets, in commerce and in the free exchange of ideas, the foundation of capitalism. We do this because, in the end, it works.

**Bob Henkel**  
Chief Investment Officer

# Disclaimer

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