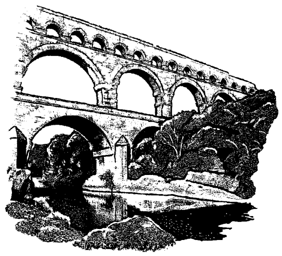

Stanley E. Rulapaugh, CFA **October 1, 2001**

The shock of September 11, by markedly raising the degree of uncertainty about the future, has the potential to result, for a time, in a pronounced disengagement from future commitments. Indeed, much economic activity ground to a halt last week.

Congressional testimony of Alan Greenspan, chairman of the Federal Reserve

When I got up on Tuesday, September 11, 2001, I turned on the television to get an indication of what the markets were likely to do that day. Instead of the usual blather on CNBC, I saw smoke coming for the World Trade Center. Unfamiliar talking heads tried to describe the incomprehensible. I flipped channels for about an hour (just like everyone else, I suppose) trying to find the latest tidbit of news. The markets had "temporarily halted" trading so I decided to hurry to work. Of course, there was nothing to do. I tried to read the *Wall Street Journal* but could not concentrate. Besides, most of the information was not only old but instantly obsolete. Did it really matter that Qwest cut their revenue growth estimates or that the budget surplus was shrinking? The pile of unread research on my desk was also useless and so was the e-mailed "research" on the computer. Meanwhile, the talking heads on TV droned on. The words "barbaric" and "uncivilized" were tossed about on every channel while the footage of the second plane played in an endless loop.

One of the problems with a liberal arts education is that your mind is cluttered with millions of quotes and facts. On Tuesday afternoon, for some unknown reason, I recalled a quote from Lord Kenneth Clark from his classic 1969 book and TV series Civilisation.

> What is civilisation? I don't know. I can't define it in abstract terms - yet. But I think I can recognise it when I see it . . .

Clark (1903 - 1983) was a noted art historian and director of the National Gallery in London. His approach to civilization (small "c") was that a society should be viewed for what they do rather than what they say.

> If I had to say which was telling the truth about society, a speech by a Minister of Housing or the actual buildings put up in his time, I should believe the buildings.

I thought of Osama bin Laden and the legacy he is creating for himself and his followers. Their words are irrelevant. It is the action that is important. The home movies of bin Laden that have been released show him sitting in the dirt beside his beloved AK47. Other shots show him crawling into a small cave or sitting in a tent somewhere unpleasant. It is ironic that Iraq and Iran, centers of the most extreme of the believers, were among the first "civilized" areas of the world. Uruk in Mesopotamia (Iraq) was the world's first walled city housing as many as 50,000 people. Written cuneiform tablets as old as 3500 BC show that these people thought they had something important to preserve. Obviously, the current generation of terrorists from this part of the world has nothing productive to offer future generations so they destroy. We are left to wonder what their vision really is - a return to the "paradise" of the seventh century when Muhammad was alive? Islam holds a fatalistic view of life that, for most followers, does not include the freedom of self-determination, especially for women. To them, Americans and the western world cannot be allowed the freedom to choose how to live our own lives. We must be taught the error of our ways, or killed. Now that's what Clark would call "uncivilized."

The stock markets have been unkind to all of us this year but September has been brutal, particularly since the September 11 attack. The decline from the top has taken us back to levels last seen in 1998. An investment valued at $1,000 in a "safe" S&P 500 index mutual fund on January 2, 1998, for example, was worth $1,073 on Friday. At the top last August, it was worth $1,564. Most people focus on the 30% loss from the top and ignore the fact that they are up from a few years ago. The exception to this statement is that too many started investing near the top and have lost a bunch. Nasdaq, the playground of the day trader, has lost more than 70% of its value since March 2000. A $1,000 investment then is now $300. Some say Nasdaq is still too high despite the drop. Aptly named Exodus Communications, a hot internet stock that was $80 eighteen-months ago, filed for bankruptcy this week and made its exodus at seventeen cents.

There are many more stories like Exodus. I call these "Virginia" stocks because their share price charts over the last three years look like the state of Virginia (map at right). Think not? Check out Exodus, and the big names Cisco, Corning, EMC and Sun Microsystems at www.bigcharts.com. The only investors making money in this market have a flaky investment philosophy that has been wrong for years. Now that they are making money, at least in the short run, they are getting the TV interviews. Ignore these manager interviews because even a broken watch tells the right time twice a day.

A *Business Week* editorial (September 24) stated that "a recession may be inevitable" as consumer confidence plummets and layoffs grow in the face of slowing sales. *BW* is late. We have been sliding for months. Most observers now believe the recession is now. Unemployment claims reached a nine-year high in late-September with more to come as the airline, aircraft and hospitality layoffs bite. Policy makers have been forced to open the purse strings, flooding the system with liquidity. The Fed lowered interest rates again before the market reopened on September 17 and is expected to lower them again the first week in October. Our politicians are showing a willingness to cut taxes, offer loan guarantees and bailouts, and generally get along with each other to get us out of the slide. The economic recovery we thought would be here by now is now forecast for next spring or summer. If life returns to normal sooner, the recovery will arrive sooner.

In the meantime, what do we do with existing portfolios? There is always a temptation to want to sell into uncertainty and wait for times to get better before recommitting cash. This never works the way you expect it to. A University of Michigan study of market activity between 1969 and 1993 showed that the ninety best trading days (less than 1% of the trading days!) accounted for 95% of the market's gains. In 1991, the S&P 500 rose 31% after the start of the Gulf War. Half of that came in the 22 days following January 16. Another 8% came in the last six trading days of the year. Obviously no one knows when the current shooting war will start, much less end, so trying to outsmart the market players is a fool's game. One objective, then, is to make sure that there is sufficient cash in accounts to take care of any emergency. Nothing is worse than selling a stock at a low price to fix a leaky transmission. That could be a very expensive transmission, indeed. Once portfolio liquidity needs are met, it is certainly a good time to buy shares of companies that stuck to their knitting through the downturn.

A second objective is to make sure that the stocks we own now are the ones we bought. Hewlett-Packard comes to mind. In my opinion, the company is making a big mistake with its proposed acquisition of Compaq Computer. Both HP and Compaq were very strong companies that have been weakened by slowing computer demand. Putting two weak companies together won't create a strong company without a revival of demand. When it does come, a company like Dell Computer will prove to be a formidable competitor. HP should call off this transaction. It is a loser.

Bonds are a particularly difficult choice right now. Rates are low across the maturity range. Yields on government guaranteed notes are below 3.0% for maturities shorter than two years, below 4.0% for five years, less than 5.0% for ten years and less than 5.5% for thirty years. The Fed's attempt to pump up the economy could lead to inflation two or three years from now and inflation is the worst thing that can happen to bond holders. Ten years is a long time and thirty is an eternity.

Finally, it is that time of year when companies will be announcing their earnings for the third quarter at the same time most mutual funds try to clean up their portfolios for an October 31 fiscal year end. Funds do this by selling "bad" stocks and buying "good" stocks. Corporate earnings announcements will determine what is "bad" and what is "good." While it is never a good idea to sell a company because of a single bad quarterly earnings report, it may be a particularly bad decision this time. Alan Greenspan warned us, in his usual obfuscating testimony, to expect bad earnings from every company the next few weeks. Hang in there.

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