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## History Repeats Itself, Again

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By Randy Zaharia

One year ago, we printed an article, "Two Tales and Holy Grails," addressing overvaluation of Internet stocks and booms and busts of the past (e.g., electric light, autos). Subsequently, with surprising speed, the tech-dominated NASDAQ fell by over 60% from its peak. The other major stock indexes declined as well, although not as deeply.

Given the history of "new technology" shake-outs, it is most constructive to view the decline of the NASDAQ as a normal correction of excessive valuations. But with the market's decline, there has been a deterioration in confidence and spending. Our economy is now facing two hurdles, both part of the normal economic process: 1) a more realistic outlook for technology companies, and 2) the downside of the business cycle. Ultimately, this environment provides opportunities to construct attractive equity portfolios for the next three to five years.

### THE INTERNET & NASDAQ COLLAPSE

The collapse of the NASDAQ (see the chart on page 2) and the hobbling of the Internet sector has been most painful to those investors concentrated in that area. Recent statistics showed "dot.coms" closing at

the rate of a dozen per week, out of the hundreds that were started during the Internet boom. Amazon.com, an Internet leader, continues to project significant losses, while major tech companies continue to consolidate and restructure.

A recent *Business Week* article (March 26, 2001) presented a timely report called "The Rethinking of the Internet." The authors noted that the impact of the Internet is not limitless and unending, but sporadic and variable. Some areas such as financial services, healthcare, education and government, could benefit substantially. Other areas, such as retailing, manufacturing and travel, will see more modest impacts.

The Internet is an efficient communication tool, lowering costs substantially for some users. Despite the current shake-out, we expect that the next decade will see accelerating application of the Internet by "old economy" companies. For example, while hundreds of automobile companies disappeared early in the 20<sup>th</sup> century, Henry Ford's assembly-line production technology revolutionized manufacturing. Similarly, the Internet should produce revolutionary changes in some

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areas over the next five to ten years. The challenge will be identifying those opportunities. Now is the time to focus on the long term, and on the companies most likely to benefit from these changes.

#### THE BUSINESS CYCLE LIVES

During the late 1990s, extensive amounts of capital were invested in plant and equipment, leading to significant business overcapacity, especially in the technology industry. Following the Federal Reserve's tightening of monetary policy in 1999 and 2000, market and business psychology subtly shifted, a change that was not apparent until the end of last year.

The falling stock market, along with other factors such as rising energy costs, contributed to a pullback in buying by businesses and consumers. As a result, by the end of 2000, inventories were building for many technology producers, as well as the retailing and auto industries. Production was cut, layoffs were announced, and prices were reduced to clear shelves. U.S. Gross Domestic Product, which had risen more than 5% in the second quarter of 2000, was up a mere 1% in the last quarter of 2000, and may be flat in the first quarter of 2001. General expectations are that this downside of the business cycle should run its course over the next three to nine

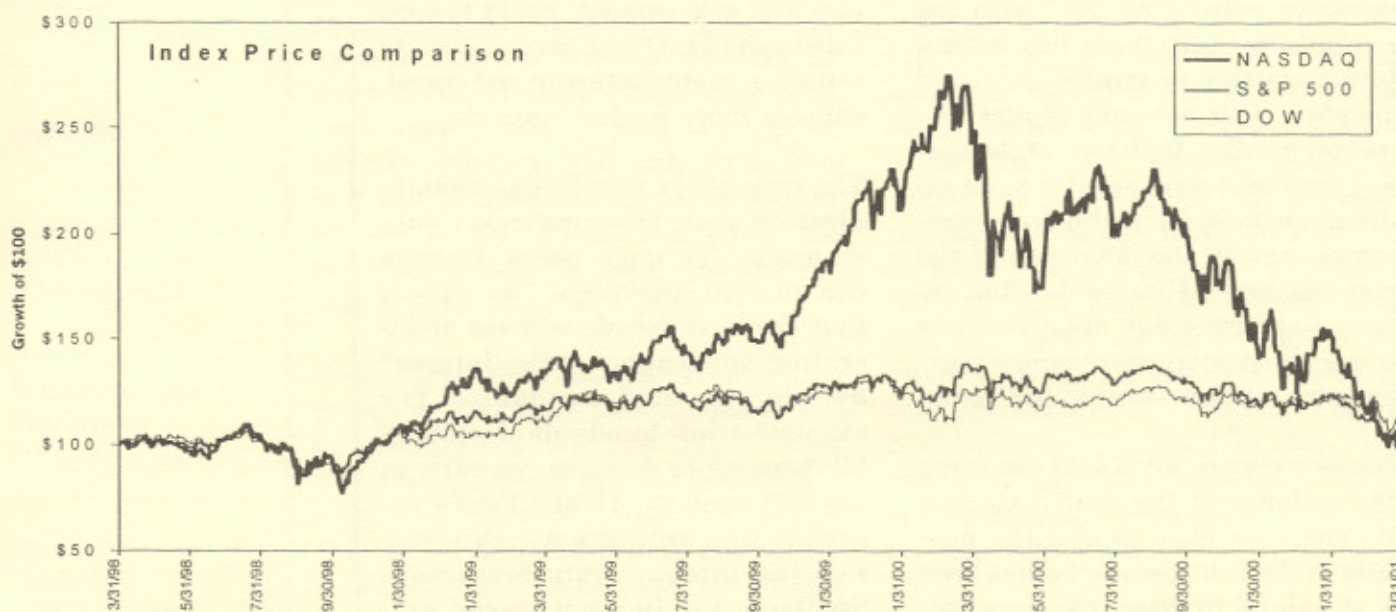
months with respect to "old economy" companies, especially given recent interest rate cuts by the Federal Reserve.

Companies in the technology sector may take longer to recover, due to the large amount of capital that flowed into this area over the last few years. More than \$50 billion in new money was poured into the tech sector in the form of initial public offerings from January 1998 through March 2000. While a lot of that money is now gone, much of it went into capital equipment that needs to find a new home.

#### WHAT HAPPENS FROM HERE?

The earnings of "old economy" companies will probably recover soonest, possibly before year-end. For example, auto inventories have already declined, helping to stabilize near-term production. It is expected that the "old economy" will lead the U.S. out of its downturn.

The wreckage from the "dot.com" meltdown will take longer to clean up. Telecommunication companies have extensive investments in equipment and lines, which could delay the next generation of broadband and wireless services. Many technology companies had increased inventories to meet anticipated demand and are now in an inventory-reduction mode. However, the state-of-the-art continues to advance, and eventually the



This chart compares the path of \$100 invested in each of three US equity indexes, the NASDAQ, the Standard & Poor's 500, and the Dow Jones Industrial Average, over the last three years. The value of \$100 invested in the tech-heavy NASDAQ rose to a high of \$275 on 3/10/2000, but fell back to \$100.25 on 3/31/2001.

next generation of equipment will become desirable. Due to the tremendous benefits in reduced costs and increased productivity, spending on technology will return, albeit at a slower pace.

What are the ramifications for the equity markets? In the early 1990s, lower interest rates stimulated the economy, resulting in strong corporate profits, investor confidence, and a rising equity market. Interest rates are falling again and the equity market should begin to recover once investors perceive that the corporate profit decline has bottomed. Even more critical than actual earnings will be improved forecasts for future earnings, since the market moves on expectations.

What about tech stocks? With the NASDAQ decline, many investors in aggressive-growth funds may divert resources to other equity sectors, cash or bonds. As this process unfolds, we expect investors to embrace the concept of diversified portfolios again. The huge flow of new cash into the tech area over the last few years is not likely to be repeated, and as a result, neither are some of the valuations that were seen. Caution will return.

#### HOW WILL WE PROCEED?

While down-market periods are inevitable, they are never enjoyable. The patient investor must remain committed, and look beyond the short term. Many factors, such as the Fed lowering interest rates and an anticipated tax cut, still favor an economic turnaround and strengthening corporate profits. As we have seen, stock prices can change quickly and dramatically. The stocks of many quality companies are now "on sale." It is precisely during periods like this that we need to stick to our time-tested investment approach and keep focused on the long term.

In reviewing companies, our approach focuses on several key characteristics:

- Superior management
- A strong financial situation
- Inflation-adjusted growth of cash flow, unit sales, and earnings
- A strongly competitive position in a growing industry
- Reasonable and attractive stock valuations

As always, well-diversified portfolios reduce risk.



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## Dealing with Unusual Securities

Clients sometimes ask us how to deal with security holdings that possess unique characteristics or challenges. Examples of these types of securities include large, highly-concentrated positions of low-basis stock, legally restricted stock, illiquid securities, stock options, etc. Customized strategies can be developed for these types of holdings, resulting in a better financial position for our clients in terms of flexibility, risk, diversification and liquidity. However, these strategies require significant knowledge and expertise about these unique securities, their terms and the effects of any strategy on trading patterns.

Clifford Associates has recently forged an alliance with W. R. Hambrecht & Co. to develop and execute customized strategies for our clients that own these types of securities and want an improved overall financial position. These strat-

egies would be devised jointly with a Clifford counselor and a dedicated team at W. R. Hambrecht. The W. R. Hambrecht team members have an average of 18 years experience developing these types of strategies. The plans will take into account the client's specific objectives, time frame and the unique characteristics of a specific security. Throughout the process, Clifford and W.R. Hambrecht will work as a team to deliver the best results to our clients.

Our goal and commitment is continued anticipation of our clients' needs. When special expertise is required, we will seek out and deliver it to our clients in a manner that is in their interest. Our relationship with W.R. Hambrecht is a good example of that philosophy. We would be delighted to discuss these new capabilities and how they may apply to your own holdings.



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## Good News for IRAs

*By Jim Fox*

The IRS recently released rules that substantially improve the distribution process for IRAs and qualified retirement accounts. The changes are clearly investor friendly and may impact your IRA strategy. It is important to review the implications with your tax advisor or estate-planning attorney. Even if you have already begun taking withdrawals under the old rules, you are no longer locked in to your original calculation method. While the new rules are expected to become mandatory in 2002, you have the option of using them now.

Calculating minimum required distributions has been greatly simplified. Nearly everyone will use one table, with much higher life expectancies, resulting in lower minimum distributions. The opportunity to reduce withdrawals will allow investments to accumulate value tax-free for a longer period of time, resulting in a larger asset for heirs or favorite charities. In most cases, the life expectancy used no longer depends upon the age of your beneficiary. The only exception is if your spouse is your junior by ten or more years. In that case, a joint life expectancy table is used, and the result is even more beneficial.

Beneficiary designations are also liberalized. You may now change your beneficiary without restriction, even if you have already started taking distributions. Moreover, the final designation of a beneficiary will not be determined until December 31<sup>st</sup> of the

year following the death of the IRA owner. This lag time means that beneficiaries have many more options than before. For example, a son or daughter who is a beneficiary may wish to have the IRA pass directly to his or her own child. He or she could disclaim the beneficial interest in favor of the grandchild, who was designated as contingent beneficiary. Or a beneficiary such as a charity may choose to "cash out" its interest, leaving the remaining heirs to divide the IRA into separate accounts and use their life expectancies for withdrawals. We suggest you consider discussing your bequest intent with your children or favorite charity. These changes open up options that may have been impractical before.

One change has not been determined. That, of course, is the estate tax issue. It is currently being debated and the outcome is uncertain. Currently, estate tax may be due on an IRA bequest, and one should pre-plan where the funds needed to pay the estate tax will come from. Your attorney should be consulted. The second tax, ordinary income tax on the IRA distributions, now can now be forestalled to coincide with the extended distribution strategy. This factor makes a review of the current investment and spending strategies essential. If you have begun distributions, review the plan with your counselor. This represents a golden opportunity to enhance the impact on your estate plan.

