

Too Late at the Ball

By David Andrew

The late comedian Eddie Cantor once told a joke that today's investors can probably relate to, after the past 18 months of market turmoil. He said, "They told me to buy this stock for my old age and it worked perfectly. Within six months, I felt like an old man." During the past year, the stock market (as measured by the Standard & Poor's 500 Index) has endured a drop of over 25% from its record high and more volatility than we've seen for some time. The fallout from the dot.com crash has spread like a virus into other key sectors bringing some stocks down to multi-year lows. As the second quarter ended, the S&P 500 was up for the quarter but still remained in negative territory for the first half of the year.

The Federal Reserve is concerned that the U.S. economic slowdown is spreading worldwide. In attempting to avoid a recession, the Fed has announced six consecutive interest rate cuts this year – a historic record. Still, corporate profits in many sectors of the economy are weak, forcing cutbacks in capital expenditures, jobs and expenses. More troubling, consumer debt is soaring, most of it relating to credit cards. Without more power to bor-

row and spend, consumers may be unable to lead us out of the slump. Most investors are hoping for recovery later this year; however, it is likely to take longer than expected.

According to a recent survey, investors still expect that stocks will deliver 15% annual returns over the next ten years. Before slumping in 2000, the S&P rose more than 20% each year from 1995 through 1999. No doubt investors are still being influenced by the heady returns of the past decade.

Recent studies indicate that investors should lower their sights. The research firm of Ibbotson Associates completed a study that suggests lower future returns are far more realistic. Over the last 15 years through year-end 2000, stocks gained an average of 16% a year. If compared to a longer time frame, these exceptional returns are *not* the norm. Ibbotson's study divided the past 75 years into 61 rolling 15 calendar-year stretches. Out of these 61 rolling periods, there were just 13 occasions when stocks generated 16% annual returns or more. As the economy continues to struggle, many knowledgeable investors, academics, and economists are pre-

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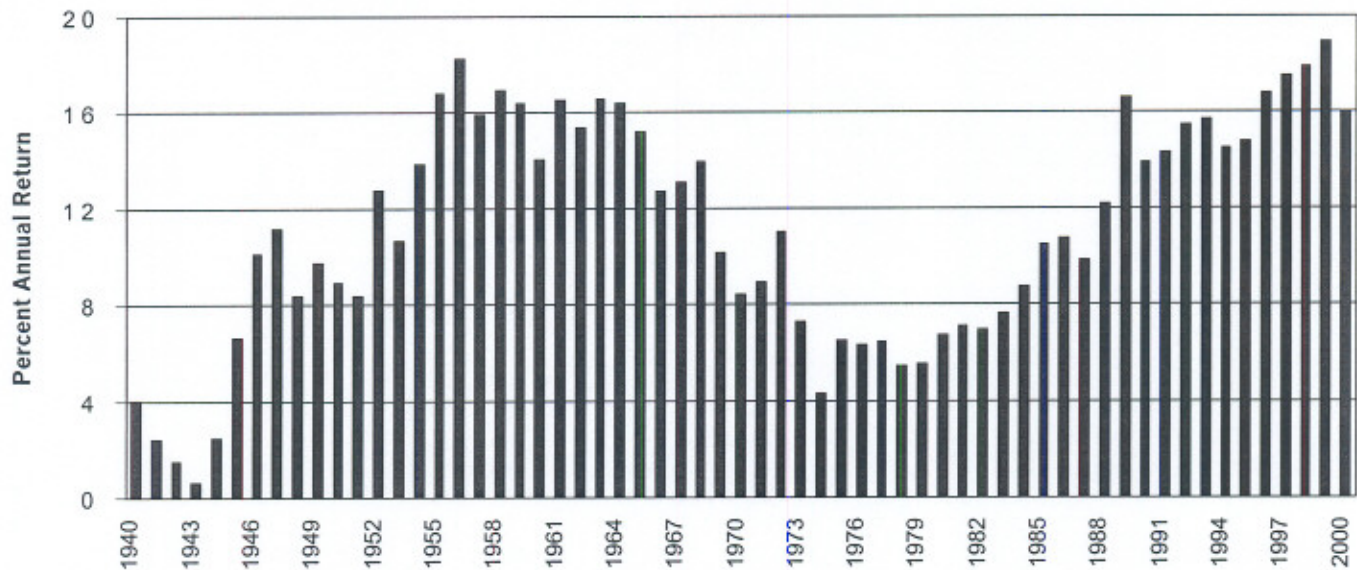
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S & P 500 Index 15-Year Rolling Period Returns



This chart shows average annual returns during 61 rolling calendar-year stretches, starting with the 15 years ending 1940, continuing with the 15 years through 1941, and so on through the year 2000. Of these 61 periods, only 13 periods had average annual returns of 16% or greater.

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dicting a slower recovery and lower investment returns. Professor Jeremy Siegel of the Wharton School and author of *Stocks for the Long Run* believes returns will be in the 8% to 10% range for the next five years. That reflects 7% returns after inflation. To support his opinion, Siegel studied the real (i.e., after inflation) returns for stocks and bonds since 1802. The following chart illustrates Professor Siegel's findings:

| Years | Stocks | Bonds |
|-----------|--------|-------|
| 1802-1870 | 7.0% | 4.6% |
| 1871-1925 | 7.0% | 3.7% |
| 1926-2000 | 7.3% | 2.2% |
| 1802-2000 | 7.0% | 3.5% |

Warren Buffett recently commented on the irrational expectation of high returns that investors still expect to realize over the decade ahead. His comments provide a great lesson on how *speculation* has led to inflated investor expectations.

"Speculation - in which the focus is not on what an asset will produce but rather on what the next fellow will pay for it - is neither illegal, immoral nor un-American. The line separating investment

and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities - that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future - will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one heckuva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands.

Last year, investor expectations had grown to several multiples of probable returns. Far more irrational still were the huge valuations that market participants were then putting on businesses almost certain to end up being of modest or no value. Yet investors, mesmerized by soaring stock prices and ignoring all else, piled into these enterprises. It was as if some virus, racing wildly among investment professionals as well as amateurs, induced hallucinations in which the val-

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Unbiased Advice?

By Maye Albanez

Back in 1921, A.M. Clifford, our founder, decided he would serve his clients exclusively as an investment counselor, and no longer as a broker-dealer. Even then, he had serious concerns about the potential conflict of interest behind selling investment advice, while earning commissions from the securities he recommended. Eighty years later, this conflict still exists in the securities industry.

As a result of dramatic losses in investors' portfolios after the dot.com bust, attention is increasingly focused on the practices of Wall Street analysts. A year ago, while the NASDAQ Composite was collapsing, analysts across Wall Street rated only 0.8% of all rated issues a "Sell" or "Strong Sell," according to First Call, a ratings and earnings estimate tracking service. In contrast, nearly

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ues of stocks in certain sectors became decoupled from the values of the businesses that underlay them.

The fact is that a bubble market has allowed the creation of bubble companies, entities designed more with an eye to making money off investors rather than for them. But a pin lies in wait for every bubble. And when the two eventually meet, a new wave of investors learns some very old lessons. First, many in Wall Street – a community in which quality control is not prized – will sell investors anything they will buy. Second, speculation is most dangerous when it looks easiest."

The words of Warren Buffett, while difficult for some to swallow, are a masterful lesson on how speculation can lead to unrealistic expectations. At this point, no one knows for sure what returns lie ahead. The stock market could quickly rebound as it has in the past. Regardless of the market's direction, diversification and stock selection will continue to play an important role in achieving the desired returns. At this juncture, it is probably realistic to assume a slower recovery and lower return, at least for the near future.



74% of all ratings were either "Strong Buys" or "Buys." Following the near extinction of many of these companies and their stocks, it should be no surprise that investors appear to have lost faith in the ability of Wall Street to provide honest, impartial advice, untainted by competing concerns.

This past April, the acting chief of the Securities and Exchange Commission reproached Wall Street analysts for the near absence of negative ratings on stocks, and the conflicts of interest at brokerage firms with investment banking arms. On June 7th, the New York attorney general's office began an investigation into Wall Street's stock research practices. On June 14th, the first of three Congressional hearings began on the inherent conflict between the ability of Wall Street firms to make independent analyses of companies, and their need to attract investment banking clients. Just a few days before, the securities industry's trade group issued a set of voluntary guidelines to address the issue.

Ideally, the investment banking arm of a securities organization is expected to be completely independent of the research arm, separated by what in the industry is known as the "Chinese Wall." Instead, the following cycle became increasingly common among many Wall Street firms:

- An investment banker secured a stake in a promising start-up company.
- Often, the knowledge of a well known research analyst at the same securities firm helped entice the start-up company to sign up as a client.
- Following a successful IPO (initial public offering), the research analyst would issue "Strong Buy" recommendations on the stock, long after investment bankers have sold their own positions, often at big profits.
- Research analysts would continue to aggressively recommend the stock, leading to

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commissions from trading business and helping attract other investment banking clients.

- Many research analysts' compensation packages are based on prestige, client service, commissions generated and contributions to banking deals.

We learned long ago that Wall Street research cannot be taken at face value. The reader must be sophisticated enough to extract the relevant facts from it and, more importantly, to understand the conflicts of interest buried inside many of these reports.

On a more constructive side, the Securities Industry Association (SIA), the trade group representing about 700 securities firms, has recently issued a series of recommendations of best practices for research analysts. According to the SIA, the guidelines were designed to "help foster ethical standards in the conduct of a securities business. They provide general guidance and do not create legally enforceable obligations or duties." Among its most significant points, the SIA calls for the following:

- The need for independence of analysts and investment bankers.
- The need for clear indications from analysts when securities should be bought and when they should be sold.
- The separation of analysts' compensation from investment banking transactions, sales and trading revenues or asset management fees.
- The need for objective and independent judgement of analysts.
- The need for client interests to

come ahead of personal investments, and the need for any conflicts to be disclosed.

The proactive response by the SIA in issuing these guidelines is commendable. The good news is 14 of the largest underwriting firms, representing about 95% of the underwriting businesses, have endorsed the SIA best practices. The bad news is most of those firms have said that their analysts already adhere to virtually all of the recommendations, and thus do not plan to alter how they operate in any major way. Will it take the SEC to put some teeth into the existing rules?

As investment counselors, these guiding principles are nothing new. The Investment Counsel Association of America (ICAA), our own professional organization, says our responsibility is to "render professional, continuous and unbiased advice oriented to the investment goals of each client," and has been saying that since 1937.

On August 31, 1921, the *Los Angeles Times* published an advertisement by A.M. Clifford, our founder. It read as follows:

An Investment Counselor should:

- *Act solely in the capacity of an advisor*
- *Have no securities for sale*
- *Place himself in a position to consider only his client's best interests to the exclusion of every other consideration, by charging a reasonable fee for his services and accepting no other compensation whatsoever.*

Need we say more...?

