

Living with Uncertainty

By Peter Boyle

Each and every day, financial markets and their participants assess the risks inherent in investments and assign prices based on those risks. Uncertainty, however, by its very definition is non-quantifiable and therefore difficult to assess. In the wake of the enormous jump in the level of uncertainty generated by the tragedy of September 11, 2001, it is no small wonder we witnessed the stock market's worst week since the Great Depression.

In much the same way other significant events have marked history, many aspects of this segment of history will be measured by whether the event occurred before or after September 11. The roots of the current economic and financial environment predate these events.

The 1990's bred an entire generation of analysts and investors who prospered in an equity-investor's utopia. Fueled by double-digit earnings growth, falling government deficits, seemingly endless productivity enhancements with plentiful and cheap capital, an illusion was created that appeared to reduce investment uncertainty to zero.

As we have repeatedly pointed out, these apparent utopias seldom are real, and in early 2000 the illusion began to blur. The slowing in capital spending for technology spread not only to other sectors of the domestic economy, but internationally as well. As a result of the Federal Reserve's response, we anticipated that monetary policy, combined with the fiscal impact of tax cuts, would be sufficient to buoy a slowing economy. A formal recession would, hopefully, be avoided as business investment recovered more quickly than deteriorating consumer confidence could slow consumer spending.

However, the events of September 11 introduced many new challenges. It now appears much more likely that we will experience a recession. Consumer confidence has been shaken, and even successful military and diplomatic campaigns will not diminish the belief that terrorism is now part of our future. Also, the ripple effect of job losses related to the airline, leisure and manufacturing sectors will have an enormous negative impact. Further, government stimulus, while being swiftly applied, can only help if the

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level of uncertainty is reduced. Zero interest rates cannot make the public fly or businesses invest.

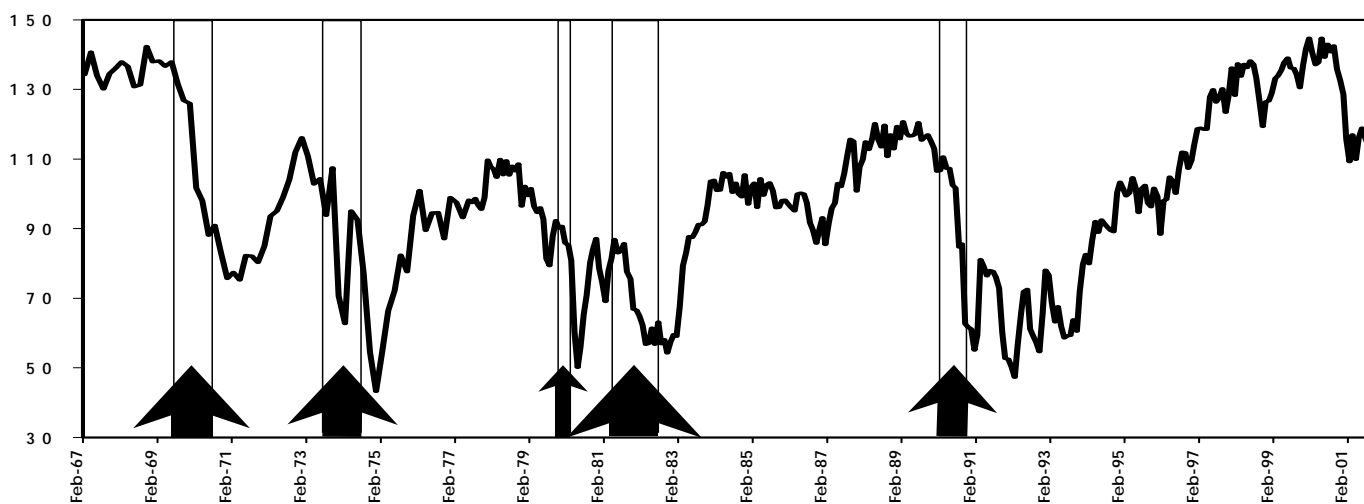
Can positives be found? Certainly. The economy does have two important points in its favor—government surplus and a lack of inflation. This gives policy makers plenty of room to craft a recovery. The Federal Reserve has already cut interest rates nine times this year and one full percent since the end of August. To date, more than \$40 billion in emergency spending has been approved and the President is pushing for \$75 billion in additional stimulus. All this on top of the \$70 billion in tax cuts already scheduled for 2002. It currently appears that roughly \$150 billion in extra spending and tax cuts will be added to the 2002 budget. This amounts to 1.5% of GDP—the biggest stimulus package since WWII. Lastly and sometimes forgotten, while our psyche is forever changed, it is important to remember that other societies such as those in Europe have adapted to terrorism. As acquiescent as it sounds, the United States will adapt as well.

What is the net result? While a recession looks imminent, the enormous degree of fiscal and monetary stimulus will likely bounce us back from a recession fairly quickly. This optimism

will be partly tempered by a cautious consumer. Because we are sure to witness further layoffs and a prolonged war on terrorism, consumer confidence will be slow to recover. Furthermore, consumers are already satiated and highly leveraged from spending in the 90’s and will therefore likely improve their balance sheets before resuming spending. As a result, while growth should return in early 2002, we would not expect significant economic growth until late next year.

What does that say about the market? In a word, patience. We will no doubt continue to witness volatility, especially during this period of military activity. While this volatility will create opportunities, the use of traditional valuation measures, such as price-earnings ratios, will be difficult. While ordinarily one could compare a company’s P/E to its historical range, reliable earnings estimates are proving extremely difficult to ascertain. More positively, it has been about a year since the first Fed rate cut. These cuts historically take about twelve months to show an impact in the economy. The markets will likely favor companies with dependable and consistent earnings and cash flow records as well as those that pay a dividend. Our efforts are focused on companies with these qualities. 

Consumer Confidence and Recessions



Consumer confidence and recessions are closely linked. This chart shows the Conference Board’s Consumer Confidence Index. The arrows indicate recessions. The recent decline in consumer confidence foretells a possible recession in the near future.

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Within the Securities Exchange Act of 1934, the Securities and Exchange Commission (SEC) was given legal authority to establish financial accounting and reporting practices for all publicly traded companies. Since 1973, the SEC has designated the Financial Accounting Standards Board (FASB) as the organization in the private sector to establish those accounting standards.

FASB's standards have become known as Generally Accepted Accounting Principles or GAAP. These are the only accounting principles allowed when reporting financial results to the SEC. GAAP reporting aims to give a fair and true picture of a company's financial position. It also is a consistent and objective way to compare results between companies and across industries.

Recently, many forms of creative or non-standard accounting have emerged as managers and investors alike have become obsessed with growth. One of the most prevalent abuses is known as *pro forma* accounting. This practice seems designed to mislead investors about the true financial condition of a company.

What is *pro forma* accounting? The use of *pro forma* statements has, by common practice, come to mean *in advance*. For example, two companies planning to merge might produce *pro forma* financial statements to simulate expected future combined results in advance of their merger.


But recently, many companies have begun issuing a second set of sales and earnings reports on a regular basis to the public and press. This is perfectly legal so long as the SEC also receives GAAP results. These new so-called *pro forma* reports have nothing to do with anything in advance of future plans. They are simply designed as a way of spinning or misleading unwary investors to reach a more positive conclusion about the financial condition of a company. *Pro forma* results are synonymous with what has otherwise been known for years as creative accounting. For

example, *Business Week* magazine reports the following:

In its press release dated April 18, Quintiles Transnational Corp. excluded the cost of Internet operations when it reported earnings from what it termed its "core operations." The result was to increase earnings per share from 6 cents to 10 cents. According to *Business Week*, the company defends itself by noting GAAP results were also attached to the press release. Quoting an interview with the investor relations officer, "We thought this was the best way to describe ourselves to the market." The same company officer also termed the Internet expenses as "unusual." In summary *Business Week* notes, "But the expenses aren't a one-time event: They have been going on for more than a year, and they are continuing."

To show the extent of the problem, Chuck Hill, the Director of Research at First Call, notes that more than 260 companies have persuaded a majority of top financial analysts to abandon GAAP when making public earnings estimates. Most professional investors rely on research services when formulating their investment decisions. But this data is becoming more and more suspect and less and less trustworthy.

At Clifford Associates, we have long felt that our analysis must start with accurate, consistent financial data. To that end, we insist our data providers use only GAAP accounting standards. But we also recognize even GAAP accounting can sometimes be manipulated and misleading.

We prefer to modify GAAP reports and view companies on a cash flow basis. This reduces all companies and industries to the lowest common denominator – cash. How much cash is earned each year, how does management spend or reinvest it, and what are the likely future results for cash growth? This type of analysis can be compared from company to company and from industry to industry. It is constant and consistent and leaves no room for private interpretation. 

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Welcome Mary Hamilton!

We are happy to announce that Mary N. Hamilton, President of Hamilton Investment Management, combined her company with Clifford Associates in September. Mary has been in the investment business for 19 years starting an investment counseling firm in Glendale in 1990. Prior to that time, she was a financial consultant and portfolio manager with Shearson Lehman (now Salomon Smith Barney). In the late seventies, she was the controller of a subsidiary of Gulf+Western Industries. She is a graduate of the University of Southern California with a Bachelor of Science from the School of Business.

Mary is serving her second term on the elected Board of Trustees of Glendale Community College and currently serves as its president. She is past president of the Glendale Chamber of Commerce and is a past president and founder of the YMCA of Glendale Housing Corporation, which owns and manages transitional housing for battered and homeless women and children. The first facility is named Hamilton Court in her honor.

Mary is co-author of *What a Woman: A Financial Planning Guide for the Newly Independent*. We are pleased to add Mary's professional experience and commitment to public service to that of our other partners. 

Time to Refinance?

We are seeing the lowest interest rates in nearly 30 years. Even though long-term interest rates have declined less than short ones, you may find refinancing of any outstanding mortgage you have to be beneficial. Rates vary daily, but you may use the following benchmark to estimate monthly payments.

The following example is based on a 30-year fixed loan with no origination points:

A \$100,000 balance at 6.875% equals a \$657 monthly payment. If rates were to drop to 5.875%, a monthly savings of approximately \$75 would be produced.

Using the above example, if your current mortgage were at 8%, and if you refinanced at current rates, you would save a little over \$75 per month for each \$100,000 of principal outstanding. savings of approximately \$75.

Call your Clifford counselor if you would like an analysis and recommendation. 