

Recession might be the time to assess portfolio

This year's Indian Market was packed with people as usual, but were they buying? It seems that America's consumers are slowly winding down a 10-year buying spree. By my analysis, we are in a recession and this will have major ramifications for our stock and bond markets. This column suggests some ways to deal with investing in this climate.

Signs of a widespread economic slowdown are becoming apparent. For one, many graduates of our nation's business schools face bleak employment prospects, as most major corporate employers have curtailed their recruitment efforts and are asking their new hires to delay starting dates. Financial companies in particular are feeling the pain of dealing with a recession. JP Morgan, which combined with Chase Manhattan late last year, is laying off 8 percent of its work force. Goldman Sachs, Merrill Lynch and Charles Schwab have also made personnel cuts, and the end may not be in sight.

Reports of consumer purchases from retailers such as Macy's, Bloomingdales, and Eddie Bauer all indicate that the public is cutting back. The 18-month pullback in stock prices has finally translated to decreased spending on the part of baby-boomers. Many mid-level retailers, such as Ames discount stores, look shaky. Ames was unable to compete with Wal-Mart, Target and other super-efficient national chains, and finally had to close its doors. Bankruptcies appear to loom for other larger companies also.

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Real Money

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In reviewing your portfolio, you may want to look at second-tier holdings and change them out for top-quality companies, those that will survive a protracted economic slowdown.

It has been some time since we have had a full-scale recession — one that the government or the Federal Reserve's short-term solutions hadn't fixed. The slowdown began with the dot-com meltdown, when young millionaires turned back into graduate students overnight. As a result of dot-com failures, the big technology suppliers such as Intel were caught first in a psychological and then in a real downturn in spending for new equipment.

After all, why buy new PCs if slightly used ones work adequately and can be purchased at much cheaper prices? However quickly one got used to plentitude now makes the downward ride in the stock market even more painful, and many investors are now wondering what's going on with their retirement-account values.

The question most often asked these days is, When will the downward spiral in stock prices be over? It is difficult to make investing plans in such an environment. On the one hand, recent full-page ads in the financial press quoted the chief stock strategist at Paine Webber, who touted an S&P 500 advance of 50 percent by the end of next year. Some people with sharp pencils disagree.

Let's see what some various financial reports show as the health of the stock market. One research service, Thomson/First Call, states that the Standard & Poors 500 index has a price-to-earnings reading of 22. Historically, it has held at an average of around 15. So, is the market 50 percent over where it should be, or is it 50 percent undervalued, as the UBS/Paine Webber's main guru believes?

The market is truly undervalued now if inflation and interest rates stay low, and if corporate profits come back soon (within nine to 12 months), then a very strong case can be made for stepping up to the plate and buying stocks now.

Many skeptics consider the publicized P/E level of 22 to be substantially understated. Pessimists feel that the S&P 500's true level may be closer to a P/E ratio of 37, or 150 percent over its 60-year norm.

Why is there such a divergence of opinion on what should be a relatively straightforward matter such as current P/E ratios? Those of us who deal with record keeping know that there are frequently one-time events that can greatly affect the current year's results. Everybody who files taxes knows that the sale of a piece of real estate, an unexpectedly good or bad year in stocks, or changes in one's employment status can vary the tax bill due with our returns. In business, there are many one-time events that happen: new equipment gets purchased, uncollected bills mount up, etc. All these things occur on a large scale for corporations.

The question concerning fair reporting is: Should these one-time occurrences be included in reports given to investors? If you think they should, then bump up the current P/E ratio of the S&P 500 to the mid-30s. If you believe that only ongoing, regular operations should be counted, then leave the valuation number at its more widely accepted level of 22.

There are some good reasons to exclude these special or "non-cash" items. It makes it easier to compare a company's efficiency and growth from one year to the next. On the other hand, life has a way of delivering surprises to

My take on this debate is that small investors are at a substantial disadvantage due to corporate publicist's exclusion of these one-time negative items. Professional analysts, who focus on a very few companies in one particular industry, are able to see through the "smoke and mir-

rors" of company presentations, but those unfamiliar with the intricacies of the financial statement are not. One accounting professor says "It's scary" and that there is only an "undisciplined number at the heart of (most company) calculations." I would like to see corporations follow GAAP (generally accepted accounting principles) so that all facts are presented in full, with no shortcuts taken. If this does not occur, then I believe we will begin to see a widespread loss of faith in the fairness of the stock market. It looks like the prices of particular stocks have become more a reflection of a complex game of public relations than basic business results. Hopefully, this is a temporary disillusionment, a sign of stress and dissatisfaction with 2000 and 2001's stock-market returns.

One way to deal with this quagmire is to try to figure out for yourself if there are truly reasonable values out there. If you own companies that are reasonably valued, it makes sense to stick it out. If stocks are really overvalued, then one should consider moving funds over to bonds, real-estate investment trusts or preferred stocks. One fear I have is that many investors will walk into a trap when they look to alternatives to stocks. Many forecasters who have a conservative bent are looking at the stock market and predicting average annual returns for this decade somewhere in the range of 8 percent. If this scenario is true, stocks that pay large amounts of dividends and other "yield" investments that pay out high levels of cash look very good.

What kind of traps am I referring to? While high quality corporate bonds are now paying between 5 percent and 6 percent, REITs appear to be yielding close to 9 percent. Any publicly traded security that looks like it has a return over 6 percent has got to have some risk in it. These risks can be hard to flush out, so before investing, try to find out under what circumstances your asset's value will go down. Look at what happened to these kinds of high-income securities the last time interest rates went up markedly, as they did from April 1994 to February 1995. Is the return of your original investment guaranteed or could a downturn in the real-estate market affect the value of your collateral? What is the underlying financial rating of the company issuing the preferred stock? Standard & Poors and Moody's are two good sources for information on the soundness of a company's finances. Most investors will want to stay with A-rated firms.

No one really knows when the cyclical downturn of the economy will end, but our strong conviction is that it will. A new cycle of improved economic conditions will follow, but it will arrive at a much later time for some industrial groups. The overall market indexes, such as the Dow, the S&P 500 or the Nasdaq, may not advance broadly for some time to come. If there is one lesson to learn from the recent past, it is that following one's instincts, along with the crowd, is not necessarily a prudent move. Try to remain skeptical of any quick fix. This may well be a period where "cash is king," as opposed to the 1990s, when "cash was trash." Bonds and REITs have already had big advances, so even though sitting tight is not easy, I think it is the right course of action. If you watch closely and wait for companies to come clean with their bad news, that is the time to take action. Recessions are good times to clean house, for corporations with their operations and for investors with their individual portfolios.

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