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Commentary
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The Markets

The markets got off to a slow start during the first quarter of 2002. The widely followed Standard & Poor's index of 500 stocks lost .06% while the Dow Jones Industrial Average gained 3.82 percent, primarily due to the performance of defense-related industries such as Boeing, United Technology and Honeywell. The worst performing members of the Dow were IBM, AT&T, technology and tele-communications companies, and General Electric. The technology-heavy NASDAQ Index declined 5.4% to 1845. The Dow outperformed both the S&P 500 and the NASDAQ because "smokestack" companies were among the best performers during the first three months. While we expect the relative out-performance of the industrials to continue for a little while longer, we do not recommend abandoning all other market sectors to invest solely in the industrials. Diversification is the best defense for an uncertain economic environment.

A headline for summarizing the stock market news during the first quarter would probably read, "Accounting Practices in Corporate America come Under the Microscope." In the wake of Enron's breathtaking collapse, it is easy to understand why Wall Street is demanding to know in full detail how a company generates its profits, and exactly where are the liabilities. Companies that fail to disclose in full are being punished severely by investors selling their shares. Furthermore, companies suspected of engaging in accounting chicanery are also seeing their shares sold with abandon. Some of the more notable companies to come under scrutiny during the first quarter: IBM, General Electric, Tyco International, and Computer Associates.

The focus on accounting practices has become a witch-hunt, where companies are presumed guilty upon accusation, and the mob (Wall Street) will not be satisfied until someone is burned at the stake. The virtual collapse of Arthur Anderson, formerly one of the most respected accounting firms, is emblematic. The tragedy is that Arthur Anderson didn't have to go down this way – if Anderson had come clean earlier in the Enron demise, they could have saved themselves. Some of the top managers of Arthur Anderson chose to stay entrenched in a culture of greed and avarice, which justified in their thinking the shredding of important documents and denial of any wrongdoing. They are now paying the price. As of this writing, Arthur Anderson is under a Federal indictment for obstruction of justice, their CEO has resigned, and former Federal Reserve chairman Paul Vockler is attempting to orchestrate a restructuring at Anderson that will leave the company a shell of its former self. This is a tragic end for tens of thousands of innocent people at Arthur Anderson.

The focus on corporate accounting practices should, in the long term, produce positive changes for investors. We are still in the cleansing stage, where companies are being judged harshly and corporate directors are scrambling to unearth problems and fix them before Wall Street discovers them. The long-term benefits of this process outweigh the short-term pain in the marketplace. First, it is clear that some companies – aided by their well-paid auditors – have overstated earnings and hid liabilities from investors. Cleaning up these shenanigans will allow investors to put capital to work with greater confidence. Second, the punishment of accounting offenders will serve as a strong deterrent for the foreseeable future.

Many people are wondering if Arthur Anderson audited the 2001 recession! In November, the National Bureau of Economic Research, the official business-cycle arbiter, announced the American economy's first official contraction in more than a decade. Considering revised data now in, it turns out that in the 4th quarter of 2001Gross Domestic Product (GDP) actually rose 1.4%. For all of 2001, real GDP grew 0.4%, the first recession year in history during which the economy managed to grow. Instead of disproving that we had a recession, the economic data shows the overwhelming strength of our economy's technology-driven productivity trends. A recession is defined as a pronounced, pervasive, and persistent decline in output, employment, income, and sales. By all these measures, the US economy suffered a recession last year. While it looks like the US economy has emerged from that recession, the strength of the recovery is in question. We believe that the US economy will have a decent recovery but that meaningful recovery in corporate profits will be a case-by-case exercise. The rising tide won't lift all boats and it will be a stock-picker's market.

The international markets gained one-half of one percent during the first quarter and the composite of all indexes gained .16 percent, which is essentially no gain or loss for the first quarter. The Rikoon-Carret portfolios did comparatively better, with an overall composite performance of a positive 1.49 percent for the first three months. Our U.S. large companies were up 1.72 percent, while our international companies were basically even.

In the bond area, the municipal or tax-free bond index declined half of one percent while the Rikoon-Carret portfolios gained three-quarters of a percent. For taxable bonds, the overall market declined .34 percent while our portfolios gained .56 percent.

Investor Education

As many people who receive our commentary do not get to see the articles I publish in the Santa Fe New Mexican, it seems appropriate to condense them here.

Value Investing

Given the sideways direction of the stock market this past quarter, it is worthwhile to look at the investment style of Warren Buffett, considered by many to be the most successful “value” or “fundamental style” investor in history. Behind Mr. Buffett’s success are some fairly simple premises. They are easy to describe but difficult to put into practice. The first is to stay outside of the emotional fray inherent in the stock market. He accomplishes this by buying companies and not stocks, which means he buys businesses for their real world results not for their short-term stock appreciation.

His second belief is that if there are few decent buys in the market, i.e., if speculation drives prices too high, the proper move is to not buy anything at all. Some of the other basic tenets of value investing can be summarized by the following statements:

1. Buy simple businesses that you understand.
2. Buy companies that have consistent profitability.
3. Buy companies whose management is concerned with having a good return for stockholders, in terms of the intrinsic value of the business (not the stock’s price action).
4. Look for companies with low debt levels.
5. Look for companies with good management in place who themselves have a long-term stake in the business.

How can we know if a company is simple and understandable? If you look at its basic business, there has to be an established place the company occupies by providing a constantly demanded product or service to society. Dairy Queen is one example of such an operation. It qualifies under these criteria, though health food buffs might disagree! Buffett has lunch every day at the local Dairy Queen in Omaha, Nebraska where he lives.

A company’s management should be focused on its shareholders to attract “value”-oriented investors. The business’s long-term prospects should not depend on constant innovation but on continued basic demographic trends and consumption patterns. Buffett owns jewelry chains, shoe makers, a soft drink provider, traveler’s checks purveyors, candy manufacturers and the like. He doesn’t take any chances that demand for his products will go away.

One important difference between value investors and other approaches to owning stocks is that the expected time period for holding onto a value investment is very long. Buffett feels that when you buy a company, if you have done your homework, you should ignore its monthly, quarterly, and even its yearly valuations evidenced by its price. Since you are in business with the company, you need to have a firm conviction that business success will eventually be recognized by a rising stock price. Companies that follow this long-term approach reward all their employees, not just top management. They are not trying to acquire new business lines that are exciting and profitable now but may expose the company to undue risk later on. Solid, dull, steady as they go, is the *modus operandi.*

Like all investors, Buffett looks to pay the right price for companies. We all like to go shopping and feel that we are getting a good deal. Unlike conventional wisdom, Buffett feels that picking a few great companies is more profitable than trying to cover all the bases with a portfolio of market neutral or index funds.

To close this section, here is a quote from Mr. Buffett that sums up the flavor of his philosophy, which we at Rikoon-Carret incorporate into our investment process: "When the price of a stock can be influenced by a herd on Wall Street, with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical."

Family Wealth Planning

As you all know, our country is now going through an unprecedented transfer of wealth between generations. Fortunately, the estate tax laws have been updated, so by the middle of this decade, most people do not need be concerned with trying to avoid inheritance taxes.

Probate, which is the process families go through to legally transfer property titles after someone dies, has been greatly simplified in most states. We have been working with most clients to ensure that their assets are held in a Living Trust. Keep in mind that writing and updating a Living Trust is easy, fairly inexpensive, and not any more trouble than maintaining a current will. Its purpose is to avoid probate for assets titled in the Living Trust and allow for ongoing management of personal affairs in the event of disability.

The conundrum that remains is not how to transfer money from one generation to another, but when and in what format. How these issues get addressed can make the difference between families that stay together or those that get torn apart. We know that initiating a family dialogue on the subject of inheritance is not easy, but it is clear that early and ample communication is one key to success. The responsibility for opening up the discussion usually falls to parents.

One format that yields good results is the “family retreat.” The focus of these offsite gatherings is primarily, but not solely, on the scope and nature of family holdings and what the elders would like to see accomplished over time. Specific requests or concerns that younger generation members may have about their present and future access to the family’s money are also a key component part of the dialogue.

There are great differences in individual levels of comfort in talking about these matters. Discussions about sex, politics and religion may disrupt many dinner parties, but there is nothing like the subject of money to bring out the possibility of long-lived family disputes. The opportunity to have a non-charged atmosphere to discuss family finances is worth the effort to set up such a meeting.

Another beneficial result of such discussions is education of the next generation, involving them and helping them mature in this difficult area. Teaching younger people how to handle money plays a pivotal role in a family’s success. Here are some suggestions on how to approach the subject in a positive way.

Involve the younger generation in learning by doing. Give people who have not done any investing a small account to handle. Ask them to justify their decisions and try to get them to calculate the results of their investment decisions. Through these simple steps, most people, no matter what their age, come to appreciate the value of simplicity and having a long-term investment approach.

If your assets are substantial, look at creating a Family Limited Partnership (FLP). FLPs provide for transferring wealth within a family while creating a blueprint for multi-generational decisions to be made under the supervision of a business-minded parent or grandparent. FLPs are good vehicles for tax planning since they also help to organize many disparate business ventures, such as real estate, small businesses, and stock/bond accounts under one roof.

For families with charitable objectives, we suggest private family foundations and charitable trusts. This involves several family generations working together, once or twice a year, to decide on what good works in the world take priority for them. Non-profit entities are less charged than Family Limited Partnerships, since the issues are philanthropic as opposed to personal, but the positive bonds created among the participants are much the same. Families that have an ongoing reason to meet together, to discuss how events are affecting their personal, professional and charitable interests are more likely to stay together and feel good about maintaining multi-faceted relationships in the long run.

The picture of family members visiting one another at their family cabin or those lucky enough to have an extended family shared vacation destination or regular reunions is analogous to the family wealth planning meeting. It is a way for relatives to interact regularly, but without much pressure. It provides rules to follow and requires agreeing on goals for the near and distant future. If it is well thought out, family meetings, no matter where or how often they occur, should provide fertile grounds for people to enjoy the fruits of their family's work and play.

Personal Notes

Several events occurred this past quarter that have been challenging and exciting. The University of New Mexico asked me to act as a visiting professor at the Anderson School of Management. Two evenings per week I have been teaching "Investment Analysis and Portfolio Management" to thirty graduate students in finance who are working toward their Master of Business Administration degrees. In addition, the Board of Regents of UNM requested my help in developing investment policy guidelines for the ethical screening of their bond portfolio, a subject of great interest.

This past winter was very difficult for the staff and myself due to the untimely deaths of several friends and family members. After the events of last autumn, we are poignantly reminded of the preciousness of our good health and of the many blessings of good fortune that we daily enjoy. To paraphrase the Bible (and the Byrds) "To every thing there is a season, and a time to every purpose under heaven."

We continue to analyze the markets for investing opportunities and are available for meetings on the telephone, in person, or via e-mail to assist anyone who wants to review their personal financial plan. In addition to that open invitation, we will hold our next afternoon "tea" here at our office, 510 Don Gaspar, on Wednesday, May 22 at 3:00pm. Refreshments will be served and you are encouraged to bring a friend. We are sure there will be plenty to discuss. We look forward to seeing you here and with these efforts, we hope to help our clients and friends maintain a healthy and realistic view of long-term investment strategies.

In closing, all of us here at Rikoon-Carret are positive about the prospects for the rest of this year. Every tax season gets smoother and we are grateful to have the opportunity to serve our clients in the role of trusted advisor. We have been out planting flowers in front of the office and hope you get the chance to plant a garden, even a small one. Enjoy the Springtime!