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Commentary
Winter 2004

Market Performance

The stock market had its first positive year since 1999 due to an economic recovery based on the lowest interest rates in forty-five years. The Dow Jones Industrial average finished 2003 with a gain of 25.3%. Rikoon-Carret's equity portfolios gained 25.44%. On the international scene, our European stock portfolios gained 23.85% compared to the Dow Jones Euro stock index increase of 15.68%.

The Dow's return to the 10,000 point level was a small consolation for most people as it first crossed that level early in 1999. This means that even after the huge rebound of the past five quarters, there has been little net progress in stocks over the last four years. The Dow is now up 43% from its low of October, 2002, while the technology laden NASDAQ index has risen 80% during the same period. The recovery in the large CAP US stocks has brought the market more than half way back to its record highs attained four years ago. The technology index, not withstanding its outstanding performance in 2003, remains 60% below its high achieved in March, 2000.

The bond markets continued to chug along with a small amount of price appreciation and shrinking yields due to low interest rates. Rikoon-Carret's taxable bond portfolios increased 5.78% compared to the market's increase of 5.65%. Our tax-free portfolios gained 3.78% compared to the longer term bond index gain of 4.38%.

What does the future hold? The prevailing view is that the combination of low interest rates, several successive tax cuts, a weaker dollar and lean inventories has already restarted the US economy and that in 2004 we will see gradually rising employment, low inflation and higher corporate profits. This is the rationalization for a market selling at 27 times average earnings, well above the historic average of 16. In other words, stocks are now "priced for perfection." This means that current prices are justified only if the economy, corporate performance and world stability remain. If any problems appear, stocks could suffer.

Our sense is that people are incredibly relieved that there haven't been any recent disasters, so things look pretty good. Worries about the future may not be gone but they seem to be suppressed for the time being. The market hopes that the economy continues to be robust without driving interest rates higher. All in all, present economic conditions appear ripe for the re-election of the current administration.

Mutual Funds in the News

The stock market is supposed to be an auction market where investors bid against one another on a level playing field. Unfortunately, individuals seem to operate at a disadvantage to the big players: mutual funds, hedge funds, institutional and inside players. The newspapers have been filled with more accounts of how some people, due to their “access” to privileged information, have been able to receive special favors, all at the expense of individual investors.

The first kind of infraction is when some, maybe many, of the big players in the mutual fund industry, household names like Putnam, Fidelity and Janus, are able to submit orders to buy or sell in the market after the closing bell has been rung and final prices for the day have been fixed. Many large banks, like Bank of America, have been caught enabling this practice, which gives mutual funds an unethical advantage over the rest of us. By seeing how the markets faired at the end of the day, both here and abroad, institutional investors have more time and information than the public. This allows them to determine whether to put more or less money in the market, taking advantage of common patterns or correlations between the closing prices and the next move up or down.

The funds move huge amounts of stock to take advantage of small discrepancies in closing prices. This hurts small investors because it generates huge fees, which, for the most part, go unreported and unnoticed by individual shareholders of the funds.   The motivation of bankers and brokers who helped with these kinds of unethical mutual and hedge fund trades was to garner commissions for themselves. After-hour trades are almost certain to generate significant profits because such large amounts of money are involved.

Apparently, insider information has also been used by mutual fund portfolio managers to benefit their personal trading accounts, again at the expense of you and me.   This takes place through the existence of “information” gaps. This gap is the difference between what the managers know to be the true value of the securities in their portfolios and what information is available to the public. Securities are “marked to market”, or priced at the end of each day. Sometimes, the computer services that perform this function do not have the most up-to-date information and inside managers are aware of this discrepancy. They know that in a few days the information will get factored into the price and advanced knowledge of the direction of the change is therefore valuable.

The government agency responsible for investigating breaches in the handling of stock and bond trading is the Securities & Exchange Commission, aka, the SEC. There appears to be a feud going on between the SEC and the office of the New York Attorney General, Elliott Spitzer. Spitzer is championing himself as the protector of individual investors and upstaging the SEC by uncovering and aggressively pursuing possible offenders. This is good but, knowing Spitzer is angling to run for public office himself makes me nervous, as when politician’s lips are moving, trouble is brewing!

The SEC has sent out over 80 requests for information about possible abuses to brokers, funds and institutions. Initial reports indicated that over half the respondents to the SEC letters uncovered possible “market timing.” Market timing, in this context, is not jumping in and out of the markets but is a form of “arbitrage,” which is when one party can quickly buy and then sell the same stock or bond at a “guaranteed” profit.

Why would pillars of the investment community, people who already possess considerable wealth, do such things? Putnam, for example, has professed since 1981 to be a leader in the mutual fund industry’s efforts to prevent such abuses. In 2000, when advised that this kind of activity was taking place, Putnam chose to only ask the offenders to cease their activities. Not until faced with public exposure three years later did they fire these managers.

During the boom years of the late 1990’s, investment bankers and brokerage firms showered favors on corporate executives that brought business to their firms. Hot stocks, called Initial Purchase Offerings (IPO’s), known to be heavily oversubscribed, were given to people within corporations so they could book quick profits and in return, the banks and brokers got a shot at that company’s corporate business. Then when brokers, advisors and investors heard about these investments, they were grossly overpriced and most of the time ended up dropping precipitously.

Besides some notable exceptions, few white-collar criminals have gone to jail. The rules that govern financial transactions are complex and smart and expensive lawyers are adept at befuddling citizen juries. Frank Quattrone, one of Silicon Valley’s most powerful investment bankers who led the technology IPO market, may not even face a slap on the wrist for his involvement in a long series of IPO’s that went bust. His obstruction of justice and witness tampering trial recently ended in a mistrial with the jury unable to reach a verdict. Mr. Quattrone, by the way, was paid 120 million dollars in 2000.

What is being done to protect investors? Some mutual funds, such as Vanguard and TIAA-CREF, pride themselves in being advocates for fair treatment of the small investor. Our government passed the Sarbanes-Oxley Act of 2002 to prohibit corporate accounting watchdogs from taking consulting jobs from the very people they are auditing, another area of widespread abuse in the 1990’s.   Still, no requirements exist for rotation of auditors to prevent such cozy relations popping-up again.

People in the financial industry realize that public confidence and trust are among the most important conditions for their success. Big players continue to say that the “markets should dictate limits to their power.”   The fact is that “free” markets require free information. If there’s one lesson we can learn from the many aspects of the still unfolding story of abuses in the mutual fund industry, it is that people on the inside continue to have more free information than you or I.   No amount of government legislation, regulation, or accounting will change this fact.

When the best and brightest young people go into public service instead of private industry, things may change. Until then, you can best protect your assets by finding the lowest cost, most tax-efficient, highly diversified and appropriately allocated investment approach that is available to you. These vehicles are out there. Just don't expect them to come to your attention on TV, in a slick brochure, or at a free luncheon.

Global Trade

The US dollar is at a record low versus the European currency. The reasons for its fall include record trade deficits, due to our national penchant for foreign goods, and a budget deficit that continues to deepen, due to politically motivated spending. This has caused deep concern on the part of investors overseas who must inject 1.5 billion dollars a day just to keep our currency on an even keel.

A weak US dollar is bad for American consumers because the effective price for us to buy imported items goes up. It's a lot like inflation, the silent but deadly nemesis of people living on fixed retirements or salaries.

As the US economy shows some signs of strengthening, consumers continue to borrow more and more money to keep spending, much as our government is borrowing to finance its deficit. As we continue to import goods and rely on foreign investors to buy our bonds, the inescapable consequence continues to be a weak dollar.

The buck literally and figuratively has to stop somewhere! We have become, as a country and as individuals, debtors, living well now at the expense of future generations. Our rate of saving is abysmal. Global trade, financed by debt is effectively raising the standard of living overseas through transferring jobs from the USA abroad. How does this work?

As Americans consume and foreigners produce, our dollars end up in their pockets. They can then create jobs with our capital. Why should we be surprised or upset that the result is exported jobs? Are not lower labor costs and reduced environmental standards attractive to business?

Not withstanding our national pride, it is likely that the next decade will see many high end service and technology jobs making a similar exodus. We will learn to like the English accents people have in Bombay, as they now answer many of our toll free inquiries. I wonder: did they all go to boarding school in England or just listen to Upstairs/Downstairs on India's public television?

The middle class is growing in India, Russia, and China at the expense of the good folks in Indiana. Hoosiers will likely have more Wal-Mart type outlets where they can buy low-cost goods. There will be less money in the pockets of many middle-class Americans. Blue-collar factory jobs and white collar middle management jobs are shrinking but that is a small price to pay for progress. (Wink!)

The danger is that the government tries to bail out America through tariffs, as recently happened with steel, bras, and then steel bras! We must face the fact that our international trading partners might then boycott our goods leading to an even higher trade deficit and trade war. Labor costs are ten times cheaper overseas so we should accept the fact that many manufacturing jobs are gone for good.

Global trade has made war passé. Trade works the same magic as guns but with less public relations work. For example, Mexico, under NAFTA has had to keep its borders open to US companies. This has been good for some Mexican workers and also helps Americans retiring down south of the border, but mostly it benefits American companies who have saved billions of dollars in labor and environmental costs. And we are not going to duke it out with China and Russia, former enemies of our government, because these countries now supply us with underwear and vodka.

In an age where the good of the commons seems lost to some folks, there are still good reasons to save money. You might want to diversify into Swiss Francs, gold, or tradable commodities. You could cast a vote for America by keeping your investments purely in US dollars. Keep in mind that the US dollar's value in the global market place is only as good as the oil that now backs it. As global trade and many imbalances continue, putting some of your assets outside the US could go a long way towards keeping your purchasing power intact.

Good as Gold

As the dollar has declined over the last year, US manufacturers received a boost while consumers suffered a decrease in purchasing power. However, this isn't the end of the story because when the dollar goes down, the price of gold goes up.

Until 100 years ago, gold was the standard measure of value. Our common use of the phrases "as good as gold," "solid as gold," and "backed by gold," indicates that for centuries, governments, businesses, and ordinary people knew that behind every piece of paper was a fixed amount of gold.

The "gold standard" was defined by the purchasing power of this set amount of gold. The amount of real, usable goods that could be acquired for an ounce of gold was the stable value for both gold and paper money, or currency, which were interchangeable with each other.

Gold was the universal, determining commodity that established value for the paper printed by governments. So, when a country extended itself too far, its gold reserves diminished and its citizens eventually demanded gold for their paper money. This cruel fact of life brought successive generations of royalty both despotic and benign to their knees. These century old constraints dissolved during the 20th century.

After World War II, the USA was the only financial powerhouse left standing and thus, created a set exchange ratio for gold to US dollars. The industrialized world had far outspent its reserves of gold in order to finance the two World Wars that ravaged Western civilization. The only drawback to the system created at Bretton Woods in 1944 was that we had to have gold to back up our promise to honor that arbitrary rate. Then the pledge to redeem dollars with gold was withdrawn. Since 1971, the "market" has set the value of gold versus all currencies with widely fluctuating prices. Gold remained a haven only for investors who were willing to speculate that it would eventually be worth more than paper currency.

Currently, there is some amount of natural expansion in the world's gold supply due to mining but it is a relatively small amount. The supply of paper money, however, is easily manipulated. When people believe that the value of their paper money is being undercut by irresponsible politicians or out of central political events, gold rises in reaction to uncertainty about the future. Paper money can lose its purchasing power and since gold is pretty darn inconvenient to cart around to use for buying groceries, many investors choose to hold some of each.

In 1935, between the two world wars, President Roosevelt declared private ownership of gold illegal, thereby forcing Americans to convert their gold to paper. The next year, he raised the price of gold 69%, devaluing the purchasing power of the dollars that US citizens had been forced to buy. Imagine the confusion and chaos that ensued!

From the 1930's until the 1970's, the US government set the price of gold. The oil-rich Middle Eastern nations and other factors ended that reign and so we entered into a market driven period of currency chaos. Capital flight is when a country's citizens doubt the ability of their domestic money to retain its value and so they look for the other nations' currencies to put their savings in. During the 1980's and 1990's one country after another saw its paper currency go down the tubes. Americans benefited from the chaos of the last two decades of the 20th century as imports became cheaper and other, less stable nations' money flowed into the US dollar. Gold went up and down in price but because the dollar could buy more and more goods from overseas no one really cared.

The US's ability to continue to attract money, essentially loans, from the rest of the world has been affected by our spending deficit of 600 billion dollars. To finance our activities worldwide, we have had to increase the amount of paper money by a huge amount. Between 1935 and 1971, the money supply, meaning the amount of paper currency that the public holds plus savings and deposits at banks, went up ten times. Meanwhile, the price of gold is not much higher than it was 30 years ago. Eventually, something has to give. We can stop printing money, produce more gold, or see the price of gold increase.

There are a variety of ways one can invest in gold. The most direct way is to own coins which are available through reputable dealers nationwide. Be careful not to pay too much over the "spot" price of gold as quoted in the newspaper. There are publicly traded stocks which represent ownership of bullion held in vaults somewhere. These companies take an intermediary role by dealing with physical possession, security, insurance issues, weight, etc. Their stock price is supposed to track the price of gold.

Gold mutual funds concentrate on holding mining companies stock. Mining companies, in addition to environmental concerns, tend to be quite volatile in price. They go way up and way down over fairly short time spans depending on the level of public enthusiasm for gold.

Gold is a worthwhile investment if there is a resurgence of inflation, or if the US government continues to successfully engineer a decline in the value of the US dollar;

buying gold in some form would not be a good idea if the US brings its international trading and domestic spending deficits down and reverses the trend of money supply growth. A moderate purchase of gold related investments might be well advised.

As you hear the news, don't mistake reports of strong economic growth as an indication that all is well. Gold is the best harbinger of impending fiscal prudence. The past two decades have seen so much printing of money and deficit spending that there is little chance, in my opinion, that the realignment of the price of gold relative to the US dollar will happen painlessly. You might want to plan your investment strategy accordingly.

News From Santa Fe

Soon, year-end tax reports will be sent to all clients via regular mail. They will be in a brown envelope with a label on it indicating, "Important! Tax Documentation Enclosed!" Please watch for these in order to use them in your tax return preparation process. You may want to forward them on to your accountant. You will also receive a 1099 from the brokerage firm which is the official tax documents used to prepare your taxes.

Please note that we will have two gatherings at our office over the next few months. The first will be on Thursday, February 12th at 3:00 p.m., and the second will be on Thursday, April 8th, also at 3:00 p.m. Along with drinks and hor d'oeurves, there is stimulating discussion about the markets, the domestic economy, and how world events are affecting the same.

With so many worthy charities in the world, our office decided to spread this year's holiday card fund equally among the following organizations: Open Hands, Community Volunteers Care, Inc. (to benefit the Care of the Dying hospice program in Santa Fe), The Empty Stocking Fund, Oxfam America, and Earth Care International. We thank everyone who made suggestions that broadened our awareness of the valuable programs available.

Over the holidays, we were thankful to have received several gift baskets. Since the baskets themselves are useful, we are donating them to Dragonfly's Delight's Foundation, a non-profit organization that helps women who have been newly diagnosed with breast cancer. Dragonfly's Delight's gives gift baskets to help comfort and soothe these women as they face so many important decisions and to send the message that they are not alone on their journey. If you have any extra baskets or would like to donate unique gift items for the baskets, please drop them by our office and we'll make sure they get put to good use by Dragonfly's Delight's. For more information or to join the Dragonfly's Delight's volunteer network, call 505-438-8844 or check out their website at www.dragonflysdelights.org.

It has been very dry and cold here in Santa Fe, but beautiful as always. Rob will be participating in the Mt. Taylor Winter Quadrathlon (for the 8th time!) which takes place on Mt. Taylor in Grants, New Mexico. This 53 mile event includes bicycling, running, cross-country skiing and snowshoeing. Good luck, Rob! We send all of you our best wishes and hope that your families stay well and cheerful through this winter season.