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Commentary
Summer 2001

The Markets

The second quarter of 2001 started off with a boom and ended with a fizzle. Even though the stock market gained 5% during the last three months, by the end of June, the blue-chip index was still under water with a (-7.26%) return year to date. The more volatile technology index had a larger gain during the second quarter but remained in the red for the first six months of the year with a (-12.55%) return. The international blue-chip index for stocks in Europe, Asia and the Far East continued its slide with a second quarter return of (-1.47), to end with a year-to-date return of (-15.47). International stock markets are heavily impacted by the performance of the telecommunications giants in Europe whose share prices continue to be under pressure.

The bond market fared slightly better. Taxable or corporate bonds gained ¾% in the last three months, to end the second quarter at a positive 5.46% so far this year. Municipal or tax-free bonds had a (-1%) return for the quarter, ending the first six months at a barely positive .15%. Part of the reason why tax-free bonds are not doing as well as taxable bonds is that the income tax rates changed. Due to the tax bill passed by Congress during the second quarter, tax-free bonds are now slightly less attractive for people in higher tax brackets, thus reducing demand for these instruments.

The portfolios here at Rikoon-Carret performed close to the market. Our U.S. large company portfolios ended the second quarter with a year-to-date decline of 8.8%. Our international portfolios declined year-to-date 15.8%. Our bond portfolios rose 3.2% in the tax-free area and 5.18% in the taxable and corporate arena. This continues to be a difficult market for stocks while bonds are providing a safe haven.

A Time for Every Season

Investing is sometimes more art than science. Keeping that in mind can make times like these more palatable. People who have had much of their money in the stock market for the last 15 months are ready for the dark days to be over and brighter times to come. Because of the many conflicting signals out there, it is especially difficult to know where to turn and what to do today.

I think most people realize that the "easy money" days are over. In the last 15 years, most growth stocks and mutual funds went up. A likely scenario for the near future is that the stock market will keep going up and down, within a fairly narrow range. At times like this, there are more opportunities for higher gains by owning individual stocks than by just following the broad market averages.

Finding and choosing individual stocks depends largely on old-fashioned analysis that focuses on issues like improved financial performance and determining which firms are gaining market share without giving up profitability. I believe that small and mid-sized companies in a wide range of industries will lead the market for some time to come. This means that picking the right stocks is harder now than ever.

Finding the right stocks requires digging through stock after stock, industry by industry, to find out which firms hold the greatest potential. The technology sector is a good example. Many tech stocks are at multi-year lows because they have been hurt by the dramatic slow-down in corporate spending. Given that a new generation of efficiency-enhancing devices is on its way, technology spending will eventually turn up again. Thus, we want to own the best ones, even if they remain depressed for a while. Microsoft, Dell, and EMC are among those we follow.

The companies that usually recover first in the cycle are the semi-conductor manufacturers. Industry giants, such as Microsoft, are hard to ignore. Microsoft has scheduled the release of new software that is designed to control a wide variety of Internet transactions. While it may have slower growth in the future, I feel it will still dominate its industry. Technology stocks will probably not have the kind of "big bang" effect on portfolios that they had in the 1990s, so investors who remain focused on making quick gains are likely to be disappointed.

Financial companies belong in an area deserving of a closer look. Rising business and consumer defaults have adversely affected lenders' earnings. Brokerage firms that rely on stock and bond trading are also faltering badly. Lower interest rates, courtesy of the Federal Reserve Bank, will help some finance companies considerably. Those whose costs are coming down due to reduced interest rates while profit margins are going up because they haven't passed these savings on to consumers will lead the way.

Savings and loan companies will also benefit from consolidation in their industry, and diversified financial companies should rally as well. One must pick stocks in this area carefully, analyzing the potential of the specific markets in which these firm operate, the skill of their management teams, and the operating results over the last several years.

There are certain types of stocks that do well during recessions while others thrive in a growing economy. Demographics and the desire for quality of life bode well for the health care industry in general. Health care stocks did well last year because they operate as defensive leaders. They are usually among the worst performers during economic recoveries. Presently, most drug companies are expensive, selling at extremely high premiums so investors are looking to biotech stocks instead. Biotech companies are racing to produce innovative drugs using research based on the cataloguing of the human genetic code completed last year. The first practical applications growing out of this landmark research project should appear in 2002. Because the risks and potential gains are high, biotech companies are expensive. One strategy to deal with the risky nature of these kinds of companies is to stick with established firms that already have drugs on the market and are turning a profit.

Competition abounds from genetic drug makers, so there are added threats to the profitability of the major pharmaceutical companies. The relative safety of firms like Pfizer, Merck and Johnson & Johnson may be preferable to the glamour of the more exciting but inherently more volatile biotech companies. I guess that’s what makes for horse races!

Consumer products are one of the most difficult areas to invest in. Trying to figure out where Americans will spend their money has never been easy. The two basic building blocks of our economy – housing and autos -- have held up fairly well so far but face an uncertain future. With many people seeking new investment opportunities, consumer companies have attracted tremendous interest during the first half of 2001 with the result that they are no longer cheap. While retailer stocks may not be trading at unreasonable prices, given their long-term prospects for growth, it will be hard for them to provide above average returns in the next six months.

One can’t rely solely on historical guidelines when looking at retail, hotel, and entertainment stocks. Hotels have great potential because, even though they are announcing bad earnings, the growth rate for new rooms is much lower than the expected increase in demand. When the economy picks up again, we expect business travel to jump and profitability of the hotel companies to increase. Stock prices of hotels may move down somewhat, but I feel their downside is limited. Try not to wait for the very bottom of a stock’s price cycle because, chances are, once a company’s share prices start moving up, they will rise quickly.

Energy is one sector of the stock market that tends to move in the opposite direction from most other companies. Rising gas prices at the pumps and continued political turmoil in the Middle East helped large oil companies hold up earlier this year. Now, the likelihood of prices continuing to go up is diminishing and many energy companies have recently taken a beating. The turmoil in California has cast a pall over energy brokering and transmission companies. Some of them are worth looking at because they were punished severely for minor involvement in the West Coast power situation and their stock prices should start going up again soon.

There have been many more negative than positive months in the stock market over the last year and a quarter. With interest rates coming down drastically, it is unlikely that the market will stay down for an extended period. If we do have another down year in 2001, pent-up demand for share prices will be felt strongly in 2002 as companies’ earnings start to catch up with an accelerating economy.

We look for companies that have steady earnings growth during both good and bad economic times. One cornerstone of successful investing is not to be rushing in and out of the market, chasing last quarter’s stellar fund or hot stock. You can sit quietly on top of your quality companies. Analyzing and buying stocks based on traditional criteria is not easy, but doing it will help you sleep well at night.

International Markets

It is rare to have the chance to see major structural changes occurring in not one, but two of the world's major economies – in this case, in Germany and Japan. In my opinion, these changes will provide major investment opportunities over the next decade for those willing to enter these markets.

For almost a decade, Japan has avoided the stiff measures needed to help its economy. Unfortunately, it may still take several years for Japan to implement the sharp measures needed to heal that country's economy with the help of its recently elected government. Recent economic news from Japan shows it will hardly grow at all in 2001. Current interest rates being paid by Japanese banks hover around 0% to 1%. What will it take to move Japan into a growth mode?

The most serious unresolved issue is bad debt on the books at major Japanese banks. The U.S. savings and loan crisis of the 1980s threatened to pull down the entire U.S. financial system, but regulators and the use of market mechanisms allowed the system to sell or write off the bad loans and then close poorly managed facilities. Our economy was able to overcome the crisis and recover within two years.

Unfortunately, Japan has relied on tax payers' money for infrastructure projects, spending more per capita than any other industrial country. This has crowded out the private sector, making it difficult to get the capital to grow a business. Is Japan going to face the music? The new minister, Mr. Koisumi, is considering having banks deal with their worst loans, but not for two or three years from now! He wants to privatize some public enterprises, like the postal system, which plays the strange role of "holding tank" for much of people's cash in Japan. None of the prime minister's plans give specific target dates, which is why I don't have much faith that they will actually be implemented.

What a contrast this is to the news coming out of Germany! Intensifying foreign competition and the elimination of a long-standing capital gains tax next year are forcing Germany's banks and insurers to undo fifty-years of corporate cronyism. Since WWII, banks, insurance companies and industrial companies were allowed to serve on each other's boards of directors and protect each other's turf. This practice provided much needed stability and secure employment for a majority of German working people, a program that now faces an uncertain future.

One of Germany's largest banks recently gave instructions to its client companies (which are both customers and shareholders) to cut 20% of their work force immediately and look hard for other cost-saving measures. This is reminiscent of the early 1980s in corporate America. The German economy used to be concerned primarily with producing high-quality products, second with treating employees well, and only then with taking care of shareholders. This is about to change.

The German economy is slowing, due to the United States recession and declining domestic demand. Unemployment in Germany is at 9.3%, with many companies predicting more lay-offs. The new capital gains tax will provide the incentive for corporate leaders to take an “Americanized” view of their firms, focussing on the bottom line with the intention to increase shareholder value. In addition, landmark legislation passed recently that will create a reason for the public to take a much more active interest in their stock markets.

At the present time, only 10% of Germans own stock, compared with approximately 50% of Americans. The new laws will create private retirement plans much like our 401(K) plans that will encourage the working- and middle-class to acquire interest in domestic companies. At the same time, many formerly government-owned monoliths are turning away from their traditional source of financing, banks and insurance companies -- towards more market-driven sources of capital -- that are both less expensive and more flexible.

In the words of one German industry chief, “Tax reform has removed all the excuses for preserving the status quo.” This reflects a change in world view and portends a shift in the economy and a potential stock market turn-around. What does this mean for investors looking to put some of their money overseas? Germany may undergo the kind of rapid change seen in the United States in the 1980s when “Reaganomics” took hold and social quality control was replaced by faith in market forces. For Germans, the expectation of life-time employment may soon fade. There was a joke in Germany that shareholders were to be treated like mushrooms -- kept in the dark and thrown a little fertilizer now and again. The reversal from social safety net to capitalistic entrepreneurs will hurt people at the bottom of the education scale but benefit investors in the German stock market.

Unions will be the biggest losers in these changes. Their members will have to work just as hard for lower pay with less security, a very difficult political maneuver. There is likely to be a lot of unrest since the German system allows for and tolerates active demonstrations by union members.

Germans realize that the financial underpinnings of their society are changing rapidly. Many of these changes have their roots in the early 1990s when the West Germans came close to overspending capital stock on the reintegration of their much poorer brethren in the East. Many jobs in industries where the unions are well organized are disappearing, and the new jobs being created are in the service sector where union power is weak. This should sound familiar to students of the American labor movement.

Dealing with change is something most Americans have gotten used to. Germany will be the first country in Europe to trade off social entitlements for individualistic opportunities. There is a commitment in Germany to give incentives to companies and individuals willing to become involved in the capital markets.

These changes will be difficult for some Germans and may be wrenching for much of the German social system. If successfully implemented, however, the growth in German stock prices over the next ten years may be similar to what we saw during the bull market of the 1980s and 1990s here in the United States. This will bring new wealth to the German economy.

Personal Notes

Santa Fe has been enjoying above-normal moisture this summer and this has helped our local fauna and flora flourish. The mood is bright among outdoor enthusiasts since fire danger remains low. Speaking of the outdoors, I have reentered the arena of semi-competitive endurance races and will participate in the Las Vegas, NM triathlon at the end of July. This is a swimming, biking and running race. I look forward to seeing the Governor of New Mexico there, as he generally makes a good showing at these events.

Later this year, I will be traveling to New York City, not only to visit with our partners at Carret & Co. in Manhattan but to run through all five boroughs in the New York City Marathon. Traveling to the East Coast will become a more regular occurrence for me in the upcoming year since my daughter Robin is going off to school in western Massachusetts at the end of the summer.

One of our staff members, Beth Humphreys, received an invitation to travel to Oxford this summer to study philosophy and literature. She will be gone for six weeks. Laure Dreher, our systems person, recently presided as judge over a culinary festival in Virginia. She occasionally demonstrates her talents in our own kitchen, here at 510 Don Gaspar.

Given the ample rain this year, northern New Mexico's golf courses are greener than usual and Steven Madeysky and Chris Schreur have been taking the opportunity to play with some of our clients. Please let us know if you'd like to go out for a round or two with either one of them!

The next quarterly tea will be held in the garden here at our offices, on Thursday, August 30, from 3:00 to 5:00 p.m. Friends, relatives, acquaintances, and countrymen are always welcome to join us.

Living in New Mexico often presents us with challenges. Along with many businesses, we will be changing our zip code and area code some time in the near future. The zip code change was actually effective July 1, when it changed from 87501 to 87505-2626. If you are also undergoing a zip code change, please give our office a call to confirm your new number.

I am doing some public speaking this summer. On July 25, I will speak at our Albuquerque offices located at 3200 Carlyle, N.E. Sessions will be from 2:00 to 4:00 p.m. and from 6:00 to 8:00 p.m. In Santa Fe, I will speak twice at Quail Run on August 29, from 2:00 to 4:00 p.m. and from 6:00 to 8:00 p.m. Current stock market strategies will be the subject of these talks. You are invited to attend any of the sessions.

Summer is my favorite time of the year because the daylight lasts so late into the evening and starts so early in the morning. I hope you are enjoying the season as well.