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COMMENTARY SUMMER 2000

The Markets

In the first year of the new millennium thus far, the stock market has cooled off and is taking the threat of inflation and unemployment seriously. Year to date, the broadly diversified index of large U. S. blue chip companies known as the Standard and Poor's 500 Index has had a negative one-percent return. While this seems rather anemic, even such a nominal loss constitutes a relatively healthy situation when compared to the more concentrated Dow Jones Industrial Index return of negative nine percent, or to the technology laden NASDAQ composite index decline of two-and-one-half percent. Why has the stock market suddenly lost its steam? Under the leadership of Alan Greenspan, the Federal Reserve Board has initiated a vendetta against inflationary expectations. While many stock market enthusiasts blame the Federal Reserve for dampening the spectacular rise in stock market prices, we at RIA feel that the Federal Reserve is doing its job by responding early to increasing prices. To cite just one example of an increase in the price of raw materials, oil now sells for over \$32 a barrel as compared with under \$20 a barrel only a year and a half ago.

A dearth of qualified labor also exists in the U. S., and unemployment levels are at historic lows. While a low unemployment rate is positive from a social point of view, it often is a harbinger of a rise in inflation as wages increase in response to demands for new employees. Retail sales have slowed down recently, but the great leveraging up of the American consumer through the use of credit cards and home equity loans has not yet decreased to any great extent. Unless wages and inflation do go up, many people are facing a personal credit crunch.

In line with the average of the Dow Jones 30 and the Standard and Poor's 500, Europe's stock markets have lost about four-and-one-half percent so far this year. Bonds continue to provide good income at this point but only very moderate total return. The municipal bond index is up four percent, and the corporate bond index is up two percent. Both of these benchmarks are in line with the Rikoon bond portfolio's increases of two-and-one-half percent.

On the stock side, our portfolios continue to keep pace with the best performing indexes. Through the end of June 2000, Rikoon's U. S. large capitalization portfolios gained one percent, while our international stocks declined two percent. We continue to believe it is important to have representation in all areas of the world, especially in the growth industries in the

U. S. Buying great companies at reasonable prices is our interpretation of how traditional value criteria should be applied in today's world of fast-changing markets. The Dow Jones Industrial averages had eight stocks that were up through the end of June while 22 moved down. The best performer was a recent addition to the Dow, Intel Corporation, which is a favorite of New Mexico residents. Also advancing nicely were Disney and Hewlett Packard. The worst performing company was Procter & Gamble, which declined 49 percent. Microsoft also fell 38 percent, while AT&T lost 34 percent of its value. In our view, none of these three companies deserves such a severe beating, so these areas of the market are where we are looking to invest new money.

Technology companies lead the Standard and Poor's performance. Two of our holdings, Scientific-Atlanta and ADC Telecommunications, led the pack in the S & P 500. One of the worst performing companies was Qualcomm, which declined 62 percent during the first six months. Qualcomm gained 2,000 percent in 1999, and so it is easily understandable why it has pulled back. Small company stocks, as a whole, advanced 1.78 percent as investors looked outside of the traditional blue-chip-company asset class. In Europe, the best performing stock market was Sweden, which gained approximately 10 percent. Two of our companies, Ericsson and Nokia, were largely responsible for this increase. The two worst performing markets in Europe over the last two quarters were England and Italy, both of which declined 11 percent. Japan declined 13 percent.

How Technology Is Changing the World

The technology driven NASDAQ market has finally taken a breather after gaining 80 percent last year. Even the wild and woolly world of venture capital has slowed down. It may prove easier now to take a saner look at the overall impact of technology on the global economy. One of America's greatest products and industries is entertainment. For better or worse, the entire world eagerly looks to the U. S. for new ideas and trends. Much of this material originates in California, where more new ideas and entrepreneurial ventures are generated than anywhere else in the world.

Let's take a look at the movie industry, and how it is being impacted by technology. Hollywood used to be able to control how quickly movie releases would be shown around the planet, and with what kind of advance promotion. By controlling communication channels, industry experts could maximize their profits by influencing demand and supply. The advent of digital video disks (DVDs), which can be played on computers and transmitted over the Internet, has vastly changed the landscape in which Hollywood operates. This kind of information can be transmitted instantaneously, so, regardless of where people live, movie fans can use the Web to access marketing materials and even download the actual movie.

As a result of such widespread and basically uncontrollable dispersal of their products, the entertainment industry is rushing towards an all-at-once global distribution for its films. In contrast with the situation even two years ago, when a film may have taken seven months to reach Portugal, new releases will be available in most of the world's markets within sixty days. Because consumers

everywhere await the release of movies eagerly, Hollywood's moguls find themselves being forced to distribute films in places and through means over which they can no longer exercise control. Loss of control is the major hallmark of the new economy and the emerging Internet/information age. With instantaneous access to information through innovative technological channels, the means by which people communicate have begun to change the way business is conducted. People in Paris do not want to wait to see new movies, nor may they even want to go to the theater to see a movie.

Because individuals readily possess the ability to reproduce information outside of traditional methods, film and music executives have had to rethink their traditional distribution methods in order to garner profits before the information is free. The Internet has allowed consumers to prove themselves quite ingenious in their ability to disseminate information around the world. The restrictive coding of DVD players, along with the ability to control the distribution of music and films, is quickly slipping away from centralized authorities. It's not just do-it-yourselfers who are altering the way entertainment is produced. Mainstream businesses in Europe and Asia have begun to do this as well.

About 10 percent of the U. S. DVD shipments go to foreign buyers; this diminishes the profitability of the major studios because, in some cases, the electronic forms of their proprietary information are reaching foreign markets before the actual films. Realizing this, the studios have responded by making simultaneous translations and releases of films worldwide. The need to speed up the process of disseminating content is difficult and expensive, so they are spending more money than in the past. Actors now must participate in additional marketing campaigns as part of this rapid global packaging of their products.

On the other hand, studios are now able to recycle and revise the same posters and materials created for the U. S. market for other places around the world. With the melting of cultural lines, media events are now executed in the same format no matter where they occur. In a technology driven age, people have to move and think quickly. Business now needs to move decisively in order to safeguard any kind of unique attribute or service.

Another example of how technology is changing the world of commerce is seen in the battle between United Parcel Service and Federal Express to become the top competitors in the lucrative business of providing service to manufacturers. While both companies deliver packages, behind the scenes they are trying to help companies deliver parts and materials to their clients' subcontractors, as well as to their customers. Federal Express is even helping small businesses grow their own on-line Web stores. Although a huge business demand for supplying and transporting goods currently exists, neither UPS nor Federal Express can be content to remain in the more traditional role of being a fleet of trucks and drivers.

Members of the U. S. Congress, in recognition of changing circumstances, have begun the process of making electronic signatures as legal as handwritten signatures. It may soon be possible to set up brokerage accounts, close mortgages, and sign certain contracts without any actual papers! This draft promises a huge increase in electronic commerce and services. Experts

estimate that such new legislation will take ¼ of 1 percent off the cost of loans. Clearing checks electronically will save banks between 4 and 5 billion dollars per year. There are predictions that the resulting productivity increases due to technology's introduction into communication and negotiation will change the very nature of products themselves. On the other hand, a growing reliance on electronic transactions will also increase the possibility of fraud. Lack of privacy remains an important concern. Congress is attempting to ensure that consumers will be able to check on the accuracy of electronic files and provide a verification check on every electronic transaction. A growing political concern is that people without access to the Internet or an email address will soon be severely disadvantaged.

International Markets—Japan

It is interesting to reflect on why Japan continues to languish in economic doldrums. Changing the very nature of a tradition-bound culture is difficult. Japanese consumers do not have a strong voice in their government's affairs. Individuals in Japan are taking the reins, however. The saga of a dissident son of an important Japanese family offers an example. K. Iwase, an insider of a Japanese company, became frustrated with the traditional ways of doing things. As a result of his dissatisfaction, Mr. Iwase ended up challenging the top executives in order to get information about what the firm actually was up to. The Japanese have believed that a company essentially belongs to its managers and its employees—not to its shareholders. This makes it hard for businesses to restructure, and the attendant inefficiencies go a long way toward explaining why Japan's economic slump has lasted so long.

Mr. Iwase was a leading executive in the Mitsukoshi Company, which is one of the members of the Mitsui *keiretsu*. A *keiretsu* is a powerful alliance of companies that are intertwined with each other. They are a kind of "good old boy" network, and they have caused Japan much trouble because of their resistance to change. Mr. Iwase's father was president of Mitsukoshi. Iwase himself was a rising star until he clashed with President S. Okada, over Okada's supporting a mistress by channeling company business to her. Mr. Iwase arranged for a journalist to interview his boss, and the reporter surprised Okada with questions regarding his mistress. After being exiled for five years to a distant island due to this abrasive ploy, Mr. Iwase returned to company headquarters to find that the company had spent half a billion dollars on a golf course that was never built. Golf is a passion of many Japanese executives, but this was going too far for Mr. Iwase. He set out to unearth the details of how Mitsukoshi could have spent and then lost so much money. He pursued access to information in much the same way as any U. S. shareholder activist or government investigator would have done in a similar situation. Iwase was then thrown out of the company, so he went to court, where he was eventually validated. The company had to consent to the release of documents regarding the golf course project. In 1998, the company was still trying to preserve secrecy regarding the project. At a shareholder meeting in 1999, the issue was raised and angry shareholders deluged the firm's management with demands for

information. The painful process of opening up a company's books confirms that Japan still has major problems. Until these closed attitudes change, it is unlikely that Japanese companies will be able to compete in the world economy with any substantial impact.

In an effort to address this situation, many Japanese are rejecting their traditional business methods and coming to the U. S. for business training. One company, Panasonic, has even opened up a research-and-development center in Silicon Valley. They hope that the entrepreneurial spirit will brush off on their young executives as mist collects on a person walking through the fog. It is debatable whether a government-mandated push to become "more entrepreneurial" will succeed. Many young Japanese executives are leaving their companies and coming to the U. S. on their own, to study at U. S. business schools, which are good places to gain new ideas and perspectives. Upon their return to Japan, most of these young executives are highly sought out by their stodgy, former employers. They may work for a year or two inside a larger company to gain access to capital; however, many of them plan to open their own businesses. This is the kind of activity that will ultimately bring Japan into the 21st century.

Green Investing

A positive aspect of the impact of technology on commerce is that traditional craftspeople and artisans have been gaining access to world markets through the Internet. In Nepal, copper tradesmen have increased their sales by 50 percent due to an Internet start-up company called World2Market.com. World2Market has established a mutually beneficial relationship with the copper tradesmen, enabling them to sell their handicrafts through World2Market's Internet site. People are able to work without being forced to leave their native community. Some people can even afford to send their children to school on the increased earnings. World2Market is a Seattle-based company that buys from organizations representing groups of rural women and disadvantaged urban youth. The opportunity to earn money in traditional handicrafts increases the cohesiveness of the village as well as cuts down on the number of people who have to migrate to large cities in order to take menial jobs. The copper smiths in Nepal sometimes work 12 hours a day, but they are willing to do so because of their increased standard of living. The craftspeople band together and one of their members takes the produced goods to a central location, to be picked up by World2Market's representatives.

Unlike traditional non-profit groups that have tried to market developing world handicrafts, these newer breeds of for-profit companies, like World2Market.com, Novica.com, and oneNest.com, use sophisticated marketing and financial techniques to boost the local artisan's income. The founders of these green companies are proud of the humanitarian and fair-trade aspects of their work. We believe that this constitutes a redefinition of socially responsible investing. Like the young U. S. entrepreneurs who co-founded World2Market, the marriage of technology, entrepreneurial practices, and international communication bodes well for traditional communities that have maintained some

aspect of ancestral handicrafts. Internet businesses aim to cut out the “middle person” by encouraging big stores, such as Neiman Marcus and Bergdorf Goodman, to order goods directly through an Internet site. This boosts sales and the flow of money to villages in third-world countries. “More work for more people is what it is really all about,” is what World2Market founder Michelle Long says. We at Rikoon Investment Advisors couldn’t agree more and hope that this aspect of technology does not evade the mainstream investment community’s attention for much longer.

Mike’s Corner

We have a rather lengthy, yet interesting, commentary this quarter so I’ll be brief with “Mike’s Corner.” Is it just me or has the first half of 2000 really blasted by quickly? Tax season has come and gone (painlessly I hope!) and I’m proud to say that Rikoon Investment Advisors, again, successfully supported our clients and their tax advisors with the critical data needed to finalize the tax year. One of the many services we offer is to prepare your end-of-year and/or end-of-quarter tax reports for you and your tax advisor.

I introduced several new team members in the last edition of “Mike’s Corner.” I hope you have had an opportunity to speak on the phone with or actually to meet our newest team additions. We’ve done several things in the most recent months to help ensure the best client services and portfolio management available. For example, by hiring qualified, motivated individuals, we can continue to offer our personal attention on a one-on-one basis. It’s this kind of service that built Rikoon Investment Advisors. Rob, I, or one of the great staff people here will be speaking with you soon about these enhancements. As always, I look forward to and appreciate your comments and feedback regarding our services and staff. Our goal is to continue building a client-focused, full-service financial management firm by listening to and acting on your suggestions and needs. I hope to see you at our next afternoon tea scheduled for August 17, 2000, from 3:00 to 4:30 p.m. Bring a friend!

Personal Notes

As many of our readers know, the second quarter has been a difficult one due to the passing of my stepson, Brian. After finishing the school year, my wife took our two girls—Robin, 14, and Hannah, 11—to Costa Rica for the month of June, to live with a Costa Rican family and to learn Spanish. Their introduction to Costa Rica, nicknamed the “Connecticut” of Central America, was educational for everyone. Athletic competitions have been put on hold this summer as I have been working towards establishing a strategic partnership with a group of like-minded investment advisers based in New York.

By the time this commentary arrives, we hope to have experienced some more moisture as so far this spring and summer we have had much wind, a few clouds, but little rain. The recent closings of the National forests provide us with a humble reminder of how many of life’s truly important things remain outside of our control. I wish all of you a safe and happy summer.