

THE TREND IS YOUR FRIEND
...A Long-Term Market Perspective



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Introduction

Over the last two months our old friend, *Investor Optimism*, has begun to poke its head out of the bunker where it has been hiding for the past two years. *Investor Optimism*, along with strong economic fundamentals, is the fuel that powers markets. Together, they have created a very powerful *trend*, which over time, has continually re-asserted itself to drive the markets to higher highs. However, these all important fuels were in short supply until recently, as the past two years have left investors shell shocked and skittish.

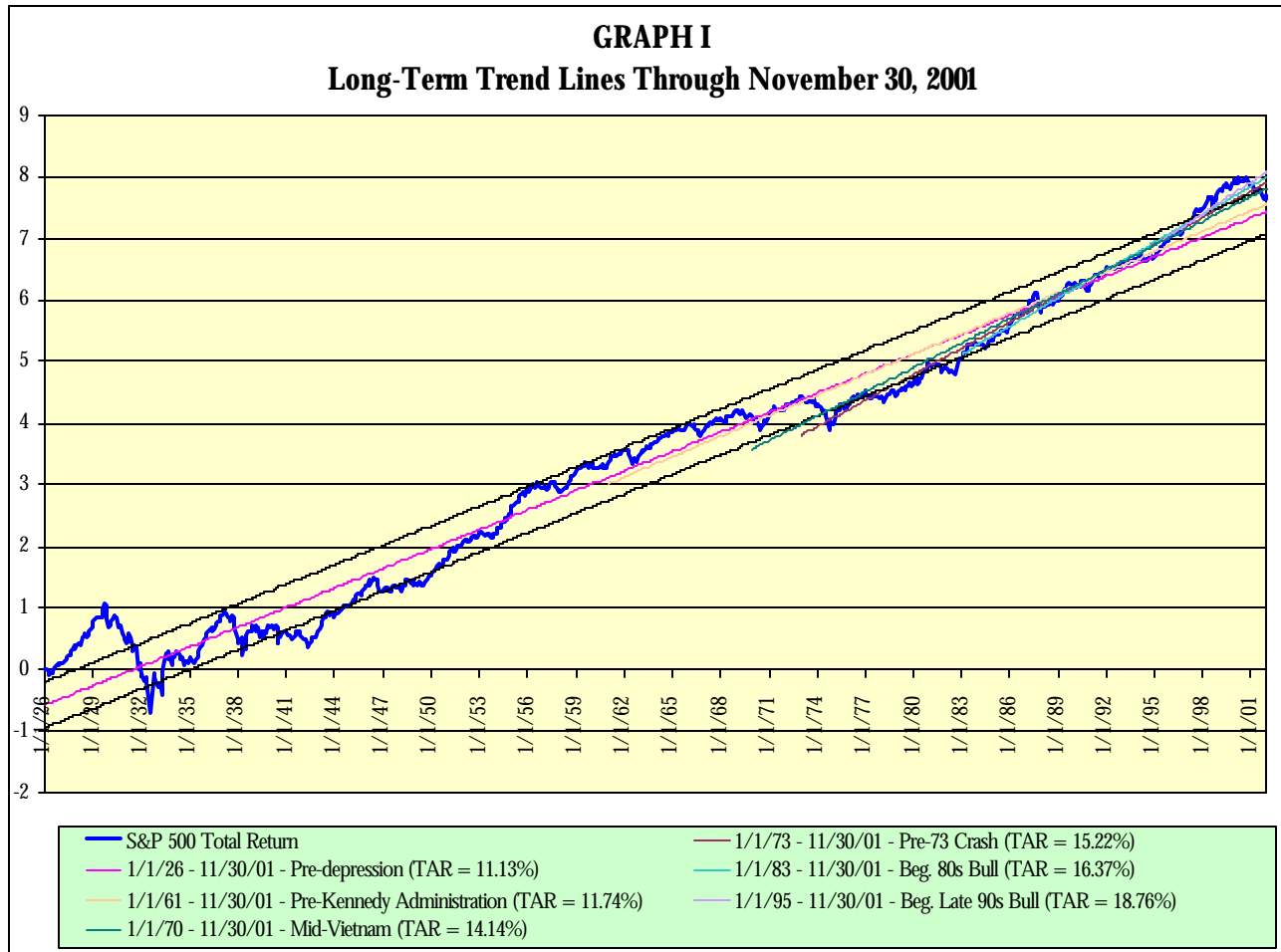
In spite of the recent market upturns, the opinions of the high profile market professionals on the near-term future of the markets remain mixed. Most “professional bulls” are cautiously bullish while most “professional bears” remain bearish. However, none of these professionals accurately predicted the events of the past two years and their impact on stock prices. We have little expectation the future will be any different.

As long-term strategic investors, we have always advocated the logical implementation of a long-term plan which allows investors to weather any financial storm. Nevertheless, we have agonized over the market performance of the last two years and the effect it has had on our clients’ equity portfolios. We have asked ourselves repeatedly what we could have done differently given the facts and markets as they existed at the time, without the benefit of today’s hindsight. Our answer is repeatedly, “not much.” At any point in time, the worldwide financial markets reflect the consensus assessment of all investors and their collective views of the future. To the extent the markets were able to anticipate the coming of a global recession, these views would have been reflected in prior valuations. Since the ability to accurately and consistently predict changes in market direction and momentum has proven as illusive to high profile market professionals as to anyone else, where do we search for guidance to determine whether the recent re-emergence of *Investor Optimism* is well founded?

Examining Long-Term Trend Lines

As we try to better understand the events of the past two years and their potential impact on the future, we find that a look at history provides us with some perspective. Graph I on the following page reflects the performance of the S&P 500 from January 1926 through present. It also highlights several other time periods of historical significance. Before evaluating the information presented in this graph, it is important to first note that the rate of return presented for each of the periods is not the actual returns from the beginning to the end of each period. Such time specific “data mining,” has the benefit of simplicity, but creates too narrow of a view. It is highly unlikely that any investor actually entered and exited the markets on the exact beginning and ending dates of any such an analysis. Rather the beginning and ending dates for any investment are generally random. Depending on the time period in question, as little as several months difference in beginning and ending dates can create a materially different result.

To eliminate this time specific element, we created *trend lines* using regression analysis to plot the best fit line through the market performance for a given period. In effect, these *trend lines* represent the “mean” or average rate of return for investments made from all potential beginning points to any random ending point during these respective periods. We refer to the averages as Trend Average Returns (“TAR”). For simplicity, each *trend line* begins on January 1 of the relevant beginning year and ends on November 30, 2001.



The first period we examined began on January 1, 1926, so as to include the stock market bubble which preceded the stock market crash of 1929. This time period is the one most often cited as the benchmark for long-term equity returns. While a 75-year timeframe may be of little relevance to any of us since we are unlikely to live another 75 years, it provides us with an interesting historical perspective from which to begin our observations. This period encompassed almost every conceivable political and economic event beginning with the boom of the “Roaring 20’s” followed shortly thereafter by the Great Depression. In addition to the Depression, it includes 11 recessions (prior to the current one) and subsequent economic recoveries – a perfect track record. This period also includes World War II, the beginning of the nuclear age and the nearly 50 year long Cold War. It encompasses numerous other wars ranging from Korea, Vietnam, and Desert Storm to Kosovo and the beginning of our new War on Terrorism. This period also saw the assassination of a President, the resignation of a President, two oil embargoes, a man on the moon, and the creation of the personal computer and Internet. It ends shortly after the September 11th attack on our homeland which resulted in one of the largest one day losses of human life on American soil. During the last three quarters of the “American Century” and into the beginning of the new millennium, the *trend line* for the broad U.S. equity market generated a rather respectable 11.13%.

Given the incredible changes we have seen over the past 75 years, we find more recent history (relatively speaking) to be of greater relevance. Therefore, the next period we examined began 35 years later in January 1961. The start of this timeframe coincided with the inauguration of President Kennedy. It was the beginning of the optimism of “Camelot” and technological progress of the space age; yet it was also the beginning of the Vietnam War and a time when the proliferation of the Intercontinental Ballistic Missile made the possibility of instantaneous nuclear annihilation a reality. This was the beginning of the end of the 1950s “Happy Days” and a time when the seeds of social unrest, and the resulting social change of the late 1960s, were being sown. Importantly, this was an era which included the formative years of today’s generation of leaders which undoubtedly shaped their personal historical prospective. The long-term performance *trend line* for this time period was 11.74 % – only 60 basis points higher than the 1926 long-term *trend line*.

The next relevant period we considered began in January 1970. This marked a time of mixed emotions for most Americans. During the preceding decade, The United States had become a nation divided. Man had just landed on the moon, yet we were deeply embroiled in Vietnam with no immediate end in sight. With the benefit of historical perspective, we note that the beginning of this period may have marked an inflection point for the stock market as we observe an apparent upward shift in the stock market *trend line*. During this period the market *trend line* was 14.14% – nearly 240 basis points or 20% greater than the period which began only nine years earlier.

This shift in the TAR may have been caused by a shift in financial and economic policies. The early 1970’s marked the beginning of the end of the gold standard and the fixed currency convention of Brenton Woods as we entered the era of floating currencies. A more active and powerful Federal Reserve Board also emerged. Today, as a consequence, the Federal Reserve Chairman is recognized as one of the most powerful people in the world. Given the number of historical events which occurred during the ensuing 30 years, including four recessions and recoveries which preceded the current recession, we consider this perhaps the most relevant time period in terms of understanding what long-term market trends may be in store for stock markets. The events occurring during this timeframe are recent enough to have relevance to today’s times. And, thirty years provides enough historical perspective to place these events in the proper context.

The next relevant time period we analyzed began in January 1973 – only three years after the last time period. However, we felt this date was worth examining since it *immediately* preceded the 1973 - 1974 bear market. Even considering the market performance of the past two years, 1973 - 1974 still marks the worst stock market decline to date since the Great Depression.

This was a period during which the pent-up inflationary pressures of Vietnam were first released. It also marks the beginning of the Watergate crisis and predates the first Arab oil embargo by less than one year. These dual political and economic crises that confronted us in the face of an already deteriorating economy were further complicated by the ever-escalating Cold War. In our opinion, these events combined to create far greater challenges than we face today. The constitutional crisis created by Watergate shook the political foundations on which this country was built. The first of two Arab oil embargoes we would experience before the end of the decade had a pervasive impact. It deprived us of the very life blood which nourished our largely industrial economy, and it shook the very economic foundations of this country.

The early 1970s were also notable for the failed experiment with wage and price controls and “WIN” (Whip Inflation Now) buttons. This gave way to the “stagflation” – a stagnant economy and double digit inflation - that marked the middle to the later part of the decade. The 1970s ended with a prime rate that ultimately exceeded 20%, and a feeling of “malaise” in which Americans

began to believe the best times were in the past. Yet, in spite of a very difficult beginning, the *trend line* for this period produced a TAR of 15.22%, nearly 110 basis points higher than the period which began merely three years ago.

The next historically significant time period we looked at began 10 years later. In January 1983, the 1980s bull market was only a 2½ month old infant. The United States had just emerged from one of its worst recessions in the postwar period. It was “morning in America.” The United States was engaged in an unprecedented military buildup which would ultimately bring about the end of the Cold War. At the same time we were in the early years of a tax revolution which brought Americans lower tax rates and greater economic growth than they had seen in almost a generation. However, the combination of these two policies was blamed in some quarters for ballooning budget deficits which would plague us for the next decade and a half. On the technology front, this was the beginning of the personal computer revolution— a revolution which forever changed our lives – as desktop computing began to take over the home and the office. From this period of time the stock market *trend line* reflected an average return of 16.37% – nearly 223 basis points or 15.77% higher than the TAR for the 1970 period which began 12 years ago. The return for the 1983 *trend line* was also some 524 basis points or 47% higher than the TAR for the 1926 *trend line*.

The final time period we analyzed began 12 years later in January 1995. This marked the early stages of the great bull market of the late 1990s which culminated in the “bubble” for which we have paid the price over the last two years. This was a period of post Cold War prosperity in which the United States enjoyed the benefits of the peace dividend and set itself on a course to balance the budget for the first time in decades. It was also a time of even more incredible advances in technology, the most ubiquitous being the wide-spread adoption of the Internet. This technological revolution, while creating unrealistic near-term financial expectations and a stock market bubble, is likely to have changed the face of the world for the next several generations. In spite of the bear market which has plagued us over the past two years, this period saw a *trend line* of 18.76% – some 203 basis points or 12% greater than the period which began 12 years ago, and some 763 basis points or 68% higher than the 75 year long-term TAR.

Making Sense of History

As we look back on these various *trend lines*, two relevant questions present themselves. The first is “which is the most relevant time period in terms of predicting future trends?” The second is “what was the impact of the post 1994 *trend line* on all the *trend lines* which preceded it?” We must examine the second question before we can examine the first.

If we adjusted the performance of the *trend lines* for the starting dates we have discussed by excluding the benefit of the post 1995 *trend line*, we see that on average the returns of these earlier *trend lines* would have been reduced by only some .5% - 1.6%. This point is illustrated on Graph II and Chart I which accompanies it. We see that among the more relevant time periods, the 1970 TAR was reduced by some 1.46% to 12.68%; the 1973 TAR was reduced by 1.13 % to 14.08%; and the 1983 TAR, was reduced by 1.56% to 14.81%. Given the perspective of the past two years, any one of these *adjusted* modern era *trend lines* would provide an excellent rate of return for the long-term equity investor.

GRAPH II
Long-Term Trend Lines Through December 31, 1994

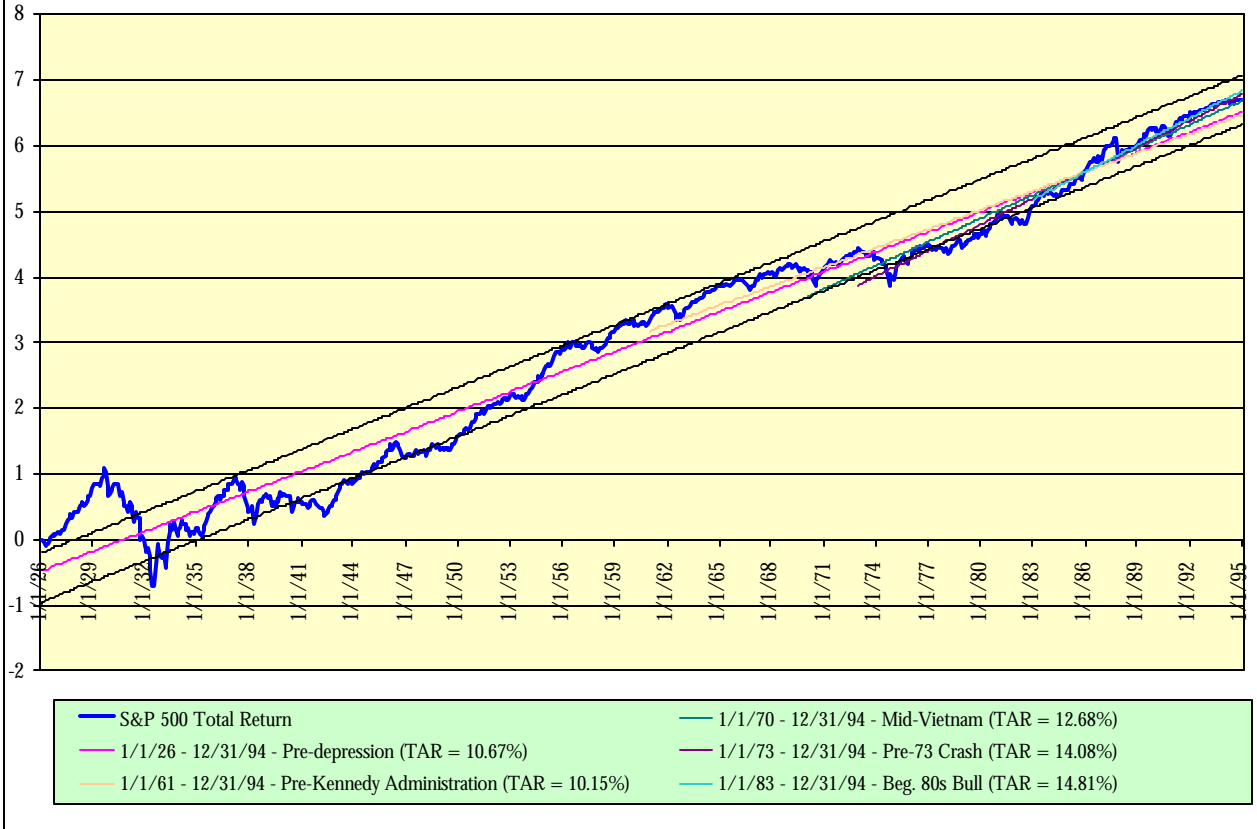


CHART I
Long-Term Performance Without 1995 Trend Line

| S&P 500 Trend Line | TAR Through 11/30/01 | Adjusted TAR Through 12/31/94 | Increase in TAR from 1/1/95 |
|-------------------------------|-----------------------------|--------------------------------------|------------------------------------|
| January 1926 TAR | 11.13% | 10.67% | 0.46% |
| January 1961 TAR | 11.74% | 10.15% | 1.59% |
| January 1970 TAR | 14.14% | 12.68% | 1.46% |
| January 1973 TAR | 15.22% | 14.08% | 1.13% |
| January 1983 TAR | 16.37% | 14.81% | 1.56% |
| January 1995 TAR | 18.76% | N/A | N/A |

As to the first question, unfortunately we cannot provide a specific, objective answer which is supported by empirical data. However, we can offer some perspective. We place less weight on the 1926 *trend line* since the world has changed radically over the past 75 years both politically and technologically. We also discount the 1961 *trend line* given the dramatic changes that ensued after 1970. In terms of reflecting modern technology, a strong argument can be made that the 1983 *trend line* is the most relevant since it marked the early days of the personal computer along with technological and productivity enhancements created by that revolutionary tool. In terms of greatest relevance to the present time, the 1995 *trend line* reflects both the post cold war political realities and recent technology advances. However, this period is too short to provide meaningful conclusion and is marked by periods of overreaction in performance at both extremes. If we exclude the aberrational performance of the 1995 *trend line* from the 1983 *trend line*, we are left with only a 12-year time frame. This time period probably does not incorporate a sufficient number of events to provide an appropriate historical reference point, and thus discounts the 1983 *trend line* as a valuable

reference tool. Therefore, we are left with either the 1970 or 1973 *trend lines* for reference. Both these periods are long enough to provide us with ample perspective since they incorporate a series of negative political and economic events to which the economy was able to adjust. Given its slightly longer perspective, a slightly more conservative TAR, and the inclusion of more varied events, we opt to look to the 1970 *trend line* as the most relevant for purposes of evaluating our current times.

As a final check, we averaged the *adjusted* TARs (i.e., excluding 1995 *trend line* performance) for the 1970, 1973 and 1983 *trend lines*. In averaging these returns (which, by definition places more weight on each of the later periods which are all included in each of the preceding periods), we get 13.8% – a return which approximates the 14.14% TAR of the 1970 *trend line* to present. While trained statisticians may rightfully take exception with this simplified methodology, this analysis provides some additional perspective leading us to suggest that the post-1970 timeframe may be the most relevant in terms of viewing our current world.

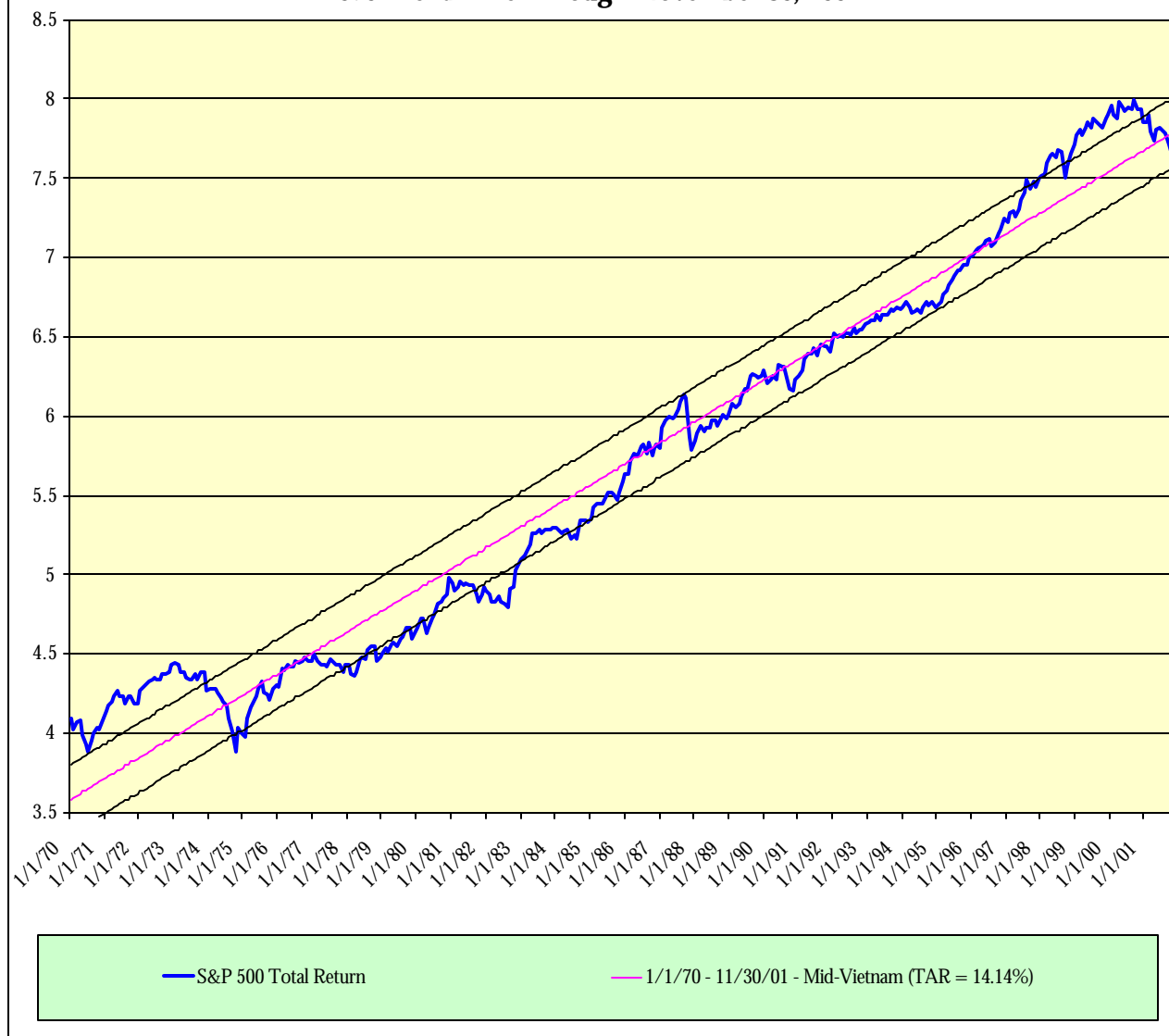
Is Past Prologue?

While we hope that the forgoing discussion has been of some interest, you may still be asking “what is the relevance in terms of how we perceive the current stock market environment?” For this question, we cite back to Graph I. In Graph I we can see that during the late 1990s a “bubble period” emerged when the market exceeded all the *trend lines* by a significant margin. The market bubble reflected all the talk of the “new economy” and a “shifting paradigm” which even the greatest skeptics had trouble ignoring after five years of unprecedented market growth at the end of the last century. However, hindsight accurately reflects that the market bubble was created by an unrealistic state of illusion that was controlling investor psychology. As has been the case throughout history, crowd psychology had created a near-term distortion in market valuations. By the same token, as we look to the end of Graph I, we can also see that even after the recovery of the two past months, the market level is still well below all but the 1926 and 1961 long-term *trend lines*. Has the pendulum now swung too far the other way?

This analysis, in and of itself, is admittedly incomplete and has limited, if any, near-term predictive value. However, given the historical perspective and the numerous events encompassed by the various historical periods, simple logic seems to dictate a reversion to upwardly biased performance within the *trend line channel* over some reasonable timeframe as has been the case throughout history. As discussed in greater detail below, even if the markets do not return to *trend line* for some time and continue to trade in the lower range of the *channel*, the power of the *trend* should drive the markets to higher highs.

Graph III helps illustrate this point. It provides a more focused perspective as it isolates the 1970 *trend line* and plots a standard deviation around it creating a *trend line channel*. As reflected in Graph III, prior to the 1973 - 1974 correction the market peaked at the end of 1972 well outside the *channel* (i.e., its performance exceeded the *trend line* by more than one standard deviation). The market proceeded to correct well below the *channel* and did not regain its prior highs until early in 1976. From that point, through 1985, the market drifted toward, and continued to trade around, the lower end of the *channel* (i.e., about one standard deviation below *trend line*). However, since the *trend line channel* had a powerful upward bias, the markets continued to make new highs through this period, albeit at a rate of growth below the TAR.

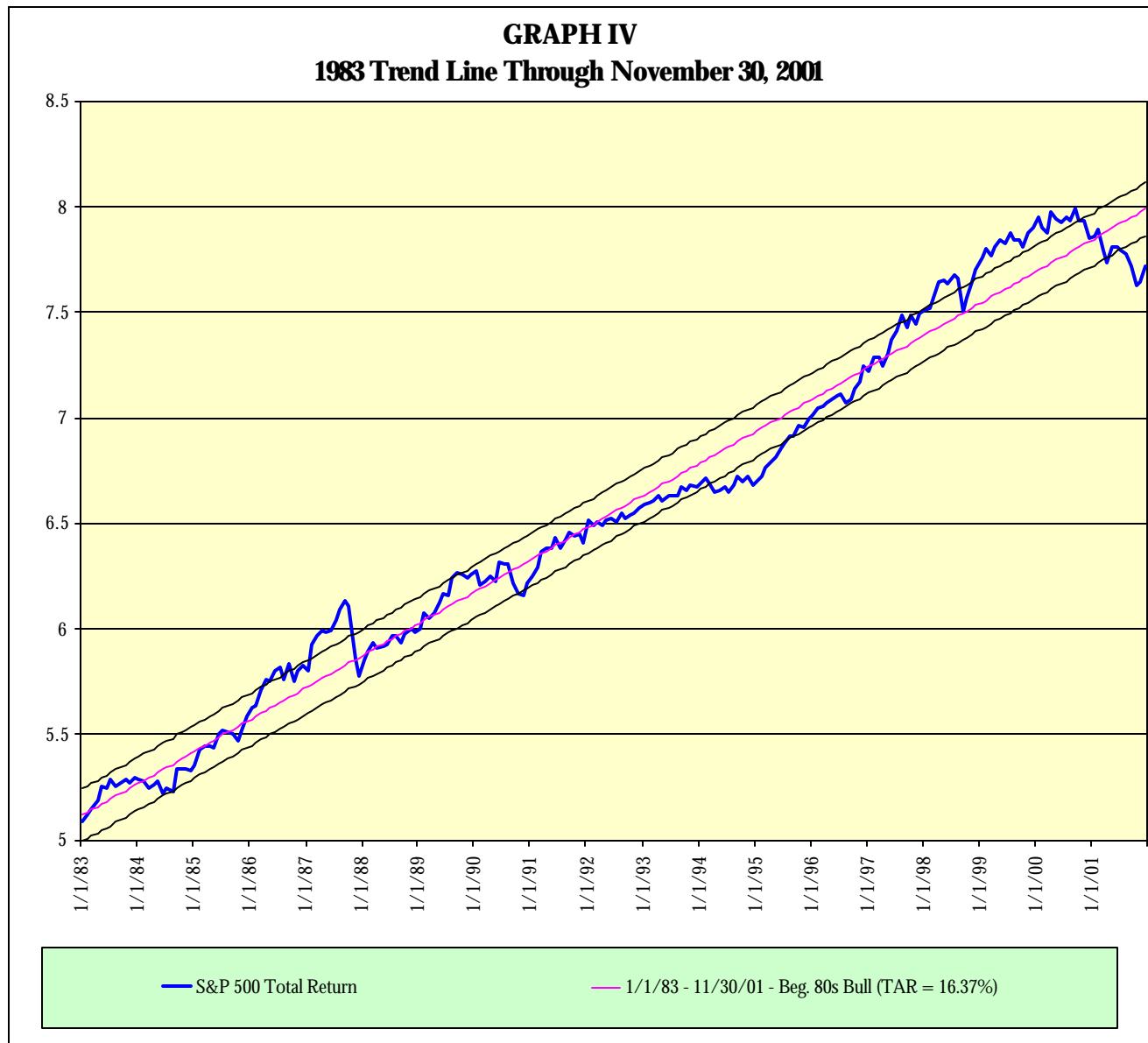
GRAPH III
1970 Trend Line Through November 30, 2001



During the recent bubble period, the market crossed the upper boundary of the 1970 *trend line channel* in an upward move for the second time in 1997 where it remained until late 2000. In 2001, the market crossed through its *trend line* in a downward move and is now trading in the lower end of the 1970 *channel*. Viewing the past several years with the benefit of an historical perspective, the aberrational nature of the “bubble” is clear. Therefore, an exit strategy to avoid the carnage of the past two years would appear obvious. Unfortunately, even with the benefit of hindsight, using the *trend line* as a tool, such an exit point is still not clear. The overvaluation was not actionable in that to exit the stock market at that time would have resulted in lower total wealth today. The market first crossed the *trend line* near the end of 1995 and the upper boundary of the *trend line channel* in mid-1997. Today, the market still remains well above both of these points. Therefore, to have used either of these points as an exit strategy would have resulted in a lower portfolio value today than by staying invested through the bubble. The market again crossed the upper boundary of the *channel* in the end of 1998. Today, the market remains marginally above this level.

To provide some additional perspective, we have also included Graph IV which plots the 1983 *trend line channel*. While the observations offered by this graph are the same as those

offered by Graph III above, the shortened time frame and greater TAR make the illustration more dramatic. Given the higher TAR, the bubble on Graph IV appears less severe than on Graph III. However, the magnitude of the correction appears more severe since the market today is well below the 1983 *channel*.



These graphs tell us little about the specifics of the near-term future, and the volatile day-to-day path the market may take in the coming weeks or months. However, we believe the historical perspective about the power of the *trend* is of more than mere academic interest. Based upon any of the *trend lines* we have examined, the market had become overvalued in the late 1990s as it traded outside all its *channels*. By the same historical measures, the market now appears to be trading within or below historical norms. Depending upon the relevant measure, the market now appears to be fully valued (see the 1926 chart), somewhat undervalued (see the 1970 chart) or extremely undervalued (see the 1983 chart) and creates a better than average entry for *new* long term investments in the stock market. As to near-term market movements, we leave the ultimate judgment for history to make.

Our role is to rise above short-term prognostications to that of a long-term strategist. For this role we look to Chart II below. As illustrated in this chart, even if the markets trade toward the lower end of the *channel*, the power of the *trend* will drive the markets to higher highs over the coming years. Based upon this analysis, to fully recover its August 2000 highs¹ from current levels, the stock market would only have to compound by 11.03% for 30 months. This rate is 71 basis points below the 1961 TAR. If the market were to compound at 13.8%, a rate of 34 basis points below the 1970 TAR, the market would recover its August 2000 highs in 24 months. If the market compounds at 18.43%, a rate of 33 basis points below the 1995 TAR (which includes the “give back” of the last two years) the market would recoup its highs in approximately 18 months. By way of additional historical reference, the market fully recovered from the 1987 stock market crash, the magnitude of which was greater than the bear market we just experienced, in a mere 18 months, albeit under different economic and political conditions.

CHART II Annual Rate of Return To Reach Trend Lines from Current Levels

| | TAR | 12 months | 18 months | 24 months | 30 months | 36 months | 42 months | 48 months | 54 months | 60 months |
|-------------------------------|--------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| August 2000 High | N/A | 27.76% | 18.43% | 13.80% | 11.03% | 9.18% | 7.87% | 6.88% | 6.11% | 5.50% |
| S&P 500 Trend line | | | | | | | | | | |
| Top Range of Channel | | 20.10% | 17.10% | 15.61% | 14.71% | 14.11% | 13.69% | 13.37% | 13.12% | 12.92% |
| January 1926 | 11.13% | -17.38% | -7.95% | -3.21% | -0.35% | 1.55% | 2.92% | 3.94% | 4.74% | 5.37% |
| Bottom Range of Channel | | -53.70% | -32.49% | -21.73% | -15.23% | -10.88% | -7.76% | -5.41% | -3.59% | -2.12% |
| Top Range of Channel | | 26.23% | 21.38% | 18.97% | 17.52% | 16.55% | 15.86% | 15.35% | 14.95% | 14.63% |
| January 1961 | 11.74% | -4.98% | 0.57% | 3.35% | 5.02% | 6.14% | 6.94% | 7.54% | 8.00% | 8.38% |
| Bottom Range of Channel | | -35.41% | -19.90% | -12.07% | -7.34% | -4.18% | -1.92% | -0.22% | 1.10% | 2.16% |
| Top Range of Channel | | 45.11% | 34.70% | 29.53% | 26.43% | 24.37% | 22.91% | 21.81% | 20.95% | 20.27% |
| January 1970 | 14.14% | 22.59% | 19.77% | 18.36% | 17.51% | 16.95% | 16.55% | 16.25% | 16.01% | 15.82% |
| Bottom Range of Channel | | 0.48% | 5.02% | 7.29% | 8.66% | 9.57% | 10.22% | 10.71% | 11.09% | 11.39% |
| Top Range of Channel | | 50.64% | 38.72% | 32.80% | 29.26% | 26.91% | 25.23% | 23.98% | 23.00% | 22.22% |
| January 1973 | 15.22% | 33.31% | 27.25% | 24.23% | 22.42% | 21.22% | 20.36% | 19.71% | 19.21% | 18.81% |
| Bottom Range of Channel | | 16.22% | 15.88% | 15.72% | 15.62% | 15.55% | 15.50% | 15.47% | 15.44% | 15.42% |
| Top Range of Channel | | 56.92% | 43.26% | 36.48% | 32.43% | 29.74% | 27.82% | 26.38% | 25.27% | 24.38% |
| January 1983 | 16.37% | 43.91% | 34.66% | 30.06% | 27.31% | 25.48% | 24.18% | 23.20% | 22.44% | 21.83% |
| Bottom Range of Channel | | 31.02% | 26.12% | 23.68% | 22.21% | 21.24% | 20.54% | 20.02% | 19.61% | 19.29% |
| Top Range of Channel | | 71.45% | 53.64% | 44.83% | 39.57% | 36.08% | 33.59% | 31.73% | 30.28% | 29.12% |
| January 1995 | 18.76% | 55.51% | 43.14% | 37.00% | 33.33% | 30.89% | 29.15% | 27.85% | 26.84% | 26.03% |
| Bottom Range of Channel | | 39.78% | 32.73% | 29.23% | 27.13% | 25.73% | 24.73% | 23.98% | 23.40% | 22.94% |

Chart II also illustrates the rates at which the market would have to compound in order to reach various *trend lines* as well as the upper and lower boundaries of their respective channels. For example, the market would have to compound at 18.36% for 24 months to return to its 1970 *trend line*. However, falling to the lower boundary of the 1970 *trend line channel* would imply a compound return of 9.57% for 36 months. Even at this rate, the market would have eclipsed its prior highs, since to accomplish that would only require a 9.18% annual rate of return for 36 months. Taking the conservative view that the 1926 *trend line* is most relevant, we previously observed on Graph I that the market still remains above this line. However, if the market were to perform at the top of the 1926 channel, it would more than surpass the market highs in 24 months by delivering a 15.61%

¹ Actual 2000 high occurred during mid-March, but since all our analyses are based upon month-end dates, the highest month-end close occurred in August 2000.

annual rate of return – greater than the 13.8% required to retake the highs. All the scenarios are well within historical ranges, we identify no logical reason to be overly bearish in the face of these powerful trends.

Conclusion

Over time, no Wall Street firm, market professional or academic has proven an ability to predict the near term future of the stock market. If one makes enough “market calls”, they are bound to be right occasionally – even a broken clock is right twice a day. However, we should collectively avoid the role of “market prognosticator” and stick with what we know works – a disciplined long-term strategy.

This approach may seem overly simplistic in this age of 24/7 market analysis and information overload from every corner of the globe. However, over any given 3-5 year rolling time horizon, it is the only time-tested approach which has proven itself. All other market timing calls have proven to be “hit or miss” at best. Therefore, we continue to advocate the same long-term investment strategy we have always advocated.

For those investors with diversified portfolios who did not get caught by the high-tech euphoria of the late 1990s, and did not make substantial bets on the Lucent and the Amazons of the world, a cyclical recovery from this cyclical recession should bring their portfolios back to some reasonable double-digit *trend line* within a reasonable timeframe. We would like to believe that we are already on this path and that the worst is behind us. However, while over the long-term the market responds to the economic fundamentals creating a powerful *trend*, over the near-term it over reacts to crowd psychology.

While we should not be overly euphoric based upon current market strength and expect an automatic “V shape” recovery, neither should we be overly discouraged by any near-term events which may cause the market to retest its lows. One thing is clear – long-term *trends* are extremely powerful. The *trend* is truly the friend of the long-term investor. Markets have consistently overcome obstacles in the past – many far more difficult than those we face today – to make new and higher highs. There is no reason that the greatest economic engine the world has ever seen will not do so again.