

# Memo

To: MDE Clients & Friends  
From: Mitchell D. Eichen, J.D., LL.M.  
Chief Executive Officer  
Date: July 25, 2002

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## ***Some Rational Thoughts for Irrational Times***

We at MDE have always been long-term strategic investors and remain so today. That said, we are also human and not immune from the emotional impact these turbulent times have brought on all investors. While we wish we could easily allay all investor fears by calling a market bottom and a “V” shaped recovery, this is simply beyond anyone’s ability. However, what is clearly within our abilities is to calmly reflect on the current situation and offer certain rational and logical strategies; the types of long-term strategies, which have served our clients well over the last 15 years, in order to allow them to weather these turbulent times and prosper in the years to come.

We realize that many investors are tired of hearing the same old songs of “stay the course,” “you have to think long term,” and “the markets always go up over time” as they observe an unprecedented implosion of the markets and an evaporation of hard-earned wealth on a daily basis. We understand that everyone is looking for assurances and words of comfort. While we might be able to offer words of comfort, unfortunately neither we nor anyone else can offer any guarantees. Over the past several weeks, we have spoken to countless money managers with hundreds of years of cumulative market experience. All feel frustrated by the irrational anxiety in the markets, but no one has any easy answers. However, a consensus emerges from everyone – namely that the market has given back much of the excesses of the 1990’s and that while some excess valuation remains in pockets of the market, valuation levels for most stocks have become attractive. While all concede that given the continued emotional frenzy, some additional downside may remain, all agree that the markets will ultimately emerge a stronger and more rational place for client investments.

In fact, we now observe more enthusiasm from managers for the market’s potential than we have seen in some time. But in our view, the next several months will be critical. The first important date is August 14<sup>th</sup> when CEOs are required to certify their companies’ financial statements. While we would expect that the vast majority of companies will be able to certify the accuracy of their financial results, no doubt a few bad apples still remain. The hope is that the market washout over the last few weeks has already discounted much of these anticipated results. However, it would be naive to expect the market not to react adversely over the near term should accounting restatements be more numerous than investors’ expectations. The next critical period will be October earning’s season as investors judge whether the new P/E multiples are justified by actual and projected earnings.

As almost any market observer will advise, market irrationality and capitulation usually reach their most frenzied pitch just as the market is about to reach its bottom. And the more tightly compressed the spring becomes, the greater the recoil, at least in the initial stages. Unfortunately, no one has the ability to accurately time the market over the next several weeks or months. To try to do so will be fruitless and will most likely result in substantial long-term opportunity costs. However, we remain strong in our beliefs that the equity markets still present an attractive investment vehicle for long-term investors (i.e., those with a 3 - 5 year rolling time horizon). With this in mind, we advise the following steps to deal with the current market turmoil.

First, investors should re-examine their investment risk tolerance in the face of recent events. This may sound ridiculous now – like closing the door after the horse has left the barn. However, we cannot look backward, but must look forward. Most investment allocations were set against the background of a bull market. Having suffered through this emotional decline clients should ask themselves if they would like to re-think their allocations to better deal with future potential market volatility.

If, the answer turns out to be “yes”, we still do not advise any precipitous changes at this point of a grossly over sold market. Rather, we suggest that you meet with your financial counselor over the near term and revisit your strategic plan in light of current circumstances. To the extent you wish to adjust your asset allocation, we suggest that your strategic financial plan be redesigned so that asset allocations are *gradually* readjusted to meet your risk tolerance, as you currently view it, as markets recover. This does not necessarily mean that you must wait until the markets recover their all-time highs. To the contrary, just as we have been advocates of dollar cost averaging into equities, we would also be advocates of readjusting your risk allocation on a gradual basis as markets meet certain milestones. Over the long-term, this reallocation may result in less growth to the extent that equities again prove to be the best performing asset class over the next decade from their current levels. However, such a gradual reallocation may allow you to better satisfy your own emotional risk tolerance needs to the extent we continue to live through a turbulent market environment.

Our second suggestion is something that can be done today. You may wish to increase your reserve of liquid cash to a level equal to at least three to five times annual living expenses not covered by pensions, existing fixed income, and other sources. In devising asset allocations, we have always suggested that clients have liquid bond and cash portfolios valued at no less than five times their excess annual cash flow needs not covered by pensions or other sources to provide for the potential of an extended market decline. We are obviously loath to sell equities into weakness. However, investors may wish to review this strategy with their advisors as an interim step to calm emotions and allow them to more rationally deal with any potential market turbulence which may persist over the coming months.

Since we cannot call the market bottom, our third recommendation involves repositioning part of our clients' equity portfolios in a more defensive manner as we look toward the next phase of the market cycle. As a firm, MDE has always subscribed to the notion of balancing growth and value investments since no statistical methods have ever been devised which will accurately and consistently predict when value will out perform growth, or vice versa. However, today we are in unique times. Although the market is rapidly working

off its excesses, we believe that this is a time where a strategic tilt toward value over growth could reap substantial benefits over the next several years. Our reasoning for this conclusion finds support in both the current psychology and history.

As it has now become obvious, the equity market became extremely overvalued in the late 1990s as traditional methods of valuation were ignored and stock prices were bid up to ridiculously high multiples. While most of this has been worked off by the recent market correction, we believe that the psychological damage done to investors will be long lasting. It will be years before investors again pay excessive multiples for stocks based upon the premise that earnings can compound at excessive rates at infinitum. While there will no doubt be trading rallies in the former high flying stocks, we believe these rallies will be relatively short-lived as investors retreat from these issues once multiples begin to expand.

Value investing first came to prominence in the middle of the 1930s when Benjamin Graham published his seminal work on this topic. Graham's thinking was in response to the speculative bubble of the 1920s and the long post bubble depression that followed. Graham argued that the stock market could be an excellent source of returns for serious long-term investors if and only if they followed a strict price discipline, i.e., low price/earnings ratios, low price/book ratios, and high dividend yields all while investing for the long-term. Over time, this premise has proven correct. However, there have been periods of time, most notably during the late 1990s, when investors were swept up in the raging euphoria of a bull market and forgot about both price discipline and taking the long-term view.

In looking for some perspective from which to view our current environment, we find ourselves drawn back to 1973-1974 which, up until the last few days, was the biggest post-bubble correction in the post-war period. As evidenced by the chart below, beginning in 1975, for the first five years of the recovery the S&P gained 99.11% on a cumulative basis. During this period, value stocks, as defined as stocks with P/E ratios in the bottom 20% of the S&P posted cumulative gains of 336.8%, while growth stocks, as defined as stocks with the top 20% P/E multiples in the S&P 500 gained 95.8% in the five years following that correction. Over the succeeding five years, value stocks again out performed growth stocks by 218.4% to 103.8%. While the S&P delivered a cumulative return of 99.0%. We do not necessarily argue that history will again repeat itself, nor are we suggesting that the magnitude of the value out performance will be as great. However, we believe that the psychological reluctance of investors to once again be burned by overpaying for earnings will keep them focused on value stocks for some time to come.

## Market Recovery After 1973-1974 Declines

Year	<u>Years of Decline</u>	S&P 500	Growth	Value	Value
			(Top 20% by P/E)	(Bottom 20% by P/E)	Out performance Over Growth
1973	1	-14.7	-15.5	-17.7	
1974	2	-26.5	-30.9	-12.8	
2-Year Cumulative		-37.3%	-41.6%	-28.2%	13.4%
2-Year Annualized		-20.8%	-23.6%	-15.3%	8.3%

### Years of Recovery

1975	1	37.2	34.5	83.3	
1976	2	23.9	18.9	50.3	
1977	3	-7.2	-9.3	11.0	
1978	4	6.6	6.7	13.1	
1979	5	18.4	26.5	26.3	
5-Year Cumulative		99.1%	95.8%	336.8%	241.0%
5-Year Annualized		14.8%	14.4%	34.3%	19.9%
1980	6	32.4	40.4	26.4	
1981	7	-4.9	-6.6	15.1	
1982	8	21.4	34.1	31.0	
1983	9	22.5	24.2	24.4	
1984	10	6.3	-6.7	34.3	
5-Year Cumulative		99.0%	103.8%	218.4%	114.6%
5-Year Annualized		14.8%	15.3%	26.1%	10.8%
10-Year Cumulative		296.3%	298.9%	1290.9%	992.0%
10-Year Annualized		14.8%	14.8%	30.1%	15.3%

In addition to purely seeking stocks, which exhibit deep value characteristics, we would also seek managers who invest in stocks which are paying above market dividend yields. These higher yields serve two functions. First, they provide a defensive quality by building a floor under returns. If, for example, a stock pays a dividend of 4.5%, the stock can retreat by a like amount and the investor still will not suffer a loss in that stock for the year. If, on the other hand, a stock trading at a price to earnings multiple of 10-12 can grow its earnings per share by 10%, then if the market multiple stays constant that stock should increase by that 10% plus the amount of the dividend. Even if the market multiple were to contract somewhat, such stocks could still post respectable total returns in the high single or low

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double digits. While we realize that investing in high dividend yielding stocks violates one of our mantras of aggressive tax management, we feel that over the foreseeable future, this may become a necessary trade-off in order provide portfolios with more stability and increased upside potential in what may be a less than robust market environment.

We are not advocating a complete abandonment of growth investing with a 100% allocation to value. We would start to gradually move portfolios from their current 50% value -- 50% growth position to one of 55% value and 45% growth and consider gradually increase this allocation to 60% value and 40% growth. However, we must remain mindful that there will likely be intermittent rebounds in growth stocks wherein they produce out sized returns during relatively short periods of time. Therefore, we do not want to abandon "style investing." In addition, given that markets are unpredictable, we want to make sure that we maintain a reasonable exposure to the growth camp. However, we will avoid very aggressive growth managers who rely solely on momentum investing.

While not offering a panacea or a magical solution to these difficult times, we believe that the above recommendations offer a sound and solid foundation upon which we can begin to stabilize our clients' portfolios and their psyches while positioning these portfolios for a recovery in the future. In addition, we urge all investors to try to avoid making investment/financial decisions while in a state of panic. Our experience tells us that decisions about money, made while emotions are high, are rarely good ones. Finally, in times like these we must keep in mind the teachings of Benjamin Graham; namely, be disciplined and invest for long-term and the returns will take care of themselves.

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