Trusted Advisor

By Gary E. Miller, C.F.P©

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Stock Market Commentary

We've seen nothing in the current stock market rally to convince us to abandon our faith in value stocks, particularly since most have captured the gains seen for the major stock market indices. A common misconception among investors is that "Value" means ownership of sleepy, boring companies. To the contrary, we love businesses that can produce 15%-25% per year top line growth with fat profit margins and returns on equity of at least 15%. We wait until they can be purchased at cheap prices, rather than getting caught up in speculative euphoria. So, stocks that may be found in growth oriented mutual funds have found their way into our client portfolios, directly or indirectly, through some of the mutual funds we hold.

It is challenging to choose good businesses while largely ignoring the daily emotions of John Q. Investor. But we believe it is the only approach that will allow our clients to achieve their financial goals when growth is desired. Proof positive that this morning's headlines can usually be ignored has been seen during the past few weeks. The Dow Jones Industrial Average suffered it's worst September since 1937 and Japan's Nikkei Index plummeted to 16 year lows in early October. A week later the U.S. markets began a rally that was described as the biggest four day move since 1933.

The foundation of our stock picking is value investing, a long term approach that pierces through day to day market action to find businesses that stand out and have been mis-priced. Yet we cannot help but notice the pulse of market sentiment. Years of observation leads us to believe this rally can continue, based upon "tape reading". For one, bearish sentiment was reaching a crescendo as the markets slipped below their September 2001 lows: One respected fund manager, Bill Gross, who handles bonds for many of our clients, wrote an article suggesting that the Dow stock average should be considered overpriced until it falls to 5000. Alan Abelson who we consider to be one of the most forthright observers of the financial scene suggested in September 30's Barron's that if the home refinancing boom slows, then consumer spending, the one sustaining engine for this anemic economic recovery, may fall out of bed. Hardly was the ink dry on this ominous prediction when the West Coast Port lockout raised the specter of empty store shelves during the Holiday Season.

Naturally, in the midst of this cacophony of gloom and doom, a powerful stock market rally took hold!

Dow Jones Index Oct. 2001 - Oct. 2002

The tape offered a number of supporting factors: Veteran technical analyst Richard Russell has pointed to numerous historical bear market rallies of 25% or more. Russell notes that the four day 1000 point Dow rise took place with good volume and a high ratio of advances to declines. While we've never claimed a talent for guessing short term stock market trends, we agree that a Bear Market rally is underway, and base this solely on the aforementioned "tape reading". What this practice boils down to is looking for incongruities between the day's news and the day's market behavior.

CFP CERTIFIED FINANCIAL PLANNER™

Gary Miller has over 28 years experience in the financial services industry as both an analyst and financial advisor. Currently he provides service to clients as a CERTIFIED FINANCIAL PLANNER™ practitioner. Gary holds a certificate in Personal Financial Planning from University of California, Irvine; and is a Board member of the Orange County Chapter of the Financial Planning Association.

Up until October 10, good news was largely ignored while anything negative was cited as a reason to abandon stocks. In the first trading days of this month, bell weather General Electric was pummeled amid fears about it's heavy exposure to the financial services industry, airplane engines and electric turbines, all soft industries in the current economic environment. Retired GE Chief Executive Officer Jack Welsh's munificent severance package, revealed during divorce filings last month had analysts wondering whether Enron – like or Tyco - like featherbedding may be part of management's game plan. Then GE reported strong earnings (despite the fact that a month earlier the company predicted exactly what it delivered), and rallied some 20% in price.

In fact good news is suddenly gaining attention while a lot of bad news has been ignored, producing incongruities in the "tape" that suggest this rally has a way to go. That the rally has legs was seemingly confirmed when the market quickly rebounded from a one day sell off on October 17, even as news broke of North Korea's perfidy, accepting U.S. taxpayer largesse while building nukes. North Korea may soon have missiles capable of reaching Los Angeles. But Wall Street, which is still out of the Korean's range, was not going to allow news like this disrupt a chance to generate commission income.

In earlier times, we relied heavily on technical analysis as a guide to market behavior. It is a most imperfect guide, and we have come to embrace the strong belief that real money is made not from trading rallies but from buying great businesses for the long haul. But we suspect the rally that began October 10, based on technical patterns of the past, has a good chance of bringing the indices up to their 200 day moving average. If this is the destiny of the current rally, we may see the Dow approach 9300 by year end, at which point the year's loss will be cut to just 6%. At about this time, overt bullishness should return to portfolio managers, the popular press and alas to much of the investing public. However, unless surprisingly good earnings are disclosed in the January reporting season, the rally will likely fizzle and another tough period ensue. If a rising tide brings some of our stock holdings close to their intrinsic worth, we may look for an opportunity to take profits as the year draws to a close.

Why are we so cautious? Future news headlines are not encouraging to the stock markets. Investors must be mindful that a war with Iraq is very possible within about three months, and a surprise terrorist attack on the United States a constant possibility. Brazil, the economic giant of South America appears ready to elect a socialist President, which will likely lead to abandonment of fiscal restraint and a collapse of their economy, taking some major American banks for a ride. Ships remain strung out along the West coast, weeks late in unloading cargoes of goods. Too, earnings surprises, which have been somewhat positive recently (comparisons to last year's terrible earnings are relatively easy), may turn lower as pension funding saps the free cash flow of many corporations. In this regard, *Barron's*[1] reported the majority of publicly traded companies listed in the Standard & Poor's 500 Index will be forced by accounting regulations to divert earnings into under - funded pensions in coming quarters. These pensions are under funded because of stock market losses to the tune of over $300 Billion, according to the article.

Many of our value stock selections and mutual funds, resilient in the first half of this year, were beaten up along with the rest of the market during this Summer's collapse. Great value names like H& R Block, McDonalds and Philip Morris, held in our mutual fund selections all were abandoned by panicky investors. As for our individual stock picks, only Lincare, which we've owned since late 2001, has held up well. Consistently great earnings, good profit margins and shrewd acquisitions make this a continuing choice for new portfolios.

We have scrutinized our other stock holdings and our belief in Shaw Group, Caremark RX, and Valero remains strong. A mid - Summer purchase, Quest Diagnostics, was clobbered on October 8 when a competitor disappointed the market with poor earnings. We wish we'd been more agile and done some additional buying on that day. Why? The stock exploded upward the next day, as the company predicted better than expected earnings outlook. Quest now stands at it's best price in three months.[2] We recently sold Simon Property Group amid worries about a consumer slow-down and a West Coast port closure.

Bond Strategy

Not surprisingly, many investors have been shifting out of stocks into bonds. Now that the horse is out of the barn for those who failed to diversify years ago, a new Religion of Diversification has gripped much of investing America. Although we strongly advocated bonds as part of a diversified portfolio, back when the stock market was running away to the upside, we are now gradually reducing bond exposure on fears that this segment of our client portfolios may under perform in the coming years.

Here are our reasons for concern:

1. Yields have fallen to their lowest levels in forty years, leading us to question how much further they are likely to decline.
2. The U.S. dollar has been trending downward as our Federal deficit balloons and our national balance of trade continues in record negative territory (we took in $38 billion more of foreign goods than we exported in September).
3. Foreign investors have been reducing their holdings of U.S. financial assets in recent months.
4. Bond Rating agencies such as Standard & Poor's, Moody's and Fitch have become more aggressive in downgrading corporate debt in light of their past failures to warn investors about Enron, Qwest, Worldcomm and the like.
5. Unprecedented mortgage refinancings have forced major lenders like Federal National Mortgage Association to "insure" positive earnings on their bond borrowings by loading up on derivatives tied to Treasury bonds. If the refinancing boom ends and interest rates creep up (as they did in the third week of October), these hedges need to be unwound. The result could be massive bond selling, driving bond prices down dramatically.[3]

All or any one of the factors listed above may lead to a significant decline of bond prices and rise in yields at any moment. While a decline in bond values for our clients' portfolios might be offset by interest payments, we are concerned that *total* returns on this sector may go flat to somewhat negative.

To deal with this unprecedented investment challenge, we took positions in Sovereign debt obligations denominated in foreign currencies that should strengthen vis-a-vis the U.S. dollar. It was gratifying to learn later that the acclaimed Pimco Total Return fund, held by many of our clients, did the same. Further, we have been uncovering attractive yields in preferred stock. Dividend yields over 7% can be had right now so that risks of an interest rise are mitigated: the market recognizes that a quality fixed income instrument providing high current cash flow can offset potential losses in principal should the price of the underlying instrument decline.

We are not ashamed to hold significant positions in money market funds either. We are not inclined to bet client money on the current rally, only on individual stock or fund opportunities that are outstanding in any market environment.

Thanks for the Referrals

It is with pride that we thank a number of our clients for their kindness in referring new business at a time when many financial professionals are losing clients. We are accepting referrals at this time.

New Business Address

As of October 28, 2002, Trusted Financial Advisors will relocate it's office to the following address:

30101 Town Center Drive, Suite 100
Laguna Niguel, CA 92677

Please note this address for your future correspondence.
Our telephone number will remain the same: 949- 254-0656.
Our fax number will change to 949-495-3867.

Thanks to client and friend Mike Rothbart who proof read this newsletter!

(Footnotes)

1 *Barron's Online* October 19, 2002
2 As of market close October 18 2002 stock closed at $66.17.
3 "U.S. Appetite for Refinancing Contributes to Bond Volatility", *Wall Street Journal Online,* September 26, 2002