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Dow Industrials trading Above 10,000 - Does It Have Further to Go?

In our November newsletter, I questioned the market's ability to penetrate 10,000 in a meaningful way: "At best the market should stall in the 10,000 to 11,000 range for months before eventually advancing. At worst 10,000 to 11,000 is the top for this market cycle." This is precisely the scenario that has been playing out for the past seven weeks. It will take a significant continued expansion of earnings momentum for a broad swath of publicly traded corporations to justify a rise beyond the market's current levels. I agree with commentators who feel the U.S. stock market is fully valued. With many corporations having reported their 4th quarter earnings in recent weeks, the majority have beaten estimates, which is a good thing. However, the stock market has not budged from its trading range. Why?

Stock prices anticipate the future. Management of many companies have suggested only a modest growth outlook for 2004. While there will likely be a continued business expansion in the United States, the possibility of rising interest rates (see discussion of Archstone Smith below) may offset the benefits of a modest earnings improvement. It works this way: most knowledgeable investors employ some form of mathematical discount model to estimate a fair price for a given stock. Rising interest rates reduce the "present value" of estimated future earnings. So two key factors, future earnings growth and rising interest rates appear to be offsetting one another in the collective mind of the market, leaving us at a Mexican Standoff, for now. Further, I suspect the next move will not be up, for some of the psychological reasons discussed below.

> Gary Miller will be teaching a workshop at Saddleback College, called "Financial Independence for Women". This two-part workshop begins February 18th at 6:30PM. For more details call our office or contact Saddleback College at 949-582-4646 or www.saddleback-ce.com.

Signs of a Market Top

Worrisome is the rapid return of bullishness to the markets. According to a *Wall Street Journal* article[1] The American Association of Individual Investors poll of it's members indicated a bullish sentiment of 65.3% which is the highest since the poll began in 1987. Usually when 2/3 of investors are bullish on stocks, an intermediate top has been reached. If nearly everyone is already bullish, who's left to buy? Anecdotal evidence of another sort emerged in another edition of the *Wall Street Journal*[2] with an article describing the lavish lifestyle that is returning to Wall Street tycoons who are spending their 2003 bonuses on conspicuous consumption. One Wall Streeter is quoted: "We're comfortable the market won't take a new downturn." says Mr. [Grant] Morgan, 36, who was comfortable enough to spend a week at The Breakers in Palm Beach last month and six months ago bought a $150,000 Ferrari 360. "Things are thawing."

As for this portfolio manager, I've recently taken profits on a number of holdings that have achieved a justified price based on realistic expectations of future free cash flow and conservative discounting assumptions. I'd rather increase our client's cash holdings and earn a small guaranteed dividend than hold over priced merchandise. In other words, Color Me Cautious.

Archstone Smith (ASN) Turns Corner

In 2003, interest rate declines eased home affordability, making it difficult for Archstone and other apartment companies to maintain occupancy or raise rents. Still, Archstone did an excellent job in a tough market for rental housing, and now, with the prospect that housing affordability will decline with rising interest rates, the stock has continued appeal. Even better, ASN announced it's first improved quarter in nearly two years on January 27. Both earnings per share and Funds from Operations, (a real estate income measure), were at record levels. Part of the company's strategy is to sell buildings when offered sky high prices for them by condominium converters. Due to such sales, a large portion of Archstone's distributions for 2003 came in the form of long term capital gains, making this an appealing investment for taxable accounts.

Meanwhile, the Federal Reserve's Open Market Committee, at it's January 28th meeting indicated that it no longer holds a bias to reduce short term interest rates. Few economists foresee a dramatic tightening of interest rates, but any rise may hurt affordability of new homes, a potential positive for Archstone Smith. ASN, like all apartment focused real estate investment trusts, benefits because it rents to those who cannot yet afford to buy. This is particularly true for the markets in which ASN operates: New York City, Washington DC and Southern California. It appears to us that Archstone has turned the corner and can enjoy a combined improvement in occupancy and rental levels by the end of this fiscal year.

Kinder Morgan

Still Pumping Out Cash Flow

During the third week in January, the Kinder Morgan entities (KMI, KMP and KMR) reported excellent earnings. Clients will recall that I am a great fan of Rich Kinder and his crew. Kinder Morgan is now the second largest natural gas pipeline operator in the United States, having grown from a small ($40MM) investment in 1997. A cold winter has increased demand for gas to heat homes and businesses, thus improving flow-through volumes above normal levels. The firm benefits by charging a "toll" for transporting natural gas from production fields to consumers throughout the nation. Kinder Morgan also announced it's intention to expand it's small but profitable commitment to oil production by acquiring a 50% interest in the Yates field in West Texas. Significantly, Kinder will assume management of recovery efforts at the field as well. Kinder has proven to be an able manager of "tertiary" fields, at SACROC, another West Texas field operated by Kinder. Yates, like SACROC will require injection of carbon dioxide gas to increase pressure and push greater volumes of petroleum products to the surface. Often such "tertiary" efforts result in initial production increases followed by a rapid decline in output. What has been remarkable about Kinder's tertiary efforts at SACROC field is that the production has continued to increase for two years with a third year of improved output predicted for 2004. Tertiary oil recovery is especially profitable for Kinder: they also own and produce most of the CO_2 gas consumed in SACROC and Yates, shipped from Kinder's McElmo Dome Field. In addition, Kinder owns the pipelines that transport this material, thus tertiary oil recovery is truly a vertically integrated business for Kinder!

Corinthian Colleges – Opportunity Knocked, and We Opened the Door!

I've liked the private education business for some time now, and had been disappointed to miss an opportunity to position about a year ago. The stocks as a group were strong through the last half of 2003. When one member of the industry, Career Education, was accused of unethical business practices in early December, the stock collapsed and pulled down other stocks in this industry. In the midst of the panic to exit the group, trading irregularities developed in the shares of rival Corinthinan Colleges (COCO). The problem arose when shares of Corinthian, a Santa Ana, Calif., post- secondary education company, suddenly plunged the morning of Dec. 5. The wild activity wasn't caused by the company, but was apparently triggered by an erroneous order.

NASDAQ, which operates the electronic trading system for over-the-counter shares then halted buying and selling, and belatedly took the unusual step of canceling hundreds of COCO trades. Some peeved market participants complained that the circumstances of the halt and decision to cancel transactions weren't properly communicated by Nasdaq, causing them to lose money. (Lawsuits against NASDAQ have already been settled in favor of investors with more suits pending.) In the ensuing confusion, the price of Corinthian plunged nearly as much as that of Career Education. Corinthian, which had not been implicated in Career Education's alleged wrongdoing, was suddenly being priced at an attractive discount to intrinsic value. Seeing this, I took a significant position for discretionary client accounts; the stock turned around in the next couple of sessions and has risen smartly above our purchase point.

Corinthian appears to be one of the best operators in the "for profit" education space. This is a business that serves the needs of mid career adults and job changers. There appears to be an unlimited demand for skill improvement among technology professionals, medical service personnel and technicians in the automotive, industrial systems and aircraft maintenance industries. The intrinsic value for this stock is in the mid $70's.

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It's not too late to get a 2003 tax deduction!

Self employed people may contribute up to 25% of their income to a SEP plan (Simplified Employed Pension). Contact us for more information.

Thanks for the referrals!

Once again we pause to say thanks to many clients who have referred friends and family members to us in recent weeks. We will do everything possible to continue to merit your confidence.

(Footnotes)
1 Online Wall Street Journal 1/25/2004.
2 With the Market Up, Wall Street High Life Bounces Back, Too WSJ online Feb 3 04