

The RORER REVIEW

SPRING, 2001

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

TOMORROW IS A BRIGHTER DAY

In recent issues of *The Rorer Review*, we have looked at “inflection points” in modern stock market history, defined as periods in time when trend reversals took place to correct excesses that had gone too far on either the upside or downside. Specifically, we have written about the great bear market of 1973-1974 (*Doris’ Conundrum*), the oil scare of the mid and late 1970’s when OPEC flexed its muscles and drove the price of oil into the stratosphere (*Inflection Redux*), and the Great Crash of 1987 (*Bob’s Lament*). These important turning points in market history were identified by the renowned value investor John Neff in his book entitled *John Neff on Investing*. Since his book was published several years ago, Mr. Neff had no way of identifying the most recent inflection point: last spring’s “dot.com” craze, today acknowledged as one of the great bubbles in the annals of investing. In this issue of *The Rorer Review*, we take a look at that era and discuss how it came about, what it has spawned, and what lies ahead.

It was about a year ago that a radio advertisement captured the essence of the mania. In it two gentlemen, let’s call them Sam and Bob, were talking about their stocks.

Sam: “One of my holdings, Xyz.com announced earnings yesterday.”

Bob: “What did they say?”

Sam: “They said they lost \$200 million in the quarter.”

Bob: “Anything else?”

Sam: “Yeah. They said they’d lose about a billion dollars this year and that there wasn’t any possibility that they’d earn a profit for the next five years.”

Bob: “Wow, that’s some report. What did the stock do?”

Sam: “It went up \$22.”

What a difference a year makes! In the first quarter of 2000, Wall Street was willing to throw outrageous sums of money at any company that had plans to use the Internet as part of its business plan. A particularly egregious example was an initial public offering (IPO) where the plan was to raise funds to purchase a portion of companies that marketed their wares on the “net.” The offering was oversubscribed, went to a premium in the aftermarket, and traded at a substantial multiple of the cash that had been raised in the public offering. The company had no operating history,

no assets, and hadn’t identified any of the companies in which it was planning to invest. Many other companies with no viable business plans and destined never to earn a profit sold stock to the public in record amounts. Looking back at that era, one would have to conclude that for all practical purposes *the cost of capital was zero*. It was truly the silly season. When capital is free, a tremendous misallocation of resources has to take place. In this case, a whole spectrum of the economy was overbuilt.

Part of the pain being felt in today’s markets is a direct result of the misdirection of the excess capital that was invested in technology over the last several years. This phenomenon occurred for several reasons. First, there was a lot of misguided hype about Y2K. Scaremongers had been warning the world about the dire consequences of the arrival of the year 2000 on computer calendars for five years. Most prominent among the theories was that computer failures would cause airplanes to crash and banks to lose track of cash balances the world over. Accordingly, a massive global effort began to upgrade computer systems and computer code amidst threats of not completing the gigantic task in time. Capital expenditure budgets were upgraded and spending plans were accelerated to ensure that the deadline would be met. Extensive amounts of capital flowed into the technology sector as companies were asked to articulate and justify their Y2K strategies. As the calendar moved into the year 2000, the deadline had been met successfully and investment

10 LARGEST HOLDINGS AS OF MARCH 31, 2001

**Emerson
Enron Corp.
HCA - The Healthcare Co.
Lowes Co.
Marsh & McLennan
MBNA Corp.
Merck & Co.
Pepsico Inc.
Viacom Inc.
Williams Co.**

spending in technology inevitably slowed from its previous hectic pace. This sluggishness in sales and earnings growth was not properly anticipated and set the stage for disappointment later on. Second, investors were enjoying enormous success in the technology sector of the markets in the latter part of 1998, 1999, and the first quarter of 2000. They bid up the prices of many companies with no earnings to absurd levels. Previously competent securities analysts got dragged into the bubble-like abyss. Because the companies they followed and were recommending had no current or future prospects for earnings, they justified other valuation yardsticks to entice investors into purchasing the stocks. Investors came to expect triple digit returns from their technology holdings in time frames measured in weeks and months, rather than years. Meanwhile, value investors such as the previously mentioned John Neff and Warren Buffet were ridiculed in the financial press as “dinosaurs” who hadn’t embraced the new era.

Today’s economy is a “Bad news...Good News” story. The bad news is that our economy is engaged in a serious slowdown, particularly as measured by corporate earnings. The good news is that the Fed is aware of the problem and is aggressively lowering interest rates to stimulate us out of the current economic malaise. More good news: the central banks of the world are joining in to resuscitate their own flagging economies. Since the start of 2001, there have been 46 interest rate reductions by central banks around the world. We firmly believe that this synchronized global response *will result in a strong economic worldwide recovery in 2002*, with the U.S. economy leading the way.

The current slowdown in the United States has yet to run its course. It has been caused by a variety of factors, including an oil price shock, previously rising interest rates, and the afore-

mentioned buildup in excess capacity that occurred during the Y2K era and the hyper investment atmosphere surrounding the technology sector. This latter condition encouraged the formation of many companies whose financial success was predicated on hopelessly optimistic assumptions and which are now destined to fail. As the affliction has spread to other parts of the economy, it has resulted in corporate earnings problems, widespread layoffs, and weakness in the stock markets. This, in turn, has caused demand for goods and services to weaken, resulting in excess inventories of unsold goods and unused supplies across corporate America. Companies will not start making their products and ordering from their suppliers again until inventories are in line with the reduced demand. As difficult and foreboding as all this sounds, things are improving even as these words are being written. First, the price of oil has peaked and is now heading down. Second, inventories are being worked down every day and eventually supply and demand will find themselves in equilibrium. Third, we believe that there is no inflation threat in the economy, so the Fed should continue to ease interest rates aggressively until signs of stability appear. Fourth, excess capacity is being taken out of the economy at a rapid rate. The “cleansing” process, while difficult, is an important step toward recovery. Wall Street and investors now recognize that capital, indeed, has a reasonable economic cost.

All of this has caused difficulty in the equity markets. Since the beginning of last year, the S&P 500 has lost more than 20% of its value. The losses in the NASDAQ have been far more serious. A year ago, investors were euphoric and giddy. Today, many are despondent. While understandable from the standpoint of human nature, neither sentiment is appropriate. In fact, if one considers that risk today is far lower than it was a year ago, the aforementioned sen-

timents are precisely the *opposite* of what they should be. You might recall last quarter’s *Rorer Review* entitled *Bob’s Lament*. Bob was despondent about the crash of 1987 and was ready to “sell everything.” Yet he, and all other investors, were being presented with perhaps the best investment opportunity of a lifetime. Today, the agony of 1987 is a mere blip on the radar screen. And so it is and will be with the current market. There may be more pain to endure and no one, absolutely no one, knows where and when the ultimate bottom will occur. But one thing is absolutely certain: this bear market will be followed by tomorrow’s bull market. Moreover, the seeds for tomorrow’s bull market have already been sown. The Fed has lowered interest rates aggressively and is prepared to continue doing so. In each of the four previous bear markets, 1974, 1982, 1987, and 1990, three interest rate reductions by the Fed have resulted in a powerful recovery in equity prices one year later. Notwithstanding the arrant nonsense today’s pundits are publishing in the financial press, the technology revolution and its accompanying productivity gains are alive and well.

At Rorer Asset Management, we manage our way through difficult markets by strictly adhering to our investment disciplines. Though we recognize that our clients abhor the negative returns that accompany bear markets, as long term investors, we embrace the opportunities that they present. The delightful Broadway musical *Annie* has a lesson for investors who are depressed over the state of today’s equity markets. Cast in a time of economic adversity far more serious than our own, the eponymous heroine brushes aside the jeremiads all around her and cries out: “The sun will come out tomorrow!!” And, indeed, it will. Tomorrow is a brighter day.

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