

PERSPECTIVES FOR A NEW YEAR

**A
TRUE
LIFE
FABLE
FOR
OUR
TIME**

“Bill, I hope you will remember that all of these wonderfully tall buildings were built by optimists.” Those words, pertaining to the impressive skyline of Manhattan, have been encountered anecdotally during client visits to the firm of Hambrecht & Quist. These were addressed to an awed young Bill Hambrecht by his grandfather on some of their occasional days together enjoying the experiences and exhilarations of Manhattan. Evidence suggests that Bill never forgot those paternally thoughtful words of his grandfather. These seem to have become a lifelong motivating lesson, as Bill Hambrecht led a team that built a leading investment banking firm sponsoring optimism, creativity, self-assurance, and determination. (Very little can be created from pessimism.) It is not known whether or not Bill’s grandfather cautioned him that the first owners of some of those buildings did not prosper, though successors did. Experienced minds know there are sometimes short-term consequences from leveraged long-term objectives that produce effects quite opposite to expectations.

For the time being, it is well to keep possible short-term consequences in mind, even though one must be motivated now by a positive longer-term view. Indeed, the “burden of proof” would seem to reside upon the optimists, with so many employee dismissals having been made already, while the bottom of the recession is yet to be traversed. Moreover, this is a worldwide slow-down, which will impose quite unevenly country by country, producing occasional unnerving crises such as those being experienced by Argentina, and the precariousness that continues in Turkey. These serve as reminders that others are especially vulnerable. This high-risk set of circumstances must be factored into policy. Do not bet the farm. However, present circumstances present extraordinary opportunities for perceptive investors who are properly constituted to take risk, and have patience. Rarely have there been such an abundance of opportunities, and purged valuations.

**THE
MARKET
RALLY
HAS
AN
ABUNDANCE
OF
FUEL**

The proof for optimism, as always, can be found only in the eventuality. While we must wait for the proof, there is much to support positively positioned patience. The healthcare industry (huge as broadly defined) is in a positive mode throughout. Local, state, and Federal government spending provides stability or strength, as do expenditures by providers of energy. Many thousands of small enterprises, among so diverse a nation, prosper. Most importantly, optimism is just basic to American society, and fundamental. It is both a driving influence and a product. It does not profit investors to be pessimistic for very long.

In practical terms (as opposed to archaic data-derived definitions by the National Bureau of Economic Research) this recession is more than a year old, and the stock market downturn is almost two years old. Meanwhile, optimism has become extraordinarily well supported by an abundance of money — an abundance that will persist. In addition, there are early signs that personal debts will shrink (as repayments overtake new extensions) or be refinanced. Investors have been so cautioned (disciplined or devastated might be better words) that many have moved their remaining funds to the sidelines waiting more assuring circumstances. The open position of short sellers is continuing to be extraordinarily high. America continues to attract interest from other nations, owing to an economy and an equity market with greater variety and less hazards than most. It seemed to us that the stock market had become poised for a rally before the September terrorist attack, which reshaped the pattern for the economy and the capital market for the succeeding months.

47 Hulfish Street (at Palmer Square North), Princeton, NJ 08542

*Telephone: (609) 924-6867 FAX: (609) 921-9502 E-mail:
info@pcminvest.com Web: <http://www.pcminvest.com>*

**PERSPECTIVE
DRAWN
FROM
THE
LAST
TWO
YEARS**

Also keep in mind that there were extra-market consequences of great influence bearing upon the stock market in the years 2000 and 2001 in addition to the internal factors that acted to devastate prices of fancifully priced shares. Sequentially, these were (1) the rise in the price of oil from the spring of 2000 which roughly doubled before topping at just over \$30 a barrel, (2) progress in the Israeli/Palestinian relationship aborted, and escalated thereafter into outbursts of extreme hostilities, (3) the election of November 2000 was an extraordinary one to say the least, and acted more as a wet blanket on the stock market than an exhilarating change as most elections have, and (4) the terrorist attack on the World Trade Center was the most extra-market event of them all. When we look back on the markets of the last two years for interpretative guides it is necessary to factor in these consequences that did not have their primary roots in economic or financial matters, but in political matters.

It would be foolish to say there will be no more politically motivated troubles. Indeed the tensions in the world are such that one should be prepared to expect the unexpected, with little or no clue beforehand what ultimate consequences might prove to be. America is event-subject and event-vulnerable. However, our alert is up and our response mechanisms are in place, and we will very likely proceed with attitudes inured to possible politically sponsored events (especially since they cannot be perceived beforehand). Optimism gains reinforcement by the demonstrated resolve to cope and conquer.

One of the cited influences of yesterday has certainly changed on a very lasting basis. The influence pertaining to the price of oil is shifting from OPEC nations to a more broadly based sourcing (that will likely prove less susceptible to coordinated production cutbacks for the sake of price increases). Moreover, producers will be interfacing with a consolidation of purchasing, as the world's oil processing industry has consolidated massively into four giant companies (with some further consolidations in America and in other nations). This cartelization can lead to an emphasis upon the spread between the barrel and refined products, rather than upon the price of crude oil itself. Profitability can result from processing instead of from oil production. Investors everywhere should factor in a very fundamental change in the energy sector as it relates to fuels — and to carbonaceous feedstocks.

Notwithstanding the origin of the factors that imposed so mightily upon the equity valuations of the past two years, consequences of unsatisfactory experience have proved memorably unnerving and mind-molding for many persons. From professionals to amateurs there is a loss of faith in one's own ability. E-traders have been purged into a much smaller group. Trustees of endowments and pension funds are generally disappointed in their results from advisors and from mutual funds. There is throughout a very broad swath of the investment community an attitude of resignation often expressed as, "I'll just index my purchases from here on when I buy stocks."

**INVESTING
ACCORDING TO
INDEXES
IS INCREASING
AS A
MARKET
INFLUENCE**

An index vogue is clearly in the ascendancy. It is directing higher percentages of the money flow into the popular indexes and seems likely to do so for months to come. In the short-run the vogue can have a self-fulfilling force (and likely self-destructing in the longer run). For much of the coming year it might be difficult to exceed the appreciation of the S&P 500 or other comparable broad market averages, once the rally becomes recognized as a change of direction (instead of merely an anticipatory rally, as it has been in part). Indeed, this new impetus to indexing vogues might do for the S&P 500 what an institutional vogue did for the "nifty-fifty" in 1972. Price earnings multiples will expand enormously for the index designated group of shares because earnings will just not be there to support this elevation in price.

**INVESTING
BY INDEXES
SEEMS FOOLISH
VIS-À-VIS
THE RANGE
OF CHOICE
OFFERED BY
DIVERSITY**

This thoughtless way of investing is riddled with contradictions. Indexing is an abrogation of deliberation, discernment, and sometimes of responsibility. It also involves a brainless weighing of holdings according to their size. For instance, one would own many times more Exxon Mobil than they would own of other American oil shares. Holdings of Microsoft would be several fold that of Oracle, and together the two would occlude all else that one might do in the software realm. Indexing according to size of market capitalizations also bears the internal absurdity of causing investors to have given increased weight to company shares because these were overvalued, such as Ciena, Cisco, JDS Uniphase, Lucent, Nortel, and Corning, all in the S&P 500 with big market caps. An inverse weighting according to size would seem to be more intelligent than a weighting according to size, for bigness often correlates with stagnation. Remember: DuPont, Dow, Ford, General Motors, and all the giant materials companies, have done relatively little for investors for a long while. Moreover, even IBM (now a most worthy holding in large part because of its service division) has earlier experienced a decade of no gain. Indexing is typically justified by such a specious analysis and interpretation of data as to cause exponents to flunk Statistics 101. We commonly hear that mutual funds do not beat the averages, investment advisors do not beat the averages, and so on. Large universes of investors by definition cannot beat the averages because large universes are representative of the market. Proponents attempt to prove it is impossible to beat the index simply by expanding the universe from which the data is drawn, rather than intelligently narrowing the universe. The critical question is this: Are there a few investors and advisors who commonly work with the independence of analysis to more often than not beat the averages? And the answer surely is that throughout our nation there are always several hundreds of managers who commonly do comparatively well.

If one wishes to trade for near term gain, however, there is the necessity to go with the flow, of course. The S&P 500 is likely to receive an impressive supply of motivation as investors come off the sideline (belatedly), shorts cover, and indexing prevails. This might propel the shares in broad averages into such rarified atmosphere that these will stall of their own height and weight. We do not think that will happen in immediate months, but it now seems to be written into the scheme of things as a not-to-be-dismissed possibility. We visualize a picture of this vogue as a counterpart of the lemmings rush to the sea. The lemmings will have some creatures that are conspicuously mingled in. They are larger than lemmings, they are not dressed in tuxedo-like clothes, their coat is brown and furry, their paws have claws in them. They waddle like a bear, and they grunt like a bear. Let's call them belated bears joining the lemmings. We are not attempting to be humorous. We are attempting to be illustrative of the sort of propulsion we visualize for our stock market as derived from personal responses to the experience of the past two years. Predominantly, it would seem the mass responses are of a thoughtless, self-injurious nature that in and of their own nature become a market factor.

**ALIGN
WITH
FORCES
OF
RENEWAL**

The business boom of 1999-2000, led by business investment and financial sponsorship, self destructed from its own excesses. A consumer led boom awaits. Its evidence should appear late in 2002 and sequentially, sponsored by a broad array of new electronic products giving new conveniences, content accessibility, and functionalities. The resulting obsolescence plays against the largest ever installed base of electronic equipment. As we move forward, demand from new users becomes scaled to relatively less importance vis-à-vis the replacement of installed equipment through obsolescence. Thus, for the reasons derived from new products and from obsolescence, we would expect the largest of consumer booms yet looms not so very many months ahead. Our Firm has commented so recurrently upon this, we shall only highlight it herein.

<p>BROADBAND FOR THE LAST MILE</p>	<p>One of the strongest aspects of communications infrastructure (almost the only major one) that will continue to attract corporate investment is the build-out of broadband access to the home and small office. There is an urgent need for the build-out of this so-called “last mile”, the only area of the communications carrier industry that seems interesting to us at this time (largely carried forward by cable companies). As more homes have high-speed access and become interactive, this will so increase communications usage that the idle backbone infrastructure installed in recent years (much of it fiber optics and still not lighted) will eventually become employed. Usage will also be enticed by falling tariffs, almost universally.</p>
<p>INTERACTIVE TELEVISION; VIEW ON DEMAND</p>	<p>Interactive television will bring about an enormous change in society. It inverts the locus of direction to the home, from studios and transmission towers. Eventually this will play to the benefit of advertising and to all providers of content, especially the latter. This will expand slowly at first, awaiting the facilities build-out and awaiting the evolution of change in consumer habits. The best means of investing in this realm at the moment is in suppliers and managers of physical facilities, such as Scientific-Atlanta and Motorola.</p>
<p>DIGITAL BROADCASTING</p>	<p>Digital broadcasting and digital transmission will interact with all of the foregoing. This is probably the most certain and largest driver of them all. This will include radio as well as television. The digitization of television broadcast will free up channels of communications that are being used now for release to other users, adding to the glut of carrier capacity. The excess capacity phenomena will be playing against a rising use and will eventually be cleared. This also implies that profitability to carriers will be highly suspect, while the inexpensiveness of transmission will facilitate use.</p>
<p>FLAT DISPLAY SCREENS</p>	<p>At the moment, the most dynamic aspect of electronic equipment is in the development of flat displays. Now, liquid crystal displays are displacing the cathode ray tubes rather rapidly. But in a very few years, even beginning now in small displays, new light emissive materials will displace liquid crystals. The manufacturers who have invested so much in the facilities to manufacture liquid crystals can convert these, which will accelerate the supplanting of liquid crystal displays with those of new materials. The quality and the brightness of the display will be increased. The speed will be increased. The weight and space saving will be significant. For mobiles, the low voltage needed to drive light emissive materials, as compared with that of liquid crystals, is also a compelling consideration. If all of these improvements are summed, it is more than enough to propel this changeover. Furthermore, the cost of producing the screens of new materials also promises to be significantly less. Thus, once again, cost will drive changeover, and lower prices to consumers will drive increased substitutability of the new for the old.</p>
<p>MOBILE DEVICES</p>	<p>Perhaps most importantly of all, mobile devices are gaining in functionalities (as the PC is being slimmed down) and are soon to be inexpensive access devices to the Internet. This of course means that the display for hand-held devices becomes a very critical item. It must be dense enough to carry the information that is comparable to that of a laptop, with windows. And it must be bright enough to be seen in differing intensities and shadows of ambient light. The necessity for low voltage is also a consideration that makes these displays critical for battery powered mobile device. For developers, this comprises a clear specific opportunity for displays made of new emissive materials, instead of liquid crystals.</p>
<p>DVDs</p>	<p>DVDs are now one of the hottest of items in the consumer electronics realm. It is a bright spot for this Christmas, and ongoing months, as more and more discs providing greater variety of content become available, and as more persons see the benefits of this improved technology. Purchases of DVDs are already growing faster than purchases of video recorders did at a comparable early stage of their introduction.</p>
<p></p>	<p>The sum of the foregoing would involve trillions and trillions of consumer spending on a world-wide scale as energized by new designs and new functionalities. It is difficult for us to consider estimating</p>

IN
SUMMARY

scale as energized by new designs and new functionalities. It is difficult for us to consider retreating from investing when opportunities loom so large, so probable, and so specific according to design, functionality, and applications. Investing in providers of technology-based newly created functionalities gives strategic guidance that is useful for years, as well as providing the attributes we look for to insure profitability for producer shares. There is also guidance enabling the avoidance of companies that are so diversified they have legacy lines of losers.

Our recent observations from technology-based companies, large and small, reveal a better feeling among managements, because customer interest and ordering has stopped falling away. The companies can now manage within the scaled-back disciplines already made, and thus they are proceeding with increased assurance. We do not find managements to be ready to announce a lasting advance, as pulled by an acceleration of consumer purchasing, but they are proceeding in faith that one will take place sooner or later. For some, new horizons appear with China's entry into the World Trade Organization, and with the renewal of Russian expansion and new trade involvements. In the healthcare industry, providers are prospering, by and large.

Investors cannot wait for business to improve before selecting shares. The stock market seems bent upon advancing ahead of a business improvement. It is not so much from a characteristic of foresight, so often attributed to the market. This is more from a money driven (necessary) condition precedent, as a causal sponsoring factor toward recreating a more optimistic attitude (via elevating the nominal wealth of Americans through appreciation in the values of financial assets). The markets will remain awash in money. Inasmuch as money is not forming on physical assets, since business is not expanding rapidly, money will form on financial assets. In so doing, it amplifies the effects of the moves toward ease in monetary policy. These effects are taking an undue length of time to work their way through the system, owing in part to (1) the Federal Reserve System's being behind the pace of change, and (2) the unwillingness of the Fed to participate directly in the processes of financial markets. The Fed only puts money into, or takes money out of, the very bottom of the financial complex, and relies upon the marketplace, and lending practices, to respond eventually.

The future calls one to invest with perception and with patience. Selection becomes of ever more critical importance. Invest with independence of thought and selection, and patiently wait for others to follow. A herd-driven elevation of prices later on seems probable. Remember, the supporting elements of corporate earnings will be generally lacking, having the effect of increasing the vulnerability of vogue-driven gains. Rely upon one of the fundamental precepts of investing: Own the things that are scarce (or not generally owned by others); avoid the plenteous. Cash is now abundant; let others own money-market items. Own long-term bonds and selected shares of providers of new products. By their very newness, these are scarce.

