

January 25, 2002

INVESTMENT POLICY MEMO

From an investment perspective the most important news is that an economic recovery seems to be underway or getting underway right now. The stock market recovery that began in late September seems to have anticipated the economy with a typical three or four month lead. This is broadly consistent with the last of these investment memos. However the mix of factors causing a recovery has been different from my expectation.

Most Americans, including stock market investors, consumers and business people, now view the war in Afghanistan and the bombing campaign, of which I took a dim view three months ago, as a great success. This is partly because the Bush administration succeeded in redefining their objectives from capturing Osama bin Laden to defeating the Taliban. But, it is also because American casualties have been low and the possibility of a prolonged commitment by U.S. ground troops now seems very remote.

The stimulus package, for which I expressed high hopes, failed to pass in 2001. It now appears headed for the usual fate of stimulus packages: to arrive on the scene precisely when it is no longer needed. However, substantial stimulus did arrive on time in the form of tax cuts passed earlier in the year and emergency spending increases in response to September 11.

In any case confidence is now returning among businesses, consumers and investors. Excess inventories have been reduced. New capital spending needs have been identified. This is likely to be a mild economic recovery just as it has been a mild recession. The inherent volatility of agriculture and manufacturing has been moderated more and more over time by the growth of services and government. Service businesses from hairdressers to auto insurance companies are inherently stable. And so are government services from schools to tax collectors. Such services are now by far the largest part of the American economy. But steady on the way down also means steady on the way up. The major part of the economy that is services will not climb any faster than it fell.

The decline was also cushioned by a disproportionate reduction in American imports. Here again, as the economy expands, the expansion will be moderated by a disproportionate rebound in imports. This will be a boon to Mexico or Japan rather than the U.S. Finally, the recession has been mild because the usual major culprit was missing. There has been no decline in auto purchases or homebuilding. By the same token, there is not much room for either of these activities to go much higher. The industries that were severely impacted by the events of September 11th, hotels, airlines, package delivery companies, are recovering sharply; but they appear unlikely to reach or exceed their pre September levels any time soon.

The September 11 attacks and the war on terrorism are likely to moderate the economic recovery in additional ways. The numerous costs of increased security are likely to reduce productivity improvements and economic growth. Fear and uncertainty about future attacks will

reduce spending by some consumers and some businesses. In the world, U.S. preoccupation with the war has strained relations with countries from Mexico to Russia. India and Pakistan stand at the edge of the precipice. The day when the people of Kashmir will finally vote on their future seems more remote than ever. In many Muslim countries on three continents there is a fear of U.S. bombs and an increased level of hatred for America. Israel, as a self-appointed deputy in the war on terrorism, has pursued its own war against the Palestinians. As a result the possibility of a viable Palestinian state peacefully coexisting with Israel seems to have been demolished. The Middle East appears to face an endless cycle of violent repression and violent resistance.

So far the effects of the war on the U.S. economy have been positive. If the U.S. persists in flying around the world and dropping bombs on people, the immediate consequences for the U.S. economy will remain positive. But, as is clear already, the longer run consequences of this murderous mayhem are seriously negative. Government instability, terrorism, inflation and interest rates will all increase. While increased instability overseas may make the United States appear to be relatively safer, the primary effect of these increases will be to dampen economic growth everywhere. In addition, each one of them will cause stocks to sell at lower prices relative to earnings or dividends.

The consequences of September 11 and the American response can thus be added to the list of reasons why the economic recovery will be moderate and the stock market recovery even more mild than the economy. Things could turn out a lot better than this or a lot worse. However the overwhelming probability is that a slow and irregular recovery is starting. The stock market will also continue to rise from its September low; but there will be episodes many months long during which it declines or moves sideways. Annual returns for the next five or ten years will more likely be 8% to 10% than the 18% or 20% that was the norm in the late 1990's.

Most of our portfolios have the highest percentage invested in U.S. stocks over the past four years. This is because much of the rest of the world has become more dangerous, and because both smaller U.S. companies continue to sell at very reasonable prices, and also because the largest, best managed U.S. companies are selling at the low end of their valuation ranges for the past five or six years. We favor companies that will benefit from a cyclical recovery and companies that will benefit from increased inflation. Stock prices in the rest of the world are particularly depressed. While there are reasons for this, some opportunities also exist, especially in Mexico, Brazil, Canada, Europe and Japan.

With interest rates at their lowest levels in many decades, bonds are particularly unattractive if not dangerous investments. We have been using them as a source of cash for stock purchases and other spending needs. In the last Investment Memo we advocated about 33% in cash and other very safe investments where possible as a hedge against uncertainty. Our target is now about 10%, reflecting the much lower degree of uncertainty. In most cases comparable amounts of cash have been reinvested in equities, usually last October and November.