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INVESTMENT POLICY MEMO

The permanent “War on Terrorism” trudges across our TV screens wrapped in a spin of lies and various colored alerts. In this respect Orwell’s “1984” has finally arrived, and with it the War Against Democracy, whose victories at home are as real as the other war’s failures abroad. Meanwhile, this Investment Policy Memo has also reappeared after a brief interruption, rising like a Phoenix from the ashes of its past mistakes.

Six months ago I confessed to the investment sin of looking too far ahead at the ultimate, but distant, consequences of the Bush administration’s foreign policy. I think now I must confess as well to the investment sin of allowing my disgust with these policies to interfere with objective investment judgment. In any case the passage of time has dispatched a number of propositions and beliefs that were advanced in the July Memo. My contention that the stock market was far more likely to go sideways or down by ten percent than to rise another ten percent was proven false toward the end of 2003 when the next ten percent milestone was passed.

The July Memo also contained much hand wringing and wondering about the failure of the economy to expand as robustly as growing government deficits and stimulative monetary policy implied. No sooner was the Memo written than the economy began to grow at an astoundingly vigorous pace. The recovery, which is now entering its third year, appears likely to be as long lasting as its two predecessors in the 1990’s and the 1980’s. The “considerable period” for which the Federal Reserve has promised to keep short-term interest rates at one percent is still considerable – at least until the middle of this year and quite possibly to and beyond the middle of 2005. Apart from energy and commodity prices, no hint of inflation has appeared. Ben Bernanke and others at the Fed have made convincing arguments that inflation is unlikely for a very considerable period; that commodity price behavior is cyclically normal and, less convincingly, that the falling dollar (one of the things we got right) will have only moderate effects on inflation.

As significant as these arguments themselves is the passion with which they are supported by members of the Fed’s Open Market Committee. This is a major reason why short-term interest rates are likely to stay low even after early signs of inflation may appear. Low interest rates, plus large increases in government deficit spending, plus the unusually strong increase that has already taken place in corporate profits, plus the stimulative effects of a falling dollar on U.S. exports, plus reasonably healthy growth in the rest of the world, except for Europe, all combine to strengthen the prospects for government spending, business spending and exports to become sources of economic growth in addition to consumption. Coupled with continued low inflation, they also suggest the continuation of a strong stock market environment; although perhaps less buoyant than the last fifteen months.

The prospect that short-term interest rates may stay very low for a long time makes longer-term interest rates appear more reasonable than we have previously argued. If, for example, the bond market expects short rates to average two percent for the next three years (compared with one percent today), then it is implicitly forecasting that short rates will jump to five percent in 2007 and climb steadily towards 6% in the following years. Given the significant possibility that political processes or a falling dollar might cause a reversal of America's deficit policies by 2007, this seems like a reasonably fair discounting of the deficit bad news.

In short, Dr. Greenspan is waving his magic wand so that he can finish his term as Chairman of the Federal Reserve with the economy back again in the Best of All Possible Worlds. Not even a whisper from the Fed about rising deficits. Not a hint of concern about inflation. A ban on the phrase "Irrational Exuberance", no matter how high the NASDAQ soars.

In response we spent most of October getting the common stock portions of our accounts more fully invested. The large cash positions we had held as insurance were a considerable drag on performance before October and would have been since if we had not invested them. Our current stock market choices are more evenly distributed across different industries than had been the case for some time past. We emphasize companies that are benefiting from an economic recovery and particular health care segments such as biotechnology and health care services. A number of investments are in industries where mergers appear more likely, such as insurance brokers and organic foods. We continue to shy away from most information technology companies and to favor less expensive and generally smaller companies.

Our common stock portfolios contain many companies based overseas, particularly in Europe, Japan and Korea, Brazil and Mexico. As a group, these investments have performed far better than American stocks and we expect this to continue because of faster growth overseas as the world economy recovers, lower valuations for these foreign stocks and greater exposure in many cases to commodity price inflation.

Although, we are for the moment far less cautious than we had been or than we usually are, we remain true to the basic precept that the first principles of investment success are to insure against risk and to avoid losses. To these ends we maintain small cash reserves, investments in stable, high-yielding stocks and investments as well in stocks with unusual exposure to renewed inflation. Our clients' stock portfolios have lower valuations compared to earnings and underlying assets, and higher dividend yields than U.S. stock market indices. We have not thrown caution to the winds. Rather, we have given it a little much-deserved rest until it is more urgently needed.