

MEMO

From Robert Zevin

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For most of the past year and one-half my approach has been to reduce ownership of the extremely high-priced and vulnerable businesses of the largest American, multi-national growth companies. Since the end of April this group of stocks has declined in price while the market continued to advance. Also, a number of companies, including Phillip Morris (which I would never buy), Gillette and Coca Cola have experienced serious setbacks.

I have invested money that came out of the big growth stocks in smaller companies, foreign companies, bonds and cash. Since April smaller companies have gone up in price significantly after a long period in the doldrums. It remains to be seen whether this will prove to be only another brief revival. However the prices of small consumer goods, grocery store, business service, office furniture, electric utility and real estate equities remain extraordinarily attractive while larger companies are at record heights. Foreign stock prices have also been quite strong, especially in Japan and South Korea, at least until the past couple of weeks.

The most striking aspect of the economic news for the past three to six months has been the evidence of strong and accelerating economic growth in the U.S. and in many parts of the world. This is the most important reason why small domestic and foreign common stocks have done so well. It is one of the important reasons why the large growth stocks have done poorly, since their perceived ability to deliver assured earnings growth in all environments is less valuable in a situation of strong economic expansion in which many other companies would experience better earnings growth. I have particularly favored health care and telephone companies because of their relative immunity to an economic downturn. In an atmosphere of higher expected economic activity stocks in these industries, at least in the United States, have not done well.

The prospect of stronger economic growth has also caused a substantial rise in long-term interest rates from under 5% last fall to over 6% in recent weeks. As a result, bonds have gone down in price over the past nine months. The Federal Reserve Bank has reacted to the same signs of stronger growth by increasing short-term interest rates. It appears likely that additional increases will be implemented before the year is over. In the meantime, holding cash reserves has not helped investment returns as stock markets continued to climb.

For the most part the smaller and foreign stocks that I have purchased have excelled to about the same extent that the bonds, telephone and healthcare stocks have drooped, so that investment performance has been roughly the same as the market

indices. I do not intend to change the portfolio mix at this time except to add a few technology stocks that have declined dramatically and perhaps a few financial stocks as well. The basic stance will continue to be defense against an economic downturn rather than exposure to a continuing boom.

This longest-ever peacetime economic expansion has been significantly powered by the boom (or bubble) in stock prices and by easy monetary policy. As inflation and interest rates increase there is a good possibility that stock prices will finally go down the way they used to. At that point the economy could switch from expansion to recession which could cause stock prices to decline further in a downward spiral of interaction that might reverse the last eight or eighteen years.

I am not forecasting such a calamity. The Federal Reserve Bank, under Chairman Alan Greenspan, has been assiduously calculating its every move to avoid just such an outcome. However, successful avoidance means continued boom or bubble and greater potential for an even bigger collapse. It is not yet clear how the Federal Reserve or anyone else can ultimately avoid some kind of contraction. Hence, I continue to prefer caution in the midst of enticing speculative excess.