July 24, 1995

SECOND QUARTER COMMENTARY

"If everyone is thinking alike, then somebody isn't thinking"
George S. Patton, Jr.
General, US Army
1885-1945

There can be little question current "thinking" has been bullish. Witnessing this is Dow Jones 4700 and the lowest dividend yield in 125 years. That's right, 125 years! At a 2.46% S&P 500 dividend yield, an important record has been broken. The previous lowest yield was in 1987 prior to a nasty "correction". This does not augur well for the intermediate term market. As usual, a vocal chorus claims it to be different this time. The "thinking" is along the following lines:

- **corporate cash flow is high,**
- **the dividend payout ratio is low, and**
- **corporate stock buybacks are at record levels.**

Let's examine the "thinking" behind each of these assumptions:

- **Is cash flow high? At a cash flow multiple of 9.5 times, cash flow can scarcely be considered high relative to market price. A "normal" multiple would be 7.8 times cash flow.**
- **A low payout ratio? At 42%, this is not cyclically lower than many other peak earnings points in past economic cycles.**
- **Stock buybacks at record levels? Although much is made of this because "capital gains are preferred to doubly-taxed dividends", the reality is eye-opening.**

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In 1994, only $6.2 billion of $68 billion in announced buybacks were actually completed. Of $43 billion announced so far in 1995, only $5.8 billion have been completed. Additionally, there were $57 billion in IPO's (initial public offerings) last year. It takes many of the IBM-takeover-of-Lotus-for-$3 billion types of transactions (removing stocks from the market) to neutralize the IPO's (putting stocks onto the market). All in all, the psychological impact of the buyback announcements may be more supportive of higher prices than the actual buybacks themselves.

Were one to be skeptical of the above analysis, one might compare the U.S. market to the notoriously rich and perpetually overvalued Japanese market (see chart #1):

	Multiple of Book Value	Multiple of Cash Flow
U.S. Market	3.7 x (S&P 500)	9.5 x (S&P 400)
Japanese Market	1.8 x (NIKKEI 225)	9.0 (NIKKEI 225)

Moreover, consider equity mutual fund cash levels. Equity mutual funds carry cash to meet redemptions and reposition portfolios. The percentage of cash carried normally fluctuates industry wide between 8% and 12% of total portfolio value. Traditionally, cash levels below 8% were strongly cautionary signals. The current reading is 6.8%!, the lowest reading in the least 17 years (see chart #2). Now there's a number for the contrarians to ponder!

Money is pouring into mutual funds like tomorrow does not exist. Fidelity's Magellan Fund passed the $40 billion market in April only to hit $50 billion in July. That's 25% in less than three (3) months, and that wasn't portfolio appreciation, it was new money pouring in. With incoming cash flow like that, it's pretty easy to prop up existing portfolio positions on weakness. Since many of the larger S&P 500 companies are heavily weighted in the averages, a normal 2% position in a stock like, say, IBM, would be a $1 billion position. At $100 per share, that's 10 million shares. That's right, 10 million, and it's only Magellan… how about the other 200 Fidelity funds…presumably

they own some too! One would not want to be on the tail-end of their sell program, except as a buyer.

Other sentiment indicators also indicate caution. The percent of NYSE stocks above their 200 day moving average is a good signal that rampant bullish "thinking" has become extreme. As is the Market Vane consensus of stock index futures traders, at 70% for the first time since mid-1987 (see chart #4).

There can be no question that money continues to pour into the market. Memories are short. There has not been a solid bearish market of normal proportions (a 26% decline) since 1987, eight (8) years ago. Market volatility has been low. Daily fluctuations of 2% were common in past markets. A 2% move today (94 Dow Points) elicits gasps of wonderment, both upside and downside. What is clear is that the baby boomers now aged 40 to 50, are saving… never mind the oft quoted "statistics" about how little we "save"… these numbers exclude the IRA's, 401(K)'s and other flavors of retirement plans… the facts are that baby boomers are moving into their peak savings years, becoming empty-nesters, and have bought into the idea that Social Security won't cut it for retirement. And with that, they've been sold the idea that they can't get from here to there owning bonds… that stocks are the only answer, volatility and bear markets be damned. So far so good. It's just that the "crowd" is never right… at least for very long. We'll see.

The biggest potential threat to the domestic equity market would be either a resurgence of interest rates from a strengthening domestic economy or a collapse of the Japanese banking system. The latter is practically a certainty since loan loss reserves only cover somewhere between 9% and 18% of bad loans. At the peak of the U.S. banking crisis in 1991, loan loss reserves covered 64% of non-performing loans. Bad loans are variously estimated at 40 to 80 trillion Yen ($470 to $940 billion U.S. dollars), an eye popping 10% to 20% of GDP! Although Japanese banks could theoretically sell some of their directly owned corporate portfolio, this would further destabilize an already depressed market triggering further defaults. The only way out for Japan at this point is to reflate asset prices or start over. The current government is in the usual political gridlock and this crisis will need to come to a head in order to craft a solution. Look for more bad

news to materialize on the Japanese scene before this is over.

Thirty (30) year Treasury Bond yield have just moved from 6 ½ to 7 percent. No sooner had Alan Greenspan given the markets what they thought they wanted… a rate cut… than the economy starts looking stronger. Further cuts are not assured, and a return to 2%+ GDP growth looks likely in Q3 and Q4. As economist Sam Nakagama was fond of stating, "The only thing worse than not getting what you want is getting what you want." Seems the bond market agrees.

It's been a rough environment to work in… when all manner of fools are willing to throw caution to the wind, keeping up with the averages is nigh unto impossible without becoming equally reckless. Be assured that we are cautious in our stock picking, and will not commit without identifying compelling values. Although this will stand you in good stead in the majority of market environments, it is not necessarily foolproof in all environments, of which the most recent is an example.

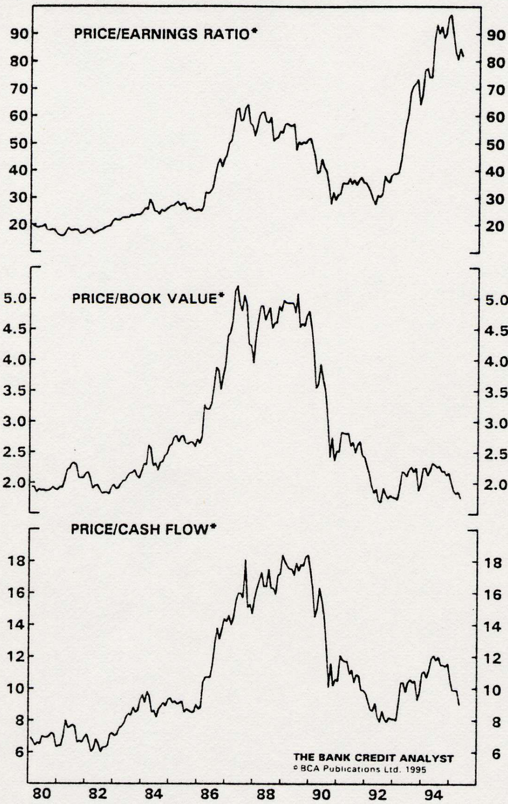
We thank you for your patience and goodwill.

Very truly yours,

Alan T. Beimfohr

Valuation of
Japanese Equity Market

CHART 1



*MORGAN STANLEY CAPITAL INTERNATIONAL

CHART 2

Mutual Fund Cash to Asset Ratio (% of Net Assets)

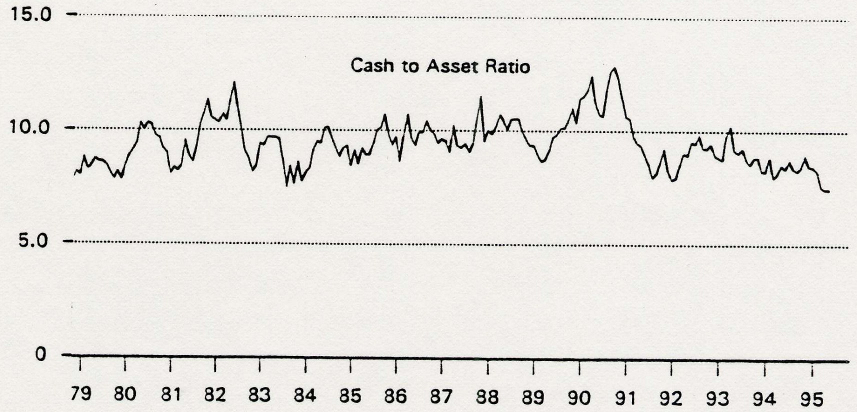
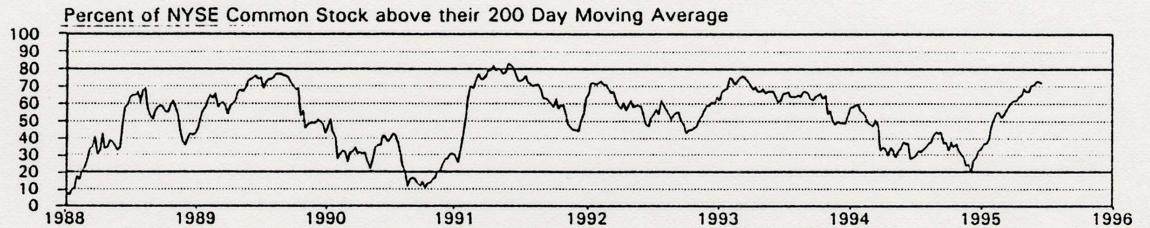


CHART 3



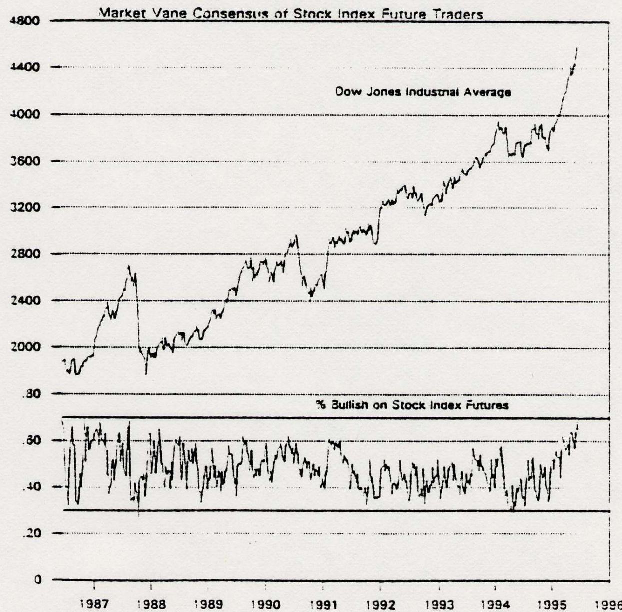


CHART 4