Sather Financial Group, Inc.
Registered Investment Advisor

Third Quarter 2000 Commentary

September and the third quarter are now over—that is good news. September is historically the stock market's worst month as is the third quarter. However, I'm not sure that October is going to be much better. The Dow Jones Industrial Average lost 5% in September, its worst performance since 1990. The S&P 500's 5.3% decline was its worst since 1986 and the NASDAQ Composite Index, with a 12.7% loss, had the worst September in its 29-year history.

Year to date the Dow is negative 7.4% and the NASDAQ is negative 9.7%. In fact, if the year were to end now it would be the first time since 1990 that all three indices finished the year negative.

Stock price volatility has increased dramatically. Much of this is due to the fact that the companies who are giving earnings warnings are quite prominent. Seven of the thirty stocks in the Dow Jones Industrial Average have issued earnings warnings. The problems that many companies are incurring are no longer individual in nature. The weaker Euro, higher fuel prices, slowing economy and decelerating growth of personal computer sales are affecting a broad group of companies. However, possibly most significant, is that during the past year valuations of investors' favorite companies soared into the stratosphere—only to guarantee a brutal awakening should bad news hit.

After the recent boom years, investor's expectations for earnings growth have simply become unrealistic. As such, you are seeing these "untouchable" companies get re-valued. For example, after Intel, which had traded at a Price/Earnings ratio of 60, issued earnings warning it dropped from $75 per share to $40 per share. It now trades at a P/E of 30. The same is true for Apple, Kodak, The Gap, Dell, Microsoft and Wal-Mart. All have suffered because the market valued them in a manner that was ridiculous.

Intel's drop has been especially interesting and damaging. Intel's earnings warning undermines the thesis that tech stocks are immune to the forces that affect old economy companies. For some time now I have stated that for short periods of time the market irrationally prices companies. This is certainly true with the froth and speculation of tech issues. However, technology companies are not going away, they are simply getting revalued.

It is also interesting to note that since 1995, US corporate earnings in the "new economy" have grown 8% annually, compared with 7% annual earnings growth for "old economy" companies. Simply put, the "new economy" has provided no more than a quite steady share of about 16% of total corporate profits during this period. Despite these similarities, the stocks in the new economy were valued at 102 times earnings at the start of 2000—compared with 26 times earnings for old economy stocks.

If one is to continue to compare earnings it is quite useful to look at a recent analysis by Dr. Jeremy Siegel. Siegel analyzed the nine large – cap companies that are currently priced at more than 100 times 1999 earnings. Dr. Siegel accepted, for argument sake, that the earnings of these companies would grow at **their estimated average rate of 33% per year over the coming decade!** For investors to earn a just a 15% annual return, they would have to sell at an average of 95 times their earnings five years from now and at 47 times earnings in a decade! He concluded, quite simply, that big cap tech stocks are a sucker bet.

Dr. Siegel also has analyzed stocks from the Nifty 50 era of the 1970's. He determined that no stock that sold above a 50 price to earnings ratio was able to match the S&P 500 over the next twenty-five years. Furthermore, as the S&P 500 slumped into the 1973-74 bear market and the broad market dropped 19%, the Nifty Fifty stocks plummeted an average of 45%.

Remember one thing: the value of any company is the present value of its earnings. On judgement day a company is only worth as much as it has earned. When investing, one must be very careful to not over-value a company or fall in love with it despite the valuation. Just because a company is growing fast or is in an exciting industry does not exempt it from the fact that in order to produce true sustained value it must provide a steady and increasing stream of earnings.

The US Presidential election also gives investors another tidbit of information to mull over. Surprisingly though, research back to 1880 shows that the stock market performs almost identically regardless of whether a Republican or Democrat is serving as President. Remember that the true value of a company is its earnings. The largest external factor upon a companies earnings is arguably that of the Federal Reserve. Fortunately for investors, the important election occurred this past January when Alan Greenspan was re-appointed to another four-year term as Chairman of the Fed.

As you have questions about your investments relative to the above comments please give us a call.

Sincerely,

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Certified Financial Planner

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