Financial Planning Magazine

How Now, Dow Jones?

By Richard J. Koreto June 1, 2001 Pages 37-47

Early last month, Senior Editor Richard J. Koreto hosted a teleconference for seven financial services professionals. The topic? What investors can, or should, be doing in these feverish times. If there was any consensus, it was that in the long term, it's the level-headed who prosper in the market. Or, as stated in an old Billy Joel song (appropriately titled "Keeping the Faith"): "The good old days weren't always good, and tomorrow ain't as bad as it seems." The participants were:

Jeffrey Auld, president of NEXT Financial Group, an independent broker-dealer in Houston.

Linda Barlow, CFP, a planner in private practice in Santa Ana, Calif.

Kathleen Day, president of The Enrichment Group, a financial planning group in Miami.

Jeffrey Everett, chief investment officer for all retail mutual funds for the Bahamas-based Templeton Global Equity Group.

Elaine Garzarelli, president of Elaine Garzarelli Investment Management, Garzarelli Capital and manager of Garzarelli Forward Fund.

Joseph Janiczek, president of Janiczek & Co., a Denver-based financial advisory firm, and author of How to Achieve Absolute Financial Freedom.

B. Clark **Stamper**, president of Stamper Capital & Investments and manager of the Evergreen High Income Municipal Bond Fund.

Financial Planning: What do you think investors should be doing in the next 12 months?

Garzarelli: We have a set of 14 indicators that tell us when to get in and out of the stock market, and they've been very good. They gave us a bear market signal last year, in May, and they are now bullish. So, I think the bear market is over, and we're two weeks into the new bull market on a cyclical basis. We should see returns of 20% to 40% in the S&P 500, from the April 4th bottom. It's time to maximize returns in the stock market.

Janiczek: The volatility we've seen here the last 18 months has been a giant wake-up call for people managing their money in a vulnerable financial condition. What I see is people

who had low cash reserves, high debt loads, poor diversification, poor spending and saving habits -- they're the ones that were really panicking over the last 18 months. I'm recommending that investors really use that as a wake-up call, to master those basics first.

Day: We're more into asset allocation and diversification, and our clients tend to be ones that are using their portfolios to provide lifetime income. It was pretty hard, during the last two or three years, to convince people that diversification was a good policy, and I guess we've been vindicated. And it's important to keep a fairly balanced position at this point, because our clients are tending to want to go more toward an overly conservative position.

Barlow: I agree. Having clients stay the course has been tough -- but people are listening. I, too, felt that the bottom was a couple of weeks ago, and being able to take advantage of some of the growth that we anticipate over the next few years is something that we're trying to go ahead and move them forward in that. And they will stay the course better this time, although I didn't have any jumping out.

Stamper: One thing we need to do is make a distinction between investing and speculating. And after the fact, it's very evident that most "investors" over the past several years were actually speculating, not responsibly investing, and even their investment managers were not holding them back. The most encompassing example would be purchasing equities at higher-than-average multiples of sales, earnings and cash flow. The other thing I have to comment on, with respect to trying to minimize risk, is a study by John Nuveen that shows that the best allocation between bonds and stocks happens to be -- for high-tax-bracket investors -- 80% municipal bonds and only 20% stocks. That happens to be large-cap stocks. That was over a 20-year period, and they did the study for 20 years in 1998, 20 years in 1999, 20 years in 2000. I haven't seen the most recent study, but it is pretty shocking. And that example would be a long-term investment strategy, not trying to time the market but rather looking at valuation.

Auld: What investors should be doing in the next 12 months is really what they should have been doing in the last 12 months, and the 12 months before that, which is, staying diversified, maintaining their proper asset allocation for their objectives and focusing on the long term.

Everett: We've seen -- and this is material -- a change away from the capitalization of stocks. Large-caps predominated, as you know; 1999 was an exceptional year, and to the degree that we've gotten away from "big companies are automatically better than small companies," in terms of performance, in terms of the way they're run -- that was dangerous for investors, and we've clearly gotten away from that. That's very healthy.

FP: Has anybody seen investors, people they work with, jumping around too much -- perhaps being unreasonable, after such a long period of steady growth?

Auld: I've called several of our representatives, and they don't have customers interested in jumping around or being unreasonable; in fact, they're being quite patient. One of the

reps said that clients don't like it, but they understand [the difficult period and] believe it will pass. And each of the representatives that I talked to has managed customers' expectations in advance of the recent market decline. And that's probably helped them during this past year.

Barlow: I would absolutely say that's true. They're not at all jumping around, and yes, it's a constant job to try to keep them to stay the course. But in the past couple of years, as the market seemed to be going straight up, I kept saying that this can't happen, you can't continue, you know it will drop -- so they were prepared.

Day: Up until last year, we were seeing an awful lot of instability. When new clients were coming in, one of the questions we asked was, "What is a reasonable return for a portfolio that's managed to produce moderate growth with average volatility?" They would tell us 18%. And we would tell them we didn't think that was reasonable.

Stamper: People's expectations were way too high. Expectations have been lowered, but are probably still too high. Also, everyone has been saying that they were long-term investors, but the volatility in the stock market has increased rather dramatically, and if everyone is in for the long term, why is the volatility so high? And you had a lot of the popular financial magazines promoting "10 Stocks That You Must Own Now," or "You Need To Dump These Stocks Before It's Too Late," aimed at people managing their portfolios by themselves, who were doing a lot of trading in and out.

Janiczek: In my financial advisory practice, I've noticed a great amount of stability throughout all of this. But on my book tour, where I really talk to a different crowd at book signings and such, that's where I really saw signs of instability -- those who didn't have the proper diversification.

FP: We have fund managers, broker-dealers and financial advisers here. I thought we should spend a few minutes just talking about what you all want from each other, particularly in a changing economy.

Day: We had a fund representative in here yesterday, and his agenda was to teach us how to sell mutual funds and how to use marketing literature. And of course, that isn't our agenda at all. What we want to know is, "What is your fund doing? What are the holdings? Not specific stocks, but sectors? What are the changes in attitudes?" For example, "Are you going in or out of Japan? If you're taking cash inflows, are you investing them immediately? Are you holding them in cash and waiting? What do you think is going to happen?" We want information that tells us what the manager's investment philosophy is today.

Auld: My sense is that most of the wholesalers who are contacting my representatives today are talking a lot about managing clients' expectations and the value of proper asset allocations. Those things certainly are important, but it would have been helpful to be included in their discussions a year or two ago. I believe, in many of the sales meetings that I've stopped in and listened to 15 months ago, the wholesalers were talking about the

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performance on their growth fund, or this technology fund, and less about managing customers' expectations and the proper allocations. I would like some more consistent information like that -- and not just focusing on the hottest funds and highest yields.

Janiczek: From the funds themselves, we're looking at sectors and asset allocation. When a fund performs outside its peer-group range, we want to know why, so we can assess whether we're achieving our allocation goals for clients. And you know, a couple of funds have done that well -- explaining what they're doing, what's working, what's not, and why, and whether they're staying with their strategy or not -- but many funds don't.

Garzarelli: With planners, we're helpful in that we can tell them what industries are likely to do well at what stage in the business cycle.

FP: Let's think about Washington: the possibility of changes in income and estate tax. Do the possibilities change the way you plan with your clients, or how they're thinking about the future?

Barlow: Folks are starting to gingerly mention tax reform, and especially estate tax reform. As far as the portfolios are concerned, I don't see that either of those things will change the asset allocation in our firm's portfolios, or what we try to coach the clients to do.

Stamper: Bush's proposed tax cut was from 39.4% down to about 30%. And because the muni bonds are still very cheap compared to Treasuries, at about 90% of the U.S. Treasury yield, the impact would be small. When you had the flat tax being pushed back in the middle 1990s, there was talk about bringing the tax level down to around 18%. This did, in effect, push the muni market down and the yields up. But any tax legislation that they expect to pass with respect to income tax would be less than Bush's original proposal, so the impact, at least on muni bonds, would be small.

Janiczek: If there was ever a flat tax of 15%, we look at that as being very negative to munis. We have a lot wealthy clients with pretty significant bond portfolios, and we always caution them of the threat, but not a highly probable one. My understanding of the proposed estate tax law is that the capital gains step-up and basis that you now get would not be there, and there would be gains in income tax on the estates, rather than the estate tax. And that would change philosophies regarding portfolios that have highly appreciated stock. Sometimes we're in a position where you're just holding long term and basically waiting until someone passes on, to get a step-up in basis, so that will change strategies if there's a significant change in capital gains law.

FP: Would income tax changes encourage high-net-worth individuals to invest more money?

Janiczek: Everybody wants to save more, so that would be more helpful to those who aren't saving than necessarily the higher-net-worth market. I think the cleaner the tax law, the better, so I'm all for reforming to clean it up. But look at what happened in the early

and mid-1980s, with tax reform in real estate. That was quite a significant change, where people were depending on write-offs that suddenly weren't there.

Everett: From the market's point of view, any change has been discounted, and I wouldn't expect to see too much. In Europe, having had a major overhaul in many of the countries' taxes hasn't meant that much to the markets.

Garzarelli: Well, I can just say, as an economist, we don't take into account any of this in running our funds. But a tax cut would influence the economy, and if it influences the economy and increases spending to the multiplier and accelerator effect, then that would increase earnings and of course would be bullish for the trend in the market.

FP: Are investors, thanks in part to the media, becoming more sophisticated?

Garzarelli: I have a product that is institutionally oriented -- a report that goes out to institutional clients, with a lot of equations. Over the years, I've had requests from individuals that call our office and ask for materials, and we've given it to them. But in the last three years, the increase in the understanding of our work, and the knowledge and the questions that we receive, is enormous. There's a big change out there; a lot of it has to do with the financial news programs.

Auld: Our customers are getting a lot more information, if not more sophistication. I almost think that the information they're getting is leading to some confusion, and maybe making them feel inadequate, as though they should be doing something that they're not. Investors that were pretty happy to invest in mutual funds, or traditional package product investments, looking long term, can't help but read the cover of Money magazine or they flip on CNN or CNBC. They feel like they should be doing something more, but don't really understand what that is. Some of those people seek professional advice, and others try to subscribe to more magazines and spend more time watching CNBC and understand it and do it on their own. But, I don't see any significant increase in the level of sophistication.

Janiczek: I definitely see more sophistication out there, but also the hype in the TV, and the news, about fear, greed and the whole culture of day trading and speculating. A lot of investors have become burned out from that culture, and they realized they're learning that they don't want to be so involved with their money that that's all they're thinking about. It takes all their time away from what really gives them fulfillment.

Day: You've got one set of people who have really taken that information and become a lot more sophisticated with it. On the other hand, it's created a real opportunity, because those people who have busy, active, full lives know there's a lot of information, and they really don't want to be bothered with it, but they realize that they need to get help, to be able to deal with the complexity.

Barlow: One of the biggest services we can provide is to help them sort through all that, sift through the noise, and put together the proper plans and allocations for them.

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Stamper: Until the Nasdaq dropped and the volatility increased, the general public was beginning to think they knew investments simply by watching those shows and reading a lot of those magazines. The media did not highlight valuation, which was a very important consideration. Now the public understands that they need professional help. Everyone feels they can understand equities, but bonds are much more mathematical and they can actually tell that they really don't know the product very well. I haven't seen an increase in sophistication or knowledge about bonds at all.

Everett: Our customer, which is the financial adviser, has become much more sophisticated. However, it's my feeling that their customers are as emotional as ever. And the emotional factor is really what is what a lot of people are getting at. The less emotional you are, the better investor you are. Some of the markets we invest in around the world are some of the most trading-oriented out there. Korea and Taiwan come to mind specifically. But yet, those investors are as emotional and as herd-like as any you'll find in the world.

Garzarelli: My institutional investors are herd-like as well. And I was in a brokerage firm for 10 years: We'd be going into a recession, and our cyclical analysts would say, "Well this time is different; we talked to the company and don't worry about anything." They're emotional as well.

FP: Let's take a look at technology. Of course, there's a huge sell-off of technology at all levels. What place is there for technology in the coming months?

Garzarelli: From our work, the semiconductors look fairly decent. So I would suggest that investors have about a market weight at this point, in tech, and that's a changed opinion from us having about half a market weight, for all of last year. A market weight would be appropriate, at this point.

Janiczek: There's going to be a great boom in technology into the future, as we learn how to utilize it in businesses to really benefit, add greater value and be more efficient.

Everett: Technology seemed to take on a life of its own. It's not dead as an investment strategy; it's simply being looked at with proper valuation techniques that it should have always been looked at. It's simply that people seemed to think, this mindset, "This time it was different." And it wasn't different.

Garzarelli: What you're saying is, discipline is the key to everything. And I remember when our valuation indicators turned bearish, in 1999. We had the market more overvalued than it was before the crash of 1987. And then, it kept going and kept going, and look at all these portfolio managers that cut back and went to cash, and hedge funds that went to cash. And they lost their jobs, because the market was irrational.

Everett: A lot of financial advisers stuck with us, Templeton, and took a lot of heat, just as much as the fund managers took for being underweight, sticking to their guns. You're

right, you really have to look at things over a multi-year period, and it gets back to discipline and truly having a longer-term perspective.

FP: Any concluding comments?

Garzarelli: I just have one thing that I'm kind of struggling with, with some of my other economic strategists, and that is: What kind of trend are we looking for, in the market, on a secular basis? From 1967 to 1982, inflation-adjusted, the market was in a down trend, and the way to play it was to go to cash, and then get back in the market for a couple of years, and then get out when the market was overvalued. And then, from 1982 until 2000, you could just pretty much buy and hold. Now, is that going to be the philosophy for the next 10 years? Or, are we going into a period where the evaluations are already fairly high for the markets? So after this cyclical run of 20% to 40%, we could very well get into a situation where the markets are overvalued again, and we have to go through another bear market like we had.

Stamper: Going back to the first question, I was talking about investing vs. speculating. You could make the case that once the valuations are way high -- say, if you're dollar-cost averaging -- maybe stop and observe valuations at the top of the market, and instead of dollar cost averaging put the money in a more defensive category, wait for evaluations to come back down and then resume the dollar cost averaging strategy.

Day: Or if you're asset allocating and rebalancing periodically, you'd be pulling money out when it gets too high.

Janiczek: I have one final comment. I think our discussion is very good, and probably applies to maybe 25% or 30% of the market. But I really see the new frontier being in the trenches with my book. Some 75% of the people who have problems with their spending controls, their saving controls, their debt -- they're not even thinking about the things that we've talked about. That, to me, is the new frontier.

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