

CONSULTANT'S CORNER

— ♦ —
E. JEFFREY ROOF

Resolutions could make life brighter for investors

Happy New Year! Auld Lang Syne! Out with the old, in with the new! The time for reflection and resolutions. The end of one calendar tax year, the beginning of another. With that last sobering thought, let's briefly reflect on last year's financial markets and begin 2001 with some investor resolutions.

For many investors, the farewell to last year's stock market was little more than "good bye and good riddance". All major composite indexes suffered during the preceding twelve months.

The week before the end of 2000, the Dow Jones Industrial Average was down 7.49 percent, the Standard & Poor 500 had slipped 11.11 percent, and the NASDAQ fell 38.15 percent. This was not 1999.

This was the first time many nouveau investors had experienced a negative market. However, while the volatile daily swings of the year were unprecedented, a stock market finishing in the red is not.

Some of the market lessons learned from 2000 are new but many were repeats from prior periods of "irrational exuberance". Here are several investor resolutions to consider for this and future new years:

■Resolution 1: Recognize that business fundamentals are critical when selecting investments.

Stocks represent ownership in a business. And a business can only be successful long term if its design and execution ultimately

produce profits. This fundamental was ignored in the last legs of the recent bull market when many investors became speculators by chasing "possibility" instead of profitability.

A striking example of this increased speculation can be found by examining trends in the market for new companies raising capital through initial public offerings, known as IPOs. The market for IPOs has typically blown either hot or cold, but new extremes were reached during the last few years.

As a comparison, in the '70s and '80s it was rare for companies to go public without first demonstrating profitability. Though this expectation gradually declined throughout the '90s, noted IPO expert Jay Ritter has observed that at least 60 percent of all IPO companies were profitable before going public until 1999.

However, in that year, less than 25 percent of all IPO companies being brought to market had demonstrated any profitability, much less the ability to sustain growth moving forward.

For example, in October 1999 Akamai Technologies went public after demonstrating a meager \$1.3 million in sales. Shares skyrocketed to \$145 the first day of trading, creating a company with a paper worth in excess of \$13 billion, larger than Sunoco, Union Carbide, and Toys R Us combined.

The share price climbed to \$345, then collapsed and now trades at about \$23. Even at this reduced level, the company's performance by most basic business standards makes it a speculative venture at best.

■Resolution 2: Remember that things are really not *that* different this time.

While hope and optimism are typically positive qualities, it is appropriate when investing to temper these traits with some historical perspective. The thought of the train leaving the station without them caused many investors to disproportionately invest in technology and Internet stocks, regardless of price or underlying valuation.

Price to earnings (P/E) ratios of 200, 300, 400 and higher were justified by analysts because it was, as one analyst suggested, "Impossible to pay too much for a stock that

will lead a business revolution". This was a New Economy with new paradigms.

But it also sounded vaguely familiar. The go-go 1960s had their technology story stocks with the likes of IBM, Honeywell, and NCR. Stock valuations climbed as speculation grew but the bear market that followed saw the prices of these stocks sliced by more than 80 percent from their heyday highs, with most never returning to the lofty P/E levels of that time.

In fact, the market as a whole slogged through the subsequent decade, with the Dow Jones Industrial Average closing in December 1979 still 13.5 percent *below* its year end peak of 1965.

Though the argument could be made that the three companies used as 1960 examples continued to grow, there's a very long list of "Astrons", "Circuitronics", and "Vulcatrons" that never survived. While our recent market was hyped by dot-coms and technologies; their new age fever was fueled by anything that hinted of super-charged electronics. How does that old song go, "Everything old is new again"?

•Resolution 3: Recognize the importance of protecting the downside of your portfolio.

Investing of any type involves risk. But this past year may have exposed a downside potential of your portfolio that doesn't match your goals or timeframe.

One way to cushion this is to assure your portfolio remains diversified among various asset classes, management styles, industry groups, etc. In doing this, it is particularly important to avoid the temptation to overly concentrate in the hot spot of today's market.

Why? Because large concentrations in one stock, sector, or asset area increases your vulnerability if that concentration has a poor performing year. And large negative numbers can have a huge impact on ongoing portfolio performance.

For example, assume a volatile, high-risk equity portfolio returned a whopping 80percent in 1999 but then fell on hard times this year and declined by 50 percent. The portfolio's still way ahead of the game, right? Wrong!

Do the math. Simply speaking, the \$100,000 portfolio would have grown to \$180,000 at year-end 1999 with the stated 80

percent return. But the negative 50 percent return this year reduces portfolio value to \$90,000, well below the original starting point.

Now consider this alternative scenario. As of year-end 1999, a balanced portfolio with a blend of stocks and bonds returned 25 percent and grew the initial investment from \$100,000 to \$125,000. In 2000, the bond exposure that held back last year's performance cushioned this year's market fall, and the portfolio only lost 5 percent. The resulting portfolio balance is \$118,750, well ahead of your original investment and far surpassing the first approach. Plus, you probably would have slept better during the past year.

Despite the turmoil of 2000, it's important to remember that stocks have come off quite a string of stellar annual performances and downturns are a natural part of the market. Besides, look at the bright side, you didn't have to wake-up this New Year's morning wondering if your lights would work. Now that's another story.

E. Jeffrey Roof is president of Roof Advisory Group, an independent investment management and financial planning firm based in Camp Hill. The firm is a fee-only Registered Investment Advisor that manages assets and preserves wealth for individuals & institutional clientele. The firm's e-mail address is roofadvisory@earthlink.net.