WILLIAM STERLING GLOBAL STRATEGIST

# Mid-Year Outlook: Who Wants to be a Survivor?

As an investor and amateur observer of pop culture, one thing that made me a little nervous a while ago was the incredible popularity of the new game show Who Wants to be a Millionaire, which hit the airwaves in 1999. Rest assured, I have nothing against Regis Philbin or millionaires. That said, I have always been suspicious of get-rich-quick approaches to investing or career planning. And with hindsight, it seems clear that the Who Wants to be a Millionaire mania turns out to have been symbolic of a widespread get-rich-quick ethos triggered by the Internet boom.

From an investment standpoint, I suppose we should all be happy that pop culture has flitted on to the hit show Survivor. Needless to say, the show focuses on the somewhat basic theme of survival – along with a few other themes reminiscent of "Me Tarzan, you Jane." I know that the winners of Survivor can get rich too, but at least it takes them several months and a fair amount of grief in the process. If Survivor represents the 21st century's idea of hardscrabble times and back-to-basic values, I figure that is nothing to complain about.

After experiencing the brutal bear market of 2000 and early 2001, many investors have probably changed their mindset to survival rather than getting rich quick. That's understandable, but it begs some important questions for investors: Does survival mean just not losing any money by staying in cash? Or does it mean toughing it out over the long run and achieving realistic and meaningful financial goals – or even getting rich slowly?

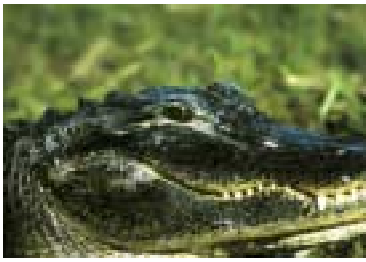
Despite the sobering experience of the last year, we at CI Global Advisors assume that most investors are still aiming to not only survive financially but to thrive in the years ahead. That means keeping a long-term perspective, having well-diversified portfolios, and staying the course when the markets are challenging. One of the goals of this report is to help our clients maintain a sense of perspective about the twists and turns of the markets that can help them block out the din of scare stories that often tend to dominate the financial media. So here are some of our thoughts on the types of questions we are hearing most frequently from our clients.

**Q: Have the global equity markets finally bottomed?**

A: We think the odds are pretty high that the bottom of this particular bear market occurred in early April. At that point, broad market indexes like the MSCI World or the S&P 500 had posted losses of roughly 30% from peak levels. As we discussed in our April report, the average bear market in the postwar period lasted about 15 months with a peak-to-trough decline of about 30%. So if April did mark the bottom, what we have just been through has been fairly normal in historical terms – at least as far as the broad market is concerned. The extreme decline of Nasdaq, which primarily reflects technology stocks, is another story.

**Q: What are the grounds for optimism about the market when current economic news is so bad?**

A: Historically, the stock market is often most risky when economic news is highly positive and least risky when the news is bad. That's because



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the market is always trying to anticipate what the news will be 12 to 18 months in the future and beyond.

From that perspective, Federal Reserve Board policy is critical because the Fed often tightens policy when the economy is booming, as it did in 1999 and early 2000, and eases when the economy is slumping, as is currently the case. Since monetary policy typically takes a year or more to affect the economy, the markets move in anticipation. That is why equity markets tend to bottom months before the economy itself shows any signs of life.

With the Fed having now cut interest rates by a whopping 2.5 percentage points in less than five months, the odds have risen substantially that the economy will pick up later this year and that 2002 will be a year of economic acceleration. As shown in Chart 1, the U.S. equity market in the past has risen on average by about 25% in the year following a major drop in interest rates of the type we have just experienced.

**S&P STOCK PERFORMANCE AFTER 30% CUT IN FED FUNDS**

| DATE | 1 month | 3 month | 6 month | 1 year |
|---|---|---|---|---|
| 01/30/1958 | 1.7% | 4.1% | 12.5% | 30.5% |
| 09/15/1960 | -0.6% | 5.5% | 18.6% | 22.7% |
| 04/27/1967 | -5.1% | 2.0% | -1.3% | 4.3% |
| 08/27/1970 | 4.0% | 9.3% | 19.8% | 22.4% |
| 12/17/1971 | 2.7% | 5.5% | 7.5% | 14.6% |
| 12/05/1974 | 3.5% | 23.5% | 33.8% | 30.2% |
| 11/02/1981 | 0.4% | 5.0% | -6.2% | 10.7% |
| 08/16/1982 | 18.9% | 30.1% | 41.6% | 57.0% |
| 05/20/1985 | -1.6% | -0.9% | 4.9% | 24.5% |
| 01/09/1991 | 15.4% | 19.9% | 20.7% | 34.1% |
| **Average** | **3.9%** | **10.4%** | **15.2%** | **25.1%** |

Source: DataStream

*Chart 1. Historically, when the Fed has cut rates by 30%, the equity market was up one year later by an average of 25%.*

As they always say in financial footnotes, past performance is no guarantee of future performance. But based on past history, the odds have clearly shifted in favour of a positive market environment thanks to the Fed's aggressive response to the economic slowdown.

**Q: What are the risks to this optimistic viewpoint?**

A: The biggest risk is that a more severe economic recession could still develop despite the Fed's efforts, especially if firms step up the pace of layoffs and consumers decide to retrench in a major way. That type of scenario occurred in the recession of 1990, which appears to have started in July 1990 even though the Fed began to ease monetary policy in March 1989. But that episode was aggravated by major strains in the U.S. financial system due to the savings-and-loan crisis and by Iraq's invasion of Kuwait and the Gulf War.

One simple way of looking at equity market risk is to contrast the current situation with the environment of March 2000:

- Then, the economy was booming and was raising legitimate concerns about economic overheating. Now, overheating is not an issue, to say the least.
- Then, the Fed was still tightening monetary policy aggressively. Now, the Fed is easing policy aggressively.
- Then, oil prices were up more than 100% from a year earlier, acting as a huge brake on consumer spending. Now, oil prices have remained steady for nearly a year.
- Then, equity valuation measures were stretched by almost any historical measure. Now, equity valuations are back to the range of fair value relative to bonds.
- Then, investor sentiment was euphoric. Now, many investors are highly cautious, if not shell-shocked.

With cash balances building up and money growth having accelerated markedly, cautious investor sentiment now has to be viewed as a plus. Put simply, there is more money that can

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be put work as investors become more confident about the economy.

Our overall conclusion is that the risk environment for equities has become notably more constructive, even if stocks are not markedly cheap. That is why we raised our target exposure to equities in our balanced funds to 65% as of mid-April.

**Q: Will the tech sector continue to recover?**

A: Every bear market tends to have one or two sectors that get hit far more than the broad market, and this time it was technology's turn. Based on historical patterns, it would not be surprising if it takes many years before the sector recovers its losses. That said, we think there are a number of reasons why the worst is over and why the recovery might be shorter rather than longer.

First, by some (not all) valuation measures, the tech sector has finally reconverged with the broader market, after having moved into uncharted territory in late 1999 and early 2000.

Second, concerns about over-investment and over-building in technology seem a bit overdone, since the recent growth in capacity appears not to have been completely out of line with historical experience in the last few years.

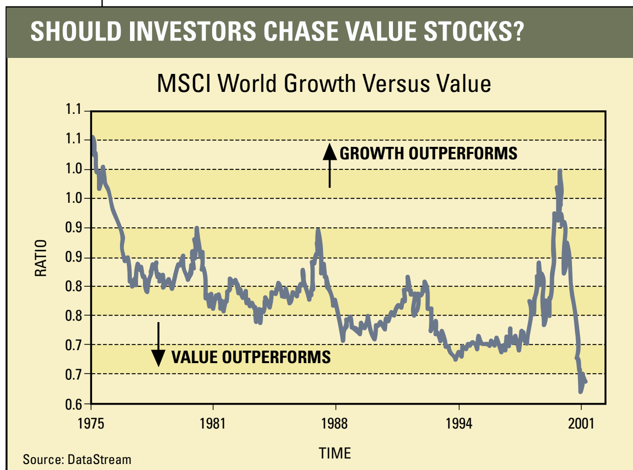



*Chart 2. The rise and fall of Nasdaq has produced an extraordinarily rapid and extreme swing in favour of "value" stocks.*

Third, although earnings have collapsed and order books have dried up, that reflects the overall slowdown in the economy. As the economy picks up, orders and earnings should rebound.

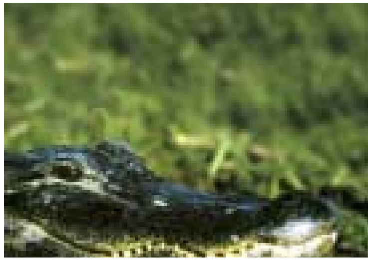
Fourth, while many investors have learned the hard way that the technology sector is cyclical after all, one thing to keep in mind about cyclical sectors is that the best time to buy is often in the middle of the cyclical downturn, when earnings are weak.

Finally, there is a major secular force that continues to favour a resumption in high levels of technology spending by corporations. That has to do with projections of slowing labour force growth in the developed nations, which suggests that labour will be relatively scarce and expensive. As the cost of technology continues to fall while labour costs rise, businesses will have strong incentives to replace expensive labour with cheap technology on an ongoing basis.

**Q: Core funds like the CI Global Fund and the CI International Balanced Fund have had disappointing performance this year. What went wrong and what are you doing about it?**

A: We made two significant mistakes early this year. First, after correctly playing defence for much of last year, with higher-than-normal positions in cash and defensive stocks, we moved toward a less-defensive posture in response to the Fed's first moves toward monetary easing. With the benefit of hindsight, that turned out to be premature. Second, even though we were generally exposed to the right sectors in the first quarter, our stock selection within those sectors still tended to favor high-quality growth-oriented companies rather than so-called value companies. Having reached a stage in the bear market when good companies became bad stocks, our performance suffered accordingly.

Chart 2, which shows the relative performance of one measure of "growth" versus "value" stocks, indicates how extreme the swing toward value has been during the last year. In view of the extreme nature of the swing, it also raises the question of



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whether it makes sense for investors to chase value stocks just because they have outperformed over the last 12 months.

What are we doing about performance? In addition to positioning our funds to benefit from the decline in interest rates around the world and a prospective global recovery in 2002, we have focused on enhancing our research process and adding staff to our investment team. We think that success in the investment management business depends critically on the "three P's" of people, process and performance. And over time, if you get the first two right, performance will follow.

On the people front, we made a key move in April by bringing on board a very seasoned global investor named Bob Beckwitt. Bob started his investment career in the early 1980s at Fidelity Investments in Boston, where he worked as a research analyst for renowned fund manager Peter Lynch. He was promoted rapidly at Fidelity and became portfolio manager for the Asset Manager funds, which grew under his leadership to more than $20 billion US. In 1996, Bob moved over to Goldman Sachs asset management in New York as lead portfolio manager for Goldman's growing international equity group. We have known and respected Bob for years and were fortunate to persuade him to help us develop a world-class research and investment process.

On the process side, we continue to focus on generating profitable investment ideas based on integrating top-down economic and demographic research with bottom-up fundamental company research. Bob is working closely with Steve Waite and our team of analysts to strengthen our company valuation discipline and quantitative stock screens.

**Q: Any other observations?**

A: Having been encumbered by substantial training in probability and statistics, I knew when I entered this business that it was highly likely that any investment approach would suffer occasional periods of underperformance. I sometimes joke that the financial services industry pays well because the often-unpredictable nature of the market requires reasonably intelligent people to feel foolish about one-third of the time.

That said, I felt strongly then that a commitment toward developing a high-quality team and a disciplined research process would pay handsome rewards to both our clients and our investment team over time. I continue to embrace that view, as do my colleagues at CI Global Advisors.

Amid all the gloomy sentiment that typically accompanies a bear market, we believe that the long-term positive trends we outlined in Boomernomics remain intact: millions of baby boomers are entering their peak savings years, inflation and interest rates are low and could easily go lower, and the technology and productivity revolution is still in its early days.

One does not have to expect a repeat of the remarkable bull market of the 1990s to remain optimistic about the global economy's ability to continue to grow and to generate new wealth. Our goal is to help our clients participate fully in the market recovery and the ongoing process of wealth creation in the years ahead.

*William Sterling*
*Global Strategist,*
*CI Global Advisors LLP*