THE EDUCATED INVESTOR

Spring 2000

FOCUS
Asset Management Company

# Technology Investing: Been There, Done That


A topic of great debate has been whether the market in general, and the technology sector in particular, has been overvalued. How long will the tech craze continue? Nobody knows for sure, and as we write this newsletter, the trend shows signs of weakening (perhaps temporarily, perhaps long-term). Regardless of where the market leads us next, there have been two viewpoints regarding the lofty value achieved by technology stocks: the "New Paradigm" vs. "Been There, Done That."

### New Paradigm ...

It's been different this time. The Internet is changing the world, supercharging the economy. Besides, great companies make great stocks. Investors should own them at any price.

### Been There, Done That ...

That is exactly what investors were saying in the late 1960s about the "Nifty Fifty," a group of roughly 50 large-cap growth stocks with high price-earning (p/e) ratios.


Like the tech sector trend, many of the Nifty Fifty were high-tech stocks. Particularly popular were electronics-related firms such as IBM, Xerox and Honeywell. Today's investors have been buying anything Internet related at even higher p/e ratios.

While the past does not precisely predict future events, we observe that, within two years of their peak, many of the Nifty Fifty stock prices had fallen 80-95 percent.

Finally, even if you are right about technology's great future, you are not alone in this knowledge, which means it already has likely been incorporated into stock prices.

### New Paradigm ...

Just look at returns over the last few years. The opportunity is obvious. You can't afford to miss out.

### Been There, Done That ...

What investors can't afford, is to be caught buying in at the end of a bubble. When bubbles burst, they burst very quickly, affording little opportunity to exit. Given NASDAQ prices as of this newsletter's writing, the implosion may already be

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Test your expertise on current events by answering the following true/false questions:

1. **True or False:** A university professor has hypothesized that the continued explosive growth of the NASDAQ market could be a result of increased Prozac® prescriptions among brokers and wealthy individuals.

2. **True or False:** A majority of Internet-related initial public offerings (IPOs) issued in the US since mid-1995 were trading above their issue prices as of this newsletter's writing.

Turn to page 4 for our Investor Tester Instant Answer

## What's Inside?

# There Must Be Another Way!

by Bill Schultheis

If the first quarter of 2000 is any indication of what the stock market has in store for investors, we're in for a wild ride. And, with more of our financial wealth tied to the stock market, the popular media is certain to play on our fear and greed in an attempt to highlight the attention-grabbing news of a constantly volatile stock market.

Our greatest investment challenge is NOT keeping up with the daily stock market activity, but ignoring it! The first step is to recognize what is important, establish a personal investment game plan, and stay committed to this plan for the long haul.

So, put down that subscription to Morningstar, close your *Wall Street Journal*, log off, and listen up. If you want a long-term investment plan that offers more common sense and sophistication than simply pursuing the next Intel or Cisco, here are three principles for you to consider.

**1. Calculate a savings goal.** Contrary to popular belief, calculating a savings goal doesn't mean harsh abstinence from the pleasures of life, it means taking control of your financial destiny, deciding what is important, and integrating it in your life.

**2. Diversify.** The paradox of diversification is that in the short run it sounds boring and unnecessary. Who wants to own bonds and cash, or worse yet, small-cap value stocks, when you can strike it rich by hooking your future to a hot IPO? But in the long run, diversification, combined with yearly asset rebalancing, maintains returns while reducing risk; it forces us to do what our emotions rarely allow – "sell high and buy low."

**3. Invest passively.** Make sure your investments are capturing as much as possible the return of each market segment, whether that be the entire stock market or a specific sector. It's easy to be enamored with the latest and greatest stock pickers (Peter Lynch, Warren Buffett, or Herbie, your cohort at work). But we need look no further than the collective performance of mutual fund managers to recognize that pursuit of performance above a benchmark is difficult to achieve and *counterproductive* to pursue.

The irony of embracing these three principles is that you can control them, unlike the frenzy of the stock market. The secret is to do it your way, not Wall Street's way, take charge of your financial destiny, and have the time of your life!

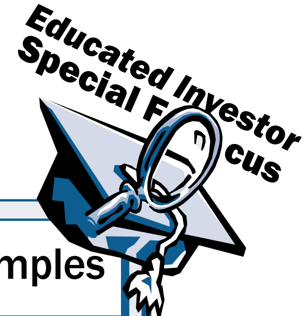

**Bill Schultheis** is author of *The Coffeehouse Investor* and www.coffeehouseinvestor.com. He has serviced individual and institutional accounts for a major brokerage firm.

## Worth Repeating

Worth Repeating

"Every age has its peculiar folly: some scheme, project, or fantasy into which it plunges, spurred on by the love of gain, the necessity of excitement or the force of imitation."

— Charles MacKay
*Extraordinary Popular Delusions and the Madness of Crowds*
(first printing: 1841)




# Studying College Tuition Plans

To date, 31 states have developed or are developing college tuition plans with features that can appear attractive. Based on our analysis of three plans (Iowa, Missouri and New Hampshire), we believe that they can be advantageous under some circumstances. Following are points to consider.

## College Tuition Plan Allocation Samples

| Child's Age | Missouri (equity/fixed) | New Hampshire (equity/fixed) |
|---|---|---|
| 4 | 65%/35% | 85%/15% |
| 7 | 45%/55% | 73%/27% |
| 10 | 40%/60% | 63%/37% |

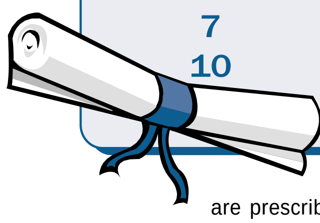


Figure 1: Investment selections within college tuition plans are prescribed by each state and are based on the child's age. Parents are limited to these selections. The above samples from Missouri and New Hampshire illustrate the significant differences that can exist between each plan.

## The College Tuition Plan

- Each participating state has formed an alliance with a specific investment provider. For example, Missouri is allied with TIAA-CREF, New Hampshire with Fidelity, and Iowa with Vanguard.
- The account is in the name of the parent (for the benefit of the child).
- Investments pay for qualified higher education at any eligible US college.
- Some plans allow adjusted gross income deductions for state taxes. Most states have added benefits, such as no state tax for distributions or gains.
- Earnings are federal-tax-deferred until used for qualified higher education. Upon withdrawal, funds are taxed at the beneficiary's income tax rate.
- Excess funds can be used by another child. Unused excess is subject to a 10 percent penalty when withdrawn and is taxed at the parents' rate.
- Investment selections are prescribed by each state, and typically include equity and fixed income funds. Asset allocations are based on the child's age, and they change over time. (See Figure 1.)
- The funding is considered a completed gift, removing the assets from the parents' estate.

Prior to the development of the college tuition plans, parents could invest within their own account or establish a custodian account in the name of the child.

## The Custodian Account

- Earnings are taxed when realized.
- Parents' tax rate is used for children under 14, except the first $700 of earnings has no tax and the next $700 is at the child's tax rate. Earnings for children 14 and older are at the child's rates.
- Federal and state taxes on realized gains are at the child's capital gains tax rate when funds are withdrawn for college.
- Parents have complete flexibility to select, manage and revise investments and asset allocation.
- If the custodian is not the contributing parent, the funding can be a gift, removed from that parent's estate.

An additional issue for both custodial and college tuition plans is financial aid. Most colleges offer less aid when they consider the assets to belong to the student rather than the parent. Most colleges treat custodial accounts as student assets and college tuition plans as parental assets.

When performing a direct comparison between a custodian account and a state tuition plan (assuming identical pre-tax returns), the latter has a slight economic benefit. However, there are disadvantages to the state tuition plan that may outweigh its benefits. Parents are unable to direct the investment plan. They are limited to available investment choices and pre-set asset allocations. Also, state college plans lack flexibility. They offer no rebalancing for market moves (until the child reaches the next age group). Some plans limit contributions, and impose penalties and/or higher taxes if funds are not used for college.

In short, no single investment approach is likely to be universally "right" for all families in all scenarios. Your investment advisor can be a particularly valuable resource when you are thinking of implementing any long-term objective such as helping your children achieve that college degree.

Sources:
- *The Best Way to Save for College,* Joseph F. Hurley, CPA.
- *AAII Journal*, February 2000.
- College Savings, Iowa.
- The Missouri Saving for Tuition Program Disclosure and Enrollment Booklets
- *The Unique College Investing Plan*sm, State of New Hampshire and Fidelity Investments.
- *Business Week*, March 13, 2000.

# Technology Investing: Been There, Done That (cont.)

under way. Bottom line: it's only obvious after the fact. At the end of the 1970s, for example, an "obvious" sector to own was oil companies that represented six of the 10 largest-cap stocks by market cap. Also popular were gold, other commodities, collectibles and hard assets in general. Despite multi-year runs, these all proved to be very poor investments during the next 20 years. Nobody can predict when the trend begins and, more importantly, when it ends.

## New Paradigm ...

But the future for new-age companies such as AOL, Amazon and Cisco is so bright, and the impact of technological developments is so strong, how can we go wrong?

## Been There, Done That ...

Today's innovations are likely to have no bigger impact than previous major inventions such as the automobile, air travel, television, radio and computers. And even high productivity and growth do not guarantee great investment returns. In the 1920s (a period of even faster growth), every "crystal ball" positive event predicted for RCA actually occurred. But it was still insufficient to compensate for its bubble valuations. RCA hit its highest value of 114 in 1929 and never recovered. (It was acquired by GE in 1986, almost 60 years later.) Its price fell 98 percent from 1929 to 1932.

Professors Eugene F. Fama and Kenneth R. French demonstrated that, while high-growth stocks have provided superior returns on assets, they have produced lower returns to investors. Their great prospects led to high prices reflecting low perceived risk. In turn, high prices led to low future returns. Using the same logic, high prices for tech stocks could reflect great earnings potential. But those same high prices also result in low expected future returns.

For example, assume investors wouldn't invest in stocks such as Cisco, AOL and Yahoo unless they expected a minimum 15 percent annual return. To justify lofty values, these firms would have to increase annual operating profits over the next decade at a compound growth rate of 54, 67 and 95 percent respectively. Even Microsoft has been unable to achieve such results.

## Our Conclusion ...

It's impossible without a rearview mirror to tell whether a market or a sector is overvalued. Because we can't know, we propose that high valuations reflect great expectations, which mean low perception of risk and in turn lower future expected returns. Speculating on whether a bubble is expanding, is bursting or has already burst may be exciting, but it's not investing.

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Sources:
- *Wall Street Journal,* January 18, 2000.
- *Wall Street Journal,* January 31, 2000.
- *Fortune,* January 24, 2000.


## Instant Answer
(from page 1)

**1. True.** In a March 5, 2000 *New York Times on the Web* column, University of Michigan Professor of Psychiatry Randolph M. Nesse observed that psychoactive drug prescriptions have nearly doubled in the past decade, probably disproportionately among "the population connected to the markets." He commented, "If investor caution is being inhibited by psychotropic drugs, bubbles could grow larger than usual before they pop…" Nesse recommended government-sponsored research into the topic, although he said he wasn't sure whether it should be carried out by the Securities and Exchange Commission or the National Institutes of Health.

**2. False.** In fact, quite the *opposite* is true. According to *The Economist,* February 26, 2000, "Dotty about dot.commerce?" nearly three-quarters of Internet-related IPOs since mid-1995 were trading BELOW their issue prices. The truth grows even more formidable for most investors, who usually obtain IPO stocks at their *opening* prices, which of course are typically even higher than their *issue* prices.

## Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:
- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP

FOCUS

Focus Asset Managment Company
A Registered Investment Advisor
5101 Cleveland Street, Suite 104
Virginia Beach, VA 23462
Phone: 757-499-5000
Fax: 757-499-6837
E-mail: info@focusasset.com