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When Alan Greenspan Speaks ... More People Should Listen

The most powerful central banker in the world, Alan Greenspan, has repeatedly warned U.S. stock and bond investors to tread carefully. Despite a favorable outlook for continued growth, low interest rates and mild inflation, we too suspect that current stock and bond valuations leave plenty of room for bad news.

This newsletter will highlight (1) why we think Mr. Greenspan is concerned; (2) why we agree with his concerns and (3) the specific steps we've taken to preserve our clients' capital in this market.

First, some background on the debate. Among public officials and market pundits, Mr. Greenspan stands nearly alone in his pessimism regarding overvalued stocks and bonds in the face of good financial news. On the good news front, we are in the midst of a remarkable economic period marked by global growth, technological advances, efficient financial markets and focused corporate managements. Naturally, the stock market has reacted (over-reacted?) positively to this environment, and has appreciated over 50% during the past 24-30 months. The corporate bond markets have become overconfident as well. Loans are now made to major corporations (with some risk) for a rate only .20% higher than a loan made to the United States government (no risk).

Mr. Greenspan worries, as we do, that there has been too much market appreciation relative to the

good economic news. In fact, steady stock appreciation has become almost routine in the minds of many investors and has probably become a self-fulfilling prophecy. We shudder to think of how many investors with maturing Certificates of Deposit or 401-K applications ask "How much do stocks pay?" and receive answers such as "23% in 1996 and 34% in 1995." Should the naive pursue the point further, they probably hear that it's O.K. to buy at the top since "this time, things are different."

A recent New York Times article covering Greenspan's testimony mentioned that he is beginning to sound like an investment manager. A fascinating observation in light of the fact that so much equity money is truly "unmanaged" today. Index Funds, for example, increased to \$65.0 billion by December 31, 1996 and one fund alone added \$3.0 billion in January of 1997. These funds have no managers and simply buy stocks in the largest 500 companies in the country. Similarly, troubled mutual funds like Fidelity Magellan are quietly turning themselves into Index funds so there will be no one to blame for "missing the market".

In our view, these are troubling trends which have yet to cause trouble. It reminds us of how investors treated real estate and commodities such as oil, gold and silver in previous "irrationally exuberant" periods of speculation. Perhaps Mr. Greenspan realizes how much money is currently "unmanaged" and feels an obligation to play the role of financial advisor. In any case, we applaud his efforts.

While there is much reason for optimism, it would be imprudent to ignore potential for disruption in the current economic cycle. For example, internationally, China has embraced capitalism but is disdainful of democracy. The post-Soviet economy is fragmented and capital starved while Turkey is struggling with a fundamentalist political shift which conflicts with its powerful military.

Domestically, we see reasons for concern as well. Wages, a key determinant of inflation, are rising. Our economy is growing, but still owes \$5.0+ trillion and runs annual deficits of \$135 billion. The question is begged... "If we run \$135 billion deficits when things go well, what would happen in a recession?" Finally, because of the shortened average maturity of debt at both the federal and consumer level, any increase in interest rates would have an uncharacteristically rapid negative impact on our economy. Underlying these negatives is the assumption that the dollar remains strong (and exports weak) so that foreigners will continue lending us money to fund our deficits! Whew.

To sum up the situation, the news is good, but not as good as current markets reflect. With little room for error, we think the surprises in the next 18 months are far more likely to be negative than positive. Therefore, over the past year, and especially the last month, we have liquidated some equity positions for our clients by selling all of their Disney and Time Warner holdings and half of their General Electric. This is on the heels of other sales during 1996.

Portfolio cash positions now are approaching or exceeding 10% and bond portfolios remain short to cushion against higher rates. Balanced accounts currently have a 60% exposure to the equity markets with an appropriate proportion of international equity. We feel strongly that if Mr. Greenspan's "jaw-boning" does not bring the markets down he will act decisively with an increase in interest rates in order to cause such a downturn. Again, we applaud his efforts and simply want to preserve our clients' capital in the face of the common sense observations by Mr. Greenspan.

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