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July, 2002

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Reprints, Referrals

I have had a number of people suggest to me (strongly recommend) that I more formally publish the series of newsletter essays that I've written over the last 5 years or so. Together the essays make an excellent record of my analysis and advice to minimize tech stocks in favor of value stocks. Many clients have expressed their deep gratitude for having missed the tech bubble and growth stock losses as a result.

Copies of the articles will be republished shortly. I will be more than pleased to send you a copy and of course, if you have friends or family who might be interested in good advice, please put them in touch with my office, or let me know. I would appreciate the opportunity to send them the articles and/or talk personally.

Thank you.

Enron, WorldCom, et al

It seems from conversations with clients over the last few months that investors are much more concerned about corruption than about September 11.

The negative mood of investors, according to The Economist, a business newspaper, is the result of three important developments. The first is the spectacular bursting of the bubble in growth stocks, led by the tech trio of technology, media, and telecommunications stocks.

The NASDAQ index, a barometer of tech-oriented stocks, is down by about 70% from its peak in March 2000, led by the truly stunning collapse of icons such as Nortel, now below $3 in July 2002 from a high of $122. The bursting of the bubble has spread to the S&P 500, an index of the 500 largest (by market value) companies in the US, down almost 40% at July 2002 from its peak in March 2000.

The second development is the behavior of a number of major corporations. Enron, WorldCom, Global Crossing, Adelphia, Peregrine Systems, Qwest Communications, Dynegy, and Tyco International have all had some or all executives and/or board of directors resign under charges of "cooking the books". Arthur Andersen, the auditors for both Enron and WorldCom, and formerly one of the most prestigious accounting firms in the world, ceases to exist as of August 2002, guilty of obstruction of justice in the Enron case, among other things.

The third development is the charges of conflict of interest leveled against major brokerage firms for the reckless recommendations of their so-called stock analysts. These analysts frequently recommend that investors buy shares in companies that are also corporate clients of the brokerage firm. The companies use the brokerage firm to issue stock to investors, and so they are interested in selling at as high a price as possible, as opposed to investors, who prefer to buy low. Merrill Lynch paid $100 *million* (US) to a New York court to settle charges in that state.

To top it all off, even Martha Stewart is under a very dark cloud. She sold a large chunk of stock in ImClone, the day before a company announcement crushed the stock to 1/5 its former price. The CEO, Samuel Waksal, has resigned and is also charged by US authorities with insider trading. Waksal is a friend of Martha's, according to the Wall Street Journal.

Let me be very blunt: in my opinion, the fault lies clearly with the CEOs and their management teams. Others may have supporting roles, but the captain of the ship is always responsible. The CEOs almost certainly knew what was going on, they knew it was clearly against the rules, and they failed to stop it. We're not talking mistake here, we're talking specific, premeditated decisions.

No wonder investors are feeling nervous. However, all is not lost. Read on.

The common thread through the litany above is simply the culture of greed that evolved through the tech bubble. Nobody will ever admit at the time that they are greedy (although some will afterwards), so I prefer to call it the 'culture of glamour'.

The riches that were apparently available were spectacular: John Roth, now ex-CEO of Nortel, cashed in C$60 million in stock options. No wonder he decided to retire. The 12 directors and executives of WorldCom, for example, between them held 50 million shares. Bernie Ebbers, the former CEO, alone held 27 million shares, according to The Economist. Certainly they had an incentive to keep the share price rising.

Boom Ahead

When you receive this newsletter in the summer of 2002 the world stock markets are at 5 year lows, down 40% from highs of 2 years ago. The financial press bleats about 'investors fleeing mutual funds' (they aren't). You might think things are gloomy.

But lets get a few facts straight. Let's understand that the financial markets are presently digesting one of the greatest destructions of wealth of all time. It may require some time, like past bubbles have.

But value stocks have been doing quite well – all of my core investment managers mentioned in the main essay have positive returns in the last 12 months (except Reed and Morgan, down about 3% and 10% respectively).

Not only that , the economy is expanding (GDP growth forecast at 3.6% for 2002), unemployment is fairly normal (7.5% at June 30), and inflation remains low (1%). Things just aren't as bad as the press would have you believe.

Don't let the bad press fool you. We are on the verge of the greatest economic boom in human history. Medical science, the knowledge economy, individual freedoms and enterprise are all coming together in the next few years to generate the greatest leap in worldwide living standards we have ever seen.

Guaranteed? Don't be silly. Uncertain? Yes, of course. But maybe not. After all, cycles have always worked this way. Remember John Templeton, " The best time to buy is at the point of maximum pessimism." Chances are, ten years from now we'll look back and say "2002 – what a great time to buy".

Enron, Worldcom, et al con't

The unfortunate fact of human nature, however, is that when these glamour companies begin to run into a rough spot, as all companies do from time to time, their glamorous executives tend to become desperate. Their driving motive is to keep the share prices inflated. Desperate people tend to do desperate things. And then the game is over, sometimes very suddenly.

So why is all not lost? There are several reasons.

First, there have always been criminal fraudsters around, and there always will be. Rolls Royce blew up in the early 70's for exactly the same thing as Enron. Seaway Trust blew up in the 80's for crooked lending to insiders. This is why one of the basic principles of investing is to diversify a portfolio across 25 or more individual holdings.

These problems don't hurt a diversified portfolio. But there's another, even better line of defense.

The investment managers that I select to invest my clients' assets are the type of people who, by their nature and experience, *tend* to avoid the glamour stocks (see my last newsletter 'A Tale of Two Markets, copies available on request). They definitely tend to avoid companies whose share price seems to be heading to the moon. They *tend* to invest in high quality, seasoned management. They *tend* to be skeptical of brokers' research 'recommendations'. And they definitely tend to do the analytical gruntwork researching the financial statements.

Is this a guarantee that the investment managers I use will avoid these disasters? Of course not. But I do know that the Optima Strategy Value and Diversified managers had *none* of the shares discussed above, according to Optima. The other core managers that I use, Bill Kanko, Bill Procter, Dina DeGeer, Heather Hunter, George Morgan, Don Reed, and the others, had *none* of the companies mentioned above in their top 10 holdings at December 2001 (and probably none anywhere in their portfolios, although I can't say that).

The third reason is that although these spectacular criminal activities are splashed across the front pages, they really are a very minor part of the overall program. The overwhelming majority of senior executives and their directors are simply hardworking, experienced people busting their guts to do a good job and move their companies forward. Their focus is on satisfying their customers. They know that the way the world works is you work hard, do a good job, and financial success will follow. They know that criminal or unethical behavior is, as it has always been, a short term trap with generally disastrous consequences.

Already this majority is working hard to ensure that their companies don't get entangled in an accounting or any other question mark. They are all scrambling to make improvements where required.

At Assante, our focus is on managing clients' investment portfolios and financial affairs. We do not issue new stock on behalf of corporate clients, so we do not try to serve two masters. End of that story.

In conclusion, I believe that our western system of honesty and justice generally works very well. However, we must be vigilant. Our civilization depends on people doing what they say they'll do, whether it is a politician representing the public interest, a CEO acting in shareholders' interests, or a neighbor borrowing a lawnmower. One of the great lessons of history is that the people with the best rule of law, from the ancient Greeks and Romans onwards, were far more successful than their lawless peers in any way you can measure. It is our job as investors and responsible citizens to support those who are trying to get rid of dishonesty and corruption, whether it is in corporate or government circles.