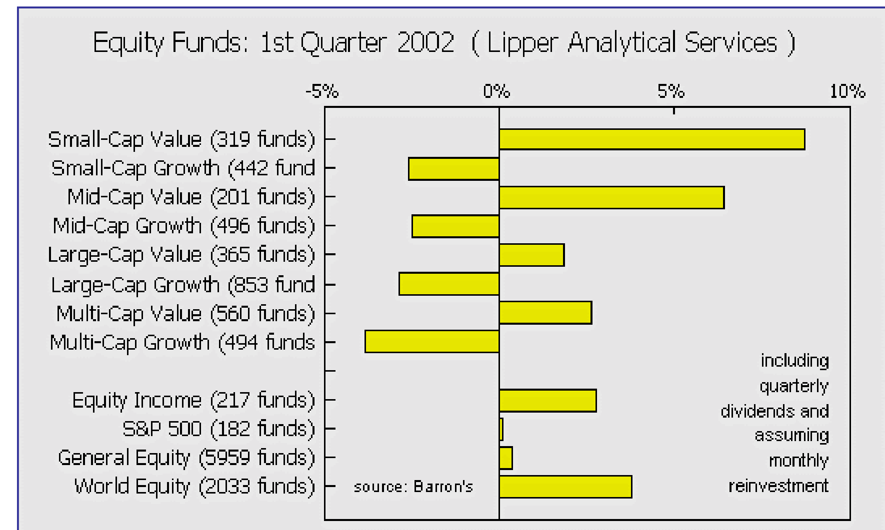
Niemann Capital Management, Inc.

First Quarter 2002 Review

0.78%.

This was the average return of 9,201 equity funds tracked by Lipper in the first quarter of 2002. As usual, the headline tells only part of the story. Telecommunication stocks resumed their vicious bear trend with an *average* 18.37% drop in that sector's funds. Mighty WorldComm trades at $2 bucks (down from $60) - Global Crossing is gone, and between the two that's over a hundred billion dollars gone to money heaven. Science & Technology relapsed with a 7.61% decline. Sun-Micro is at $6 bucks, Oracle at $8. Two years ago I wouldn't have believed these prices on a bet. The unemployment rate in Silicon Valley is 7.5% and rising, with the HP/Compaq merger expected to cut 15,000 jobs – not all in our valley I hope. The world's largest mutual funds fell short with Fidelity Magellan losing 1.6% and Vanguard 500 Index edging 0.24% higher. In retrospect, 0.78% doesn't look that bad.

The bright spots of this first quarter make for interesting bedfellows. The Real Estate sector extended its 2-year bull trend adding 8%, and Natural Resources advanced 11%. Emerging Markets gained 12.24% following a strong 4th quarter, and gold (yes, Gold) glittered – up 35%. A whiff of inflation expectations perhaps? As you can see in the chart nearby, the value styles bested growth once again, with small to mid-cap leading the way. Mix all of the above together, and you end up with a flat first quarter.



Notably, the world in general fared somewhat better than the US. In addition to strong Emerging Markets, Latin America gained over 9% and Pacific (without Japan) almost 12%. International markets have under-performed the U.S. for several years. In fact, over the past 10 years, World Equity funds have earned less than half the return of their US counterparts. It should be of considerable interest to investors when this trend might change. Allocations to foreign markets have really helped our Variable Annuity & Life portfolios recently, where limited selection makes it harder to hack out profits in declining and conflicted markets.

Active Management on a Roll.

Bank another good quarter for our FIAG (Fidelity Investment Advisor Group) mutual fund portfolios. We're often asked why these accounts out-performed "the market" by such a wide margin over the past few years, and seem to consistently best our Variable portfolios. This is a good question. The primary ingredient to FIAG's success is the incredible selection of managers from which we have to choose in building each of the portfolios. I've often said the essence of our investment process with FIAG is "managing the managers". After the recent addition of several hundred new mutual funds, we are analyzing about 2000 daily. Each of these has a management team dedicated to maximizing performance within their style and objective. Our job is uncovering a few nuggets in the vast pile of rocks; those managers positioned to deliver performance in the current market environment (and remember, performance also means losing less in down markets!). So while the Variable products may have one or two Small-Cap Value choices we can use (sometimes none…), in FIAG, we'll select a position from a group of one or two hundred Small-Cap Value funds – a decided advantage.

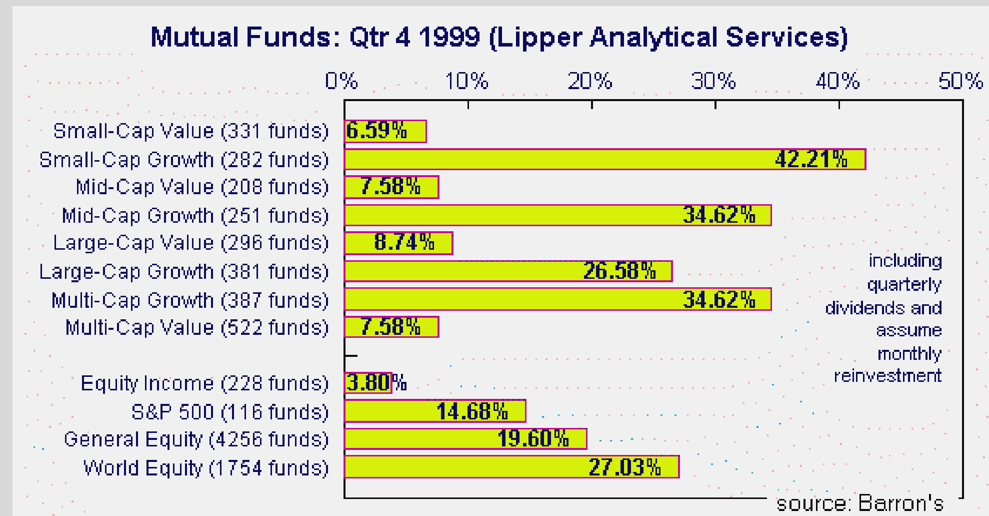
Another reason our FIAG portfolios have excelled is that active managers (like us) typically out-perform passive investments in bear markets. Passive strategies, including buy & hold and index investments, can be very hard to manage in conflicted markets. An investor buying WorldComm at a split-adjusted price of $10 in 1997 has seen both a 500% gain and an 80% loss over the past five years (unfortunately the later is now the case). His buy & hold strategy was to buy a good company for the long run – his fatal assumption was that the price at the end of the day was going to be greater than $0. Passive investments in mutual funds are not as hazardous as individual shares, but have the same characteristics. What if a previously great mutual fund like Janus, simply doesn't come back in the next bull market? Active managers don't (or shouldn't) get married to any position. The potential to sidestep disasters, like the technology meltdown, really adds to the bottom line over time.

When Virtuous Becomes Vicious.

There is a more subtle force helping many active managers "beat the averages": the massive unwinding of marquee growth and index mutual funds. Through the last half of the 90's, active managers struggled to keep up with index funds, like Vanguard 500, as well as high profile growth vehicles, like Twentieth Century Ultra and Janus Twenty. As the great bull market matured in 1998/99, it became tightly focused on technology companies. This focus created what we call a "virtuous cycle": Investors poured money into technology, chasing performance, and the new dollars were simply cycled into the same stocks that created the performance in the first place. This self-reinforcing process eventually pushed tech stocks to unsustainable heights, as one can see from the explosive growth returns in this excerpt from our 4th quarter 1999 Quarterly Review:

"**On Fire.** How else could one describe the manic surges in share prices of technology companies (and many of our portfolios) for the fourth quarter and year 1999? Growth *(read: technology)* funds of all stripes posted eye-popping numbers as you see in the chart (nearby). Technology represents approximately 30% of the market value of the S&P 500, yet accounted for close to 90% of its 1999 advance.

Slumping applies to everything else. The financial sector of the S&P 500 rose 2% in 1999 compared with the 75% surge of the tech sector. One trader quipped that the sure way to tell the difference between "old economy" companies and "new", is in the later case share prices go up. …"



Back then, everyone stayed happy until the music stopped. Now, an alter ego dominates the NASDAQ, and the S&P 500 with its heavy technology components. Bloated with multi-billions of dollars at the market peak, massive growth-oriented mutual funds like *Ultra* and *Twenty* are slowly disgorging their assets. With performance sinking, more investors are pulling money out - forcing sales of shares, which pushes prices lower. This in turn further depresses performance, which encourages more investors to sell. This is called a vicious cycle, and is as self-reinforcing as its virtuous twin. How long might it take to unwind? Consider that after the severe declines of the last 2 years, there is still in excess of $110 billion in the three funds mentioned above.

Another Millstone Around Tech's Neck.

In most pursuits, there's a gentleman's rule against "piling on". Not so in congress. Maybe it's our Puritan heritage that's driving the financial witch-hunt this year. First we have the Enron and Global Crossing frauds (where were our pols when the money was rolling into their campaign funds?). Then we have "the Brokerage Scandal" – analysts touting stocks publicly while trashing them in internal e-mail (these guys are *salesman* for god's sake). And there's the growing hysteria over "option accounting". The latter is what's troubling technology shares.

A recent study by Merrill Lynch guesstimated that FY2000 technology earnings would be about 60% lower if options were on the books. As the volume of the rhetoric surrounding this issue increases, it comes as no surprise that tech shares have set about discounting the worst outcome in their price. Looking at a business from a price/earnings standpoint, if you lower the e, then with all things being equal, the p comes down as well. It's the uncertainty that's weighing on these companies.

Don't misunderstand; I believe all of these issues are serious - but they've been "known" to be serious for years by anyone paying attention. In the end, congress cannot legislate away the people's reluctance to do their homework. And the people should never under-estimate a politician's ability to make matters worse by acting after the play is finished.

The Bottom Line.

It would feel more like a bull market if tech shares stopped swirling down the drain. I think this will happen when some certainty on the option issue unfolds. Meanwhile, investors are slowly discovering the small and mid-cap value bull trend. Upwards of $190 billion has flowed into these funds over the past two years. Sounds like a lot, but considering this flow represents less than half the losses of Cisco alone, our little "stealth" bull market may have a ways to go.

Thanks for your continued confidence,

Don Niemann
President
Niemann Capital Management, Inc