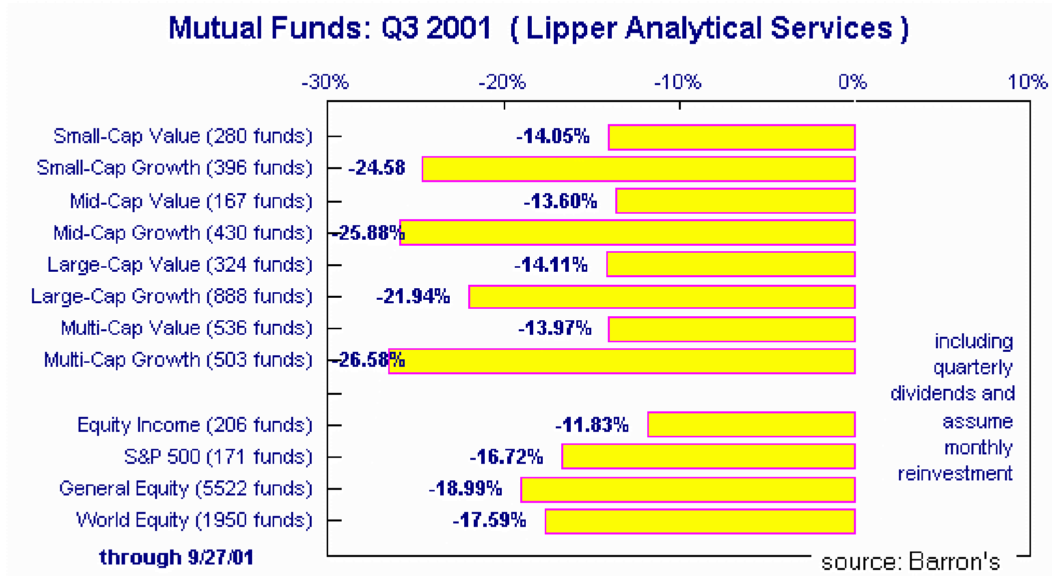
Niemann Capital Management, Inc.

Third Quarter 2001 Review

Even now, going on two months later, it seems incongruous to ruminate on the financial toll extracted by the terror of September 11, when the human loss was so overwhelming. Yet this being the task, we must begin it by saying: good riddance to a dreadful quarter.

Heading into that fateful event, we were positioning our portfolios for a successful test of the April lows. Clearly this was not to be, but as it turned out, we were quite fortunate in two respects. The markets had been forcing us to raise cash in risk-managed accounts well before the attack, so the resulting plunge on Wall Street didn't hit Niemann portfolios as hard as it might. And we've been positioned in the value classes over the past year +, which as you can see in the chart to the right, fared considerably better than growth, as well as the broader averages. Still, we are suffering through this period along with everyone else.



A towering Wall of Worry.

There is an old saying on Wall Street that a bull market climbs a "wall of worry". Usually, by the time a market reaches an important turning point, the reasons for the previous advance or decline have not only become known, but are widely believed by market participants. (That's why most investors, acting on their beliefs, are under invested at market bottoms, just as they would be fully invested at tops.) In other words the psychology of the market becomes pervasive. When the trend finally turns, investors don't believe it – since to respect the change in trend would mean to act *contrary* to what is perceived as "common knowledge". A market that rallies against a backdrop of overwhelmingly negative news is said to be climbing a wall of investor worries.

Consider the wall that now confronts us. The story of the US economic slowdown is obvious to investors: too much capacity for just about everything, and stock prices driven so high by the previous bull market that even after the *once in a lifetime* declines we've witnessed over the past eighteen months, stocks are still considered expensive by many. Before the attack, about the only point of contention was whether consumers were strong enough to keep the US from dropping into recession. Now, amidst sharply rising unemployment, no one doubts recession is upon us. Finally, adding to the growing list of economic woes, US markets, like its citizens, must confront potential event risks driven by prosecuting a war and the defense against further terrorist attacks. Not exactly the most comfortable climate for investing.

Looking over the valley.

Yet over the history of the New York Stock Exchange, our country has faced many daunting challenges and emerged stronger than ever. Studying market history, one finds that our equity markets have the uncanny ability to look over the valley of investor concerns to the brighter days ahead. Markets discount the future as prices anticipate events 6 to 9 months in advance. Remember the highs in technology shares in March 2000? Business (orders) fell off the cliff in October, seven months later. Just as typically, when economic news is the worst, the broad markets have already found their lows.

Lets revisit our list of indications that the longer-term trend of the equity prices may be at or near an important low:

As you can see, most of the checklist is in place. There is some question about whether the downside leaders of this bear market, technology shares, have stopped making new lows. While these stocks in general have rallied well from their September lows, the true measure of a turn comes in the next sell-off. Can these issues put in higher (than their September) price lows, and follow that by rallying back to prices higher than their subsequent highs? If so, we will put a **v** in this column.

	Yes	No
A normalized yield curve (Bullish Bonds)	v	
Downside Leadership stops making new lows	?	
20%+ Price Declines in major Indexes	v	
Recession Headlines in the Press	v	
Plunging Confidence (Consumer & Business)	v	
Investors find a new growth catalyst	?	
Coordinated Rate Cuts around the globe		
Japan	v	
England	v	
United States	v	
European Central Bank	v	

Another outstanding challenge is finding a new growth catalyst. Examples of growth catalysts in past bull trends were the release of Windows by Microsoft in the early nineties, and the Internet mania that took hold in 1998. In the first case, this new product unleashed a hardware upgrade cycle in computers that in turn drove the strong technology bull move in 1995. We all know what happened with the net-related stocks. What is the next catalyst? Microsoft has recently released the operating system “XP”, one of their best products ever from a technical standpoint. This product will drive hardware upgrades, but we doubt business is in position to launch a massive upgrade cycle quite yet. Congress may help by accelerating depreciation and/or expanding the investment tax credit. Another potential (and our best bet currently) would be the Biotech/Health area, where strong demographics are a powerful motive force. The catalyst here may be the recent mapping of the human genome. Experts agree that the products and devices coming over the next few years will revolutionize medicine. We note that Biotech shares have held up very well through this bear market to date. In fact the Amex Biotechnology Index made it’s low in April 2000, and has held that low since!

Bottom Line.

Adding event risk to a terrible economic backdrop creates a formidable wall of worry for investors. While our country has overcome tremendous adversity in the past (two World Wars in this century), getting our arms around the concept (and risk) of terrorist attacks on US soil will be neither easy nor quick. We do know that successful investors remain focused on the message of the markets. A few months ago we commented on the poor price action in stocks by pointing out that: “Bear markets wear out investor enthusiasm through a succession of brief sharp rallies followed by a protracted disheartening decline. The best offense is good defense, stay systematic and disciplined.”

We have certainly not reached the point where the “best defense is a good offense”, but market action *has* improved recently. Have you noticed that stocks are grinding higher over the past several weeks, interrupted by brief sharp retreats? At least for the short run this market has turned the tables on the bears, which is fine by us.

Thanks for your continued confidence,

Don Niemann
President
Niemann Capital Management, Inc.