Niemann Capital Management, Inc.

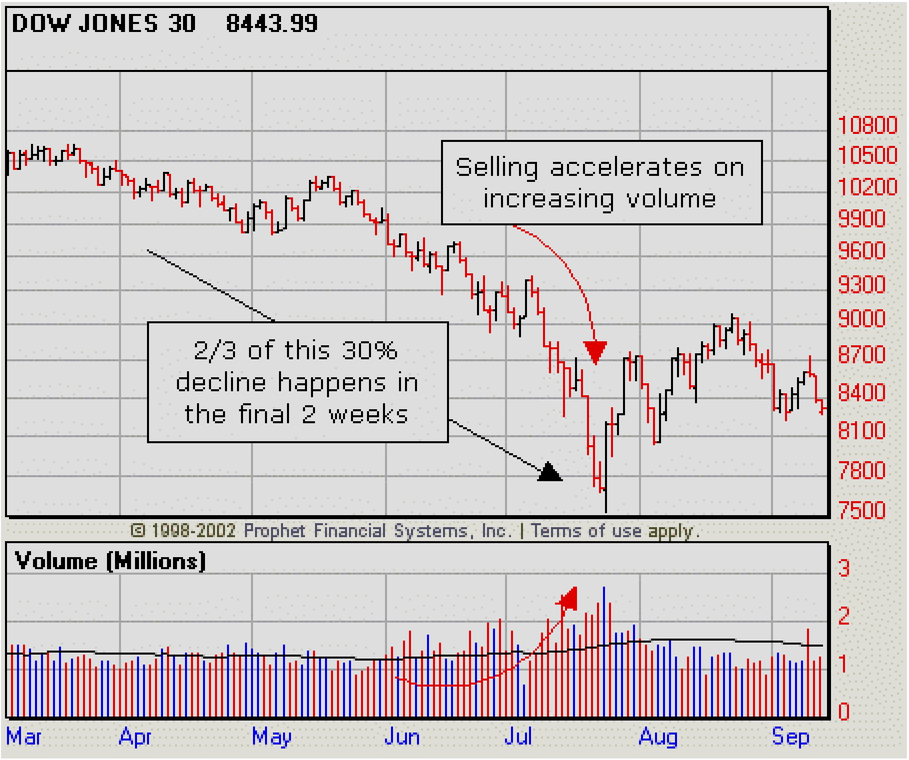
Third Quarter 2002 Review

ca·pit·u·la·tion (kə-pĭch′ə-lā′shən) *n.*

1. The act of surrendering or giving up.

The American Heritage® Dictionary of the English Language, Fourth Edition (from Dictionary.com)

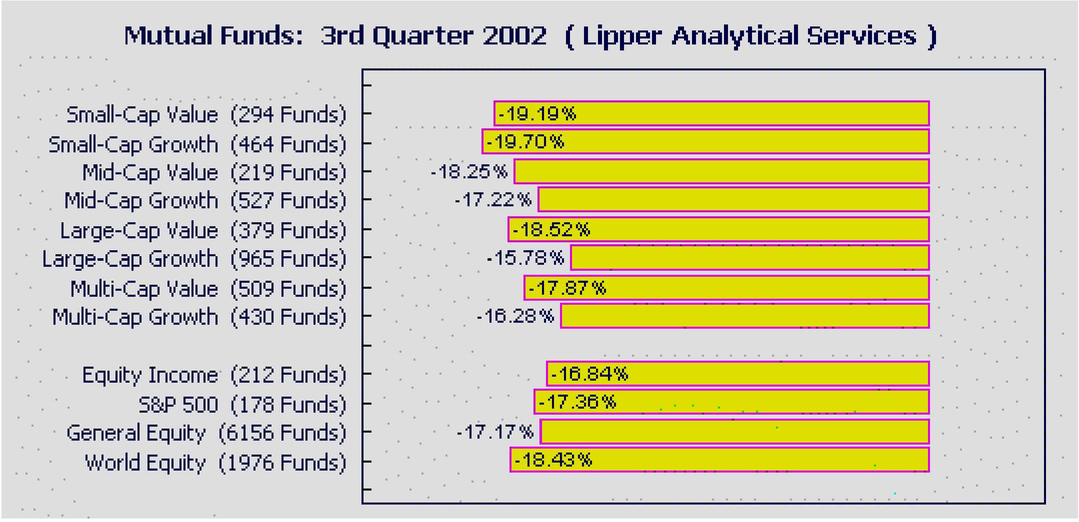
In the stock market, capitulation is associated with the act of *giving in* to the emotion of the day. When the market is in a bear, or down trend, investors capitulate by selling equities to get out of the market and into investments they perceive as less risky, like bonds or money market funds (or a mattress). Important to understand is that **capitulation is an emotional act**. Taking a tactical loss is not emotional, though it can irritate the heck out of us. But selling because one just can't take it anymore is irrational and full of emotion. I know this because I've been there – every seasoned investor has at one time or another. You know you've capitulated when you feel relieved immediately – and usually, that feeling doesn't last.



Individual acts of surrender happen every day in the markets for one reason or another. What thoughtful investors are always on the lookout for is the public giving up en masse. Why? Because the hallmarks of capitulation, widespread and indiscriminate selling, drive prices sharply lower, to the point where good bargains abound in stocks. Everyone who wanted to get out of a stock, for any reason, has sold. This is why professional investors see true capitulation as a sign of a bottom in stocks.

Looking at the chart of the Dow Jones 30 nearby, the market low this past July may be just such an event. Signs of mass capitulation are evident with two thirds of the overall 30% decline unfolding in the final 13 days. Volume expanded as increasing numbers of equity owners panicked, reaching a crescendo on the reversal day at the market low. There is more evidence.

- We know there was a mass transfer of assets from stock mutual funds to safer investments: the Investment Company Institute reports that investors pulled $55 billion from stock funds in July and August alone, a record amount for a two month period.
- Good stocks were thrown out with the bad as investors sold anything and everything, and mutual fund managers did the same to meet redemptions. 6156 diversified US equity funds, as tracked by Lipper Analytical Services, fell an average –17.17% over the 3rd quarter, with every type - large, small, growth and value showing double-digit declines. This underscores the “widespread and indiscriminate selling” mentioned earlier.



- The media is filled with stories of investors losing their shirts, replacing the go-go stories of the late dot.com 90’s. I haven’t heard the phrase “buying the dips” in many, many months. Good market bottoms are marked by pervasive pessimism.

Did July 2002 mark the internal bottom of this epic bear market - that point where the majority of stocks find their lows? Only in hindsight will we really know. It seems highly probable that much of the excess created in the last bull market has been wrung out of stocks, and that is good news for investors.

Distrust the Conventional Wisdom.

Markets are mechanisms for discounting the future. This is to say investors, in the case of an individual stock for example, buy and sell shares based on their current view of what the future holds for that particular company. According to the theory of efficient markets, the price of the stock will reflect what all market participants, acting on their views, currently believe. Choosing not to sell, or not to buy, is also figured in. This same dynamic extends to the broad markets, which are simply collections of stocks.

Bull and bear trends unfold when investors begin to realize their expectations of future events do not match the probable reality. The further off expectations are, the more powerful the reversion to reality will be. Take the change from bull to bear market in 2000 for example. Back then the conventional wisdom was that investors were riding a tidal wave of expanding earnings (real or imagined!). Telecomm and technology companies were leading the markets higher on expectations of an insatiable need for broadband, which would change the face of business. It was thought that every company in every industry would be forced to join the dot.com boom. Consumer confidence was at all time highs. The government was pumping out a surplus expected to run into the trillions (in this case, real or contrived!). Public investors loved the market, and there were daily success stories in the media. Stock prices (Sun Micro SUNW @$60, Cisco CSCO @$80, General Electric GE @$60, Intel INTC @$70, and so on, etc.) reflected this optimism.

Stocks surged higher even though, as we now know with perfect 20/20 hindsight, the seeds of recession were already sown and beginning to sprout. Thus the bear trend began like a thief in the night, as the cold hard evidence revealed that conventional wisdom was way too optimistic. The depth and length of the current bear market is a testament to just how far expectations differed from reality by the end of the last bull.

Now it is going on three years later, and how expectations have changed! Fear and pessimism rule the day. Assessing the conventional wisdom these days we hear:

1. The economy may soon fall back into recession, or at most, growth will be sluggish.
2. Consumer confidence is at a nine year low.
3. Companies have no pricing power, too much capacity for everything.
4. The government is in deficit spending.
5. The US faces a continuing terrorist threat.
6. Soon we will go to War.

Depressing? Yes. Why would anyone want to buy stocks? Well, one good reason is that all this pessimism is already priced into shares. The negative emotional content of today's conventional wisdom is why stocks trade at the prices they do.

The Bottom Line.

Beware the emotional undercurrents, and don't get sucked into conventional wisdom. While they're the playground of the media and politicians who seek to exploit them, emotions are the enemy of investors. Some may think waxing on about our "terrible economy" may make good politics, but ask any American who understands the numbers what he or she thinks about the largest economy the world has ever seen operating with 3% growth, 5.7% unemployment, long-term mortgage rates around 6%, and inflation below 2% - and the word "terrible" won't come to mind.

The vast majority of investors are always looking the wrong way at major market turns. It is simply human nature, reinforced by sensational media. Ask yourself which of the two environments discussed above is more risky for investors? Clearly it was much easier emotionally to buy stocks in 2000, but I submit it was considerably more risky. Today it is very hard to step up to the plate and put money to work in stocks.

Successful investors control risk by controlling emotion. Our task is to remain patient and disciplined. Systematic implementation of investment policy will see us through these troubled times.

Thanks for your continued confidence,

Don Niemann
President, CIO
Niemann Capital Management, Inc