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Economic Commentary

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Bubble, Bubble, Toil and Trouble

Where We Stood on Common Stocks

There are a few advantages to being old. Not many, but a few. One of those rare gifts that one obtains is experience. We are all products of a particular gene pool of which we have no choice. On the other hand we do have some control over the experiences that come our way. As a matter of fact our choices in life primarily determine what our experiences are and what we make of them for either good or bad.

During the late 1950's I was a young stockbroker trying my best to sell common stocks to individuals and institutions in Kansas. These people had just been through a depression and dust bowl in the 30's and then a world war during the 40's. Obviously these 15 years had a very telling effect on their outlook for the future. I found it very difficult to make a living selling stocks when almost to a person everyone was very bearish on the U.S. economy. In hindsight, those that did buy the mutual funds recommended were handsomely rewarded. The time and expense expended upon obtaining the sale was not even close to the compensation received. Married with four children, I was certainly very motivated however. My most interesting experience was attempting to sell the proverbial "little old lady" who lived alone on a farm in northern Kansas. She had as companions a half a dozen dogs and more cats than one could count. I made it through the first visit with only teeth marks on my legs, no broken skin. The next day I stopped by the dime store and purchased some safety pins and wrapped my legs inside my suit pants with extra cloth diapers, which we always had in our car's back seat. It helped immensely with the dogs, but alas there was no sale. The local city fathers became aware of my presence and politely asked that I leave town. You see this maiden lady was the last of seven brothers and sisters who lived alone, never married and owned everything in Kansas north of the Oregon Trail. All deaths went unprobated and the community was on the last deathwatch having a new hospital designated for the collective assets. Bankers and lawyers with money on their minds are a formidable foe. I called my boss and he said leave town, there are other fish to fry. So ended the saga of Marysville, Kansas. What did I do? I found a new way to starve. I went to work for a bank and spent many years trying to convince numerous committees that common stocks should be at least 50% of a normal trust fund.

During my stay at the bank I also lobbied the State Legislature on behalf of the Kansas Public Employees Retirement System (of which I was a trustee) to increase the amount of common stocks this pension fund could own. I had one legislator tell me the Dow Jones

Industrial Average would never reach 1000. Contrast that experience to what has occurred over the last six years. No one would buy bonds; no one would buy value stocks. The only thing that mattered was the new paradigm stocks, dot coms and other techs. Many endowment funds, as well as others, were and are 100% invested in stocks and had no interest at all in bonds.

As we have made ad nauseam in the past, our point is we live in a circular world. Things are not linear, what goes around comes around. Bubbles come and bubbles go. Undervaluations and overvaluations occur because of human behavior. Human behavior has not changed since the beginning of time. The real story is that at turning points, both cyclical as well as secular, one needs to be able to go against the grain. Barton Biggs of Morgan Stanley is one of those rare individuals who is able to do just that. He started talking overvaluation in 1997 and we actually feared for his job as it was notable that he was being ridiculed by the “all knowing” media and either was no longer invited to be on the various shows and/or was restricted by his own company. After all Merrill Lynch’s chief economist was fired during this time period for being too bearish. But guess what? Barton Biggs is back!!!

We said many times during 1998 and 1999 that we remained invested in stocks, but were not sleeping well at night. Finally we terminated our equity programs in the summer of 2000 suggesting that bonds were the place to be for the next year or so. The surprise always is that no one wants to believe things are going bad as long as prices are still rising. Most of us don’t want to say it, let alone hear it. One never knows when markets will top out and you run the risk of losing business if you’re vocal and wrong for any period of time longer than the next price tick in the market place. Even if one is mostly right about things, shortcomings are quick to be assigned. Take for example our long held position on interest rates. We have been bullish since 1981. Over the last 19 years our accounts have returned 14.5% annually yet we have been criticized for “always saying the same thing” and “never changing our mind.” Over the last 10 years the number is 15.0%, near double the Lehman Govt/Corp index of 8.0%. You tell us how can one respond to criticism like that?

Where We Stand on Common Stocks

It’s always easy to talk about the past. If you’re right, you print it (as we did above). If you’re wrong, you go on to other things. Looking to the future is a horse of a different color. What you print stays forever. Our opinion has been and continues to be that the slowdown (recession, if you please) probably started during the 1st quarter and will last at least one year. If our analysis is close to being correct then sometime over the next 3 to 6 months might be the time to expect the stock market to bottom out. A note of **caution** however. The overvaluation became so great it’s possible the unwinding may take longer. Please keep in mind just as not all stocks top out at the same time likewise they don’t bottom out simultaneously. Value stocks for example did little through 1998 and 1999 as the averages boomed but acted well in 2000 and seem to be resisting somewhat the downturn in 2001.

Economy

The economy continues to drift downward, particularly in the manufacturing sector. In the most cyclical parts of the economy only housing and construction have become somewhat resistant to the downturn. It could be that because interest rates came nowhere close to moving as high as in other pre-recession periods, the lack of real estate money never really choked off construction. This could be a new post WW II experience. If so, lower interest rates may be sending the wrong signal to the industry. Demand is expected to be strong when rates are low. This just might not be the case this time around. After all the baby boomers are housed, probably over-housed. Could it be that there is also a real estate bubble out there that will need be corrected? From sources we deem reliable it appears as if Fannie Mae is force feeding the housing industry. They did it in 1998 and are so doing again today. The recent increases in the money supply may be their doing. We would suggest caution in this area. Just as academia has force fed Keynesian economics and index funds, so might the above be true. Just recently the mortgage bankers association announced that delinquencies were rising sharply.

Bonds

Many have wondered why long interest rates have not moved lower since the first of the year. First of all, they led interest rates lower last year and are resting while short-term rates adjust to the Fed.'s lowering of the federal funds rates. Also we noted that 29% of margin debt was liquidated during 2000. At January 31, 2001 there was still approximately \$200 billion left, more than 2 times the amount outstanding in 1997. When "bad" stocks go lower "good" stocks of instant liquidity and government bonds become sources of cash to take care of margin calls. We expect much of that will need to be liquidated over the next several months. This might keep long rates higher than they ordinarily might be, however, when the next move comes it will be huge, therefore the risk of being shorter is too great an opportunity cost. 3% long-term governments remain in our future. Zero coupon bonds (which are in some respects the modern day series E bonds of yesterday) are clearly now the asset of choice. Talk about what goes around comes around. During the late 1950's most people would only buy government bonds, recently it's been only stocks. The old zero's, series E, were destroyed by inflation. Will the late 1990's asset of choice (stocks) be destroyed by deflation? Stay alert and stay tuned.

A Final Thought

We are convinced that unless a large tax cut comes quickly the economy has little chance of doing appreciatively better. The federal government has balanced its budget (and then some) on the backs of consumers and business. They should have done it by reducing expenditures but instead chose tax increases. Without a sizeable tax cut the consumer will need to do one of two things. Sell stocks and/or borrow in order to maintain spending or quit spending altogether. Either choice will not be good for the economy as things stand now. The rhetoric in Washington opposing the tax cut by members of both parties is down right childish. It is a shameful display of economic illiteracy. The only problem with the tax cut is it is not big enough. We suppose that if things get bad enough the light might come on. The problem we are facing cannot be corrected by lower

interest rates. Don't get us wrong, lower rates will be beneficial and are needed. However the quickest and most direct way of raising after tax income is to lower taxes. The government can't raise salaries and lenders won't always continue to loan to debt-ridden consumers and of course at some point there will be no more stocks to sell.

A New Face at CPAI

As you may recall we discontinued our equity programs in June of 2000 fearing a major melt down in common stocks due to overvaluation. We are now happy to announce that we are joining with Dr. Michael Berry as of April 1, 2001 to launch a series of equity programs that will include the following. Value investing is our major suit.

- (A) Mid/Large Cap Value (equity)
- (B) Balanced Program (equity & bonds)
- (C) Exchange Traded Funds Value & Growth (equity)

The U.S. equity market has been characterized as a "growth" market for the past few years. In fact, investors have been focused entirely on price momentum during the 1998, 1999 and early 2000 timeframe. In particular, they have bought stocks with price momentum (to the exclusion of those with strong fundamentals) such as reliable earnings growth and cheap valuations as indicated by their low P/E multiples.

The "price bubble" has been a result of growth investors chasing equities without regard to their valuations. As value investors we seek stocks which have been ignored by the broad marketplace. These stocks have low P/E multiples and produce very good returns over the average 5 year timeframe.

Often, we are contrarians in our role as value investors. We shun industries such as the Internet industry, which we considered a "fad." Instead we look for "values" in underpriced stocks in areas such as cyclical stocks, basic industries and undervalued energy issues.

We never "chase" a stock. We are content to be early in our purchase decision and allow the stock to find its higher valuation. As value investors we are often buying stocks no one else is interested in and hence we tend to have less downside than upside potential in returns.

Finally, we know that value investing, buying cheap stocks of great companies, is being recognized by the market after the hiatus of 1999 – 2000. We look forward to producing returns in the resurgent value cycle in the coming year.

For your information we are enclosing Mike's resume. The above programs will be launched over the next several months. We invite your inquiries.

Don Peters

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