



Facing the Bear: The Extraordinary Events of September, 2001



*Association of Financial Professionals
Annual Conference
September 21, 2001
San Juan, Puerto Rico*

Objectives

- ❖ Provide a framework for determining realistic investment expectations going forward.
- ❖ Provide ideas for communicating to board members and plan participants.

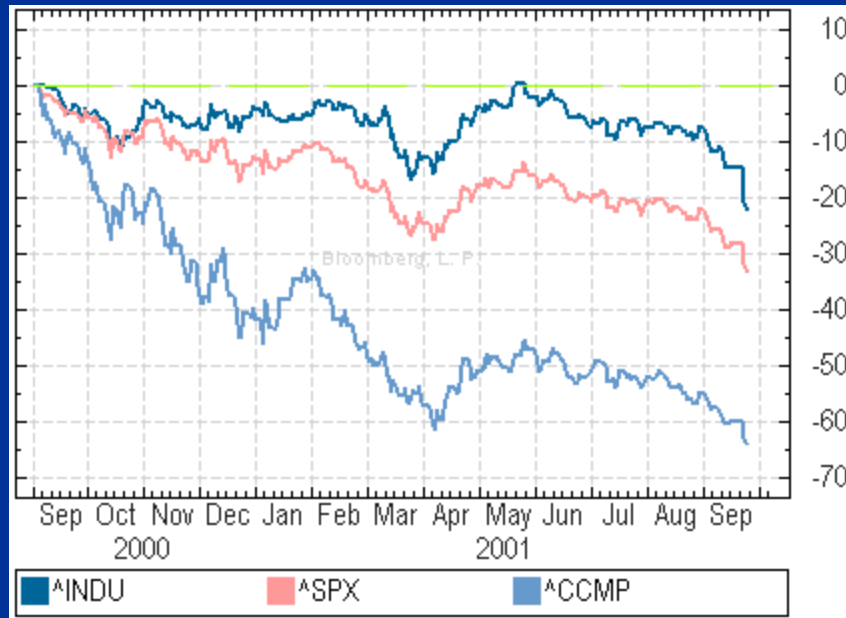
Agenda

- ❖ History as a baseline
- ❖ Market P/E's, Past and Present: What will it take to boost Earnings?
- ❖ Best and Worst Case Scenarios for next twelve months
- ❖ “What do I do...???”

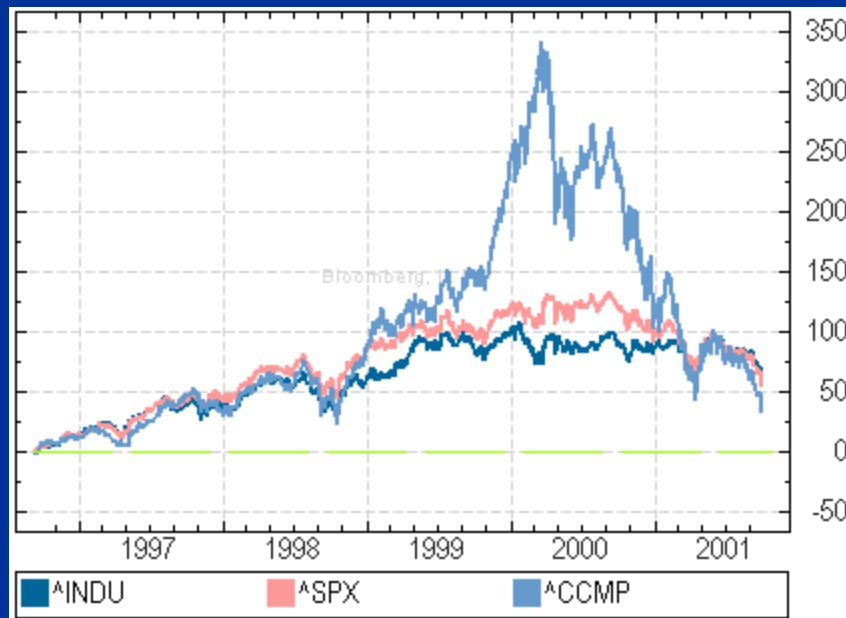
History as a Baseline:

This, too, shall pass...

Twelve months...



Five years...





Abrupt, Violent Events

Event	1 day	2 days	5 days	10 days	20 days	30 days	1 year
Cuban missile crisis	-1.13	-3.78	-1.89	3.89	7.61	12.68	33.52
Assassination of President Kennedy	-2.81	1.06	2.85	3.27	3.06	6.12	23.55
Chicago riots	-0.07	0.05	1.95	2.07	4.10	6.00	-3.15
Attempted assassination of President Reagan	-0.27	1.00	0.62	-0.10	0.62	-3.67	-16.64
World Trade Center bombing	0.24	-0.07	1.13	2.57	1.93	-0.11	6.16
Oklahoma City bombing	-0.09	-0.02	1.33	1.88	4.52	5.55	27.74

Historical S&P 500

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1970	-7.37	5.58	0.44	-8.75	-5.78	-4.66	7.69	4.78	3.62	-0.83	5.06	5.97
1971	4.32	1.17	3.94	3.89	-3.91	0.33	-3.87	3.88	-0.44	-3.92	0.02	8.88
1972	2.06	2.77	0.83	0.68	1.97	-1.95	0.48	3.69	-0.25	1.19	4.81	1.42
1973	-1.49	-3.52	0.08	-3.83	-1.63	-0.40	4.07	-3.41	4.27	0.17	-11.09	1.98
1974	-0.72	-0.07	-2.05	-3.59	-3.02	-1.13	-7.42	-8.64	-11.52	16.81	-4.88	-1.56
1975	12.72	6.38	2.54	5.10	4.76	4.77	-6.44	-1.76	-3.12	6.53	2.82	-0.81
1976	12.17	-0.84	3.37	-0.78	-1.11	4.43	-0.48	-0.18	2.58	-1.86	-0.41	5.61
1977	-4.73	-1.82	-1.05	0.42	-1.96	4.94	-1.24	-1.72	0.15	-3.90	3.16	0.75
1978	-5.74	-2.03	2.94	9.02	0.92	-1.38	5.83	3.01	-0.32	-8.72	2.15	1.96
1979	4.43	-3.21	5.96	0.63	-2.17	4.35	1.34	5.77	0.43	-6.40	4.75	2.14
1980	6.22	-0.01	-9.72	4.62	5.15	3.16	6.96	1.01	2.94	2.02	10.65	-3.02
1981	-4.18	1.74	4.00	-1.93	0.26	-0.63	0.21	-5.78	-4.93	5.40	4.13	-2.56
1982	-1.31	-5.59	-0.52	4.52	-3.41	-1.50	-1.78	12.14	1.25	11.51	4.04	1.93
1983	3.72	2.29	3.69	7.88	-0.87	3.89	-2.95	1.50	1.38	-1.16	2.11	-0.52
1984	-0.56	-3.52	1.73	0.95	-5.54	2.17	-1.24	11.04	0.02	0.39	-1.12	2.63
1985	7.79	1.23	0.07	-0.09	5.78	1.57	-0.15	-0.85	-3.13	4.62	6.86	4.84
1986	0.56	7.47	5.58	-1.13	5.32	1.69	-5.59	7.42	-8.27	5.77	2.43	-2.55
1987	13.47	3.95	2.88	-0.89	0.87	5.05	5.07	3.73	-2.19	-21.54	-8.24	7.61
1988	4.21	4.66	-3.09	1.11	0.86	4.59	-0.38	-3.40	4.26	2.78	-1.43	1.75
1989	7.32	-2.49	2.33	5.19	4.05	-0.57	9.03	1.96	-0.41	-2.32	2.04	2.40
1990	-6.71	1.29	2.65	-2.50	9.75	-0.68	-0.32	-9.04	-4.87	-0.43	6.46	2.79
1991	4.36	7.15	2.42	0.24	4.31	-4.58	4.66	2.37	-1.67	1.34	-4.03	11.44
1992	-1.86	1.29	-1.95	2.94	0.49	-1.49	4.08	-2.05	1.18	0.34	3.40	1.23
1993	0.84	1.36	2.11	-2.42	2.67	0.29	-0.40	3.79	-0.77	2.07	-0.95	1.21
1994	3.40	-2.71	-4.36	1.28	1.64	-2.45	3.28	4.10	-2.44	2.25	-3.64	1.48
1995	2.59	3.90	2.95	2.94	4.00	2.32	3.32	0.25	4.22	-0.36	4.39	1.93
1996	3.40	0.93	0.96	1.47	2.58	0.38	-4.42	2.11	5.63	2.76	7.56	-1.98
1997	6.25	0.78	-4.11	5.97	6.09	4.48	7.96	-5.60	5.48	-3.34	4.63	1.72
1998	1.11	7.21	5.12	1.01	-1.72	4.06	-1.06	-14.46	6.41	8.13	6.06	5.76
1999	4.18	-3.11	4.00	3.87	-2.36	5.55	-3.12	-0.49	-2.74	6.33	2.03	5.89
2000	-5.02	-1.89	9.78	-3.01	-2.05	2.46	-1.56	6.21	-5.28	-0.42	-7.88	0.49
2001	3.55	-9.12	-6.33	7.77	0.67	-2.43	-0.98	-6.26	-10.00	?	?	?

Historical S&P 500

	<u>Worst</u>	<u>Month</u>	<u>Worst</u>	<u>Quarter</u>
→	-7.37	Jan-70	Q2 '70	-18.03 ←
	-3.92	Oct-71	Q3 '71	-0.58
	-1.95	Jun-72	Q2 '72	0.67
→	-11.09	Nov-73	Q4 '73	-9.18
→	-11.52	Sep-74	Q3 '74	-25.16 ←
	-6.44	Jul-75	Q3 '75	-10.95
	-1.86	Oct-76	Q3 '76	1.91
	-4.73	Jan-77	Q1 '77	-7.45
	-8.72	Oct-78	Q1 '78	-4.94
	-6.40	Oct-79	Q4 '79	0.14
	-9.72	Mar-80	Q1 '80	-4.12
	-5.78	Aug-81	Q3 '81	-10.23
	-5.59	Feb-82	Q1 '82	-7.31
	-2.95	Jul-83	Q3 '83	-0.13
	-5.54	May-84	Q2 '84	-2.57
	-3.13	Sep-85	Q3 '85	-4.10
	-8.27	Sep-86	Q3 '86	-6.97
→	-21.54	Oct-87	Q4 '87	-22.52 ←
	-3.09	Mar-88	Q3 '88	0.34
	-2.49	Feb-89	Q4 '89	2.06
	-9.04	Aug-90	Q3 '90	-13.74 ←
	-4.58	Jun-91	Q2 '91	-0.23
	-2.05	Aug-92	Q1 '92	-2.53
	-2.42	Apr-93	Q2 '93	0.49
	-3.64	Nov-94	Q1 '94	-3.79
	-0.36	Oct-95	Q4 '95	6.02
	-4.42	Jul-96	Q3 '96	3.09
	-5.60	Aug-97	Q1 '97	2.68
→	-14.46	Aug-98	Q3 '98	-9.95
	-2.74	Sep-99	Q3 '99	-6.24
	-7.88	Nov-00	Q4 '00	-7.83
→	-12.49	Sep-01	Q4 '01	-16.00 ←

Worst Years -

1973: -14.69%

1974: -26.47%

1977: -7.16%

2000: -9.10%

2001: -22.30%
thru Sep 20th.

Subsequent Years

Worst Years -

1973: -14.69%

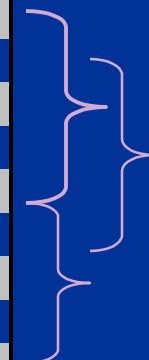
1974: -26.47%

1977: -7.16%

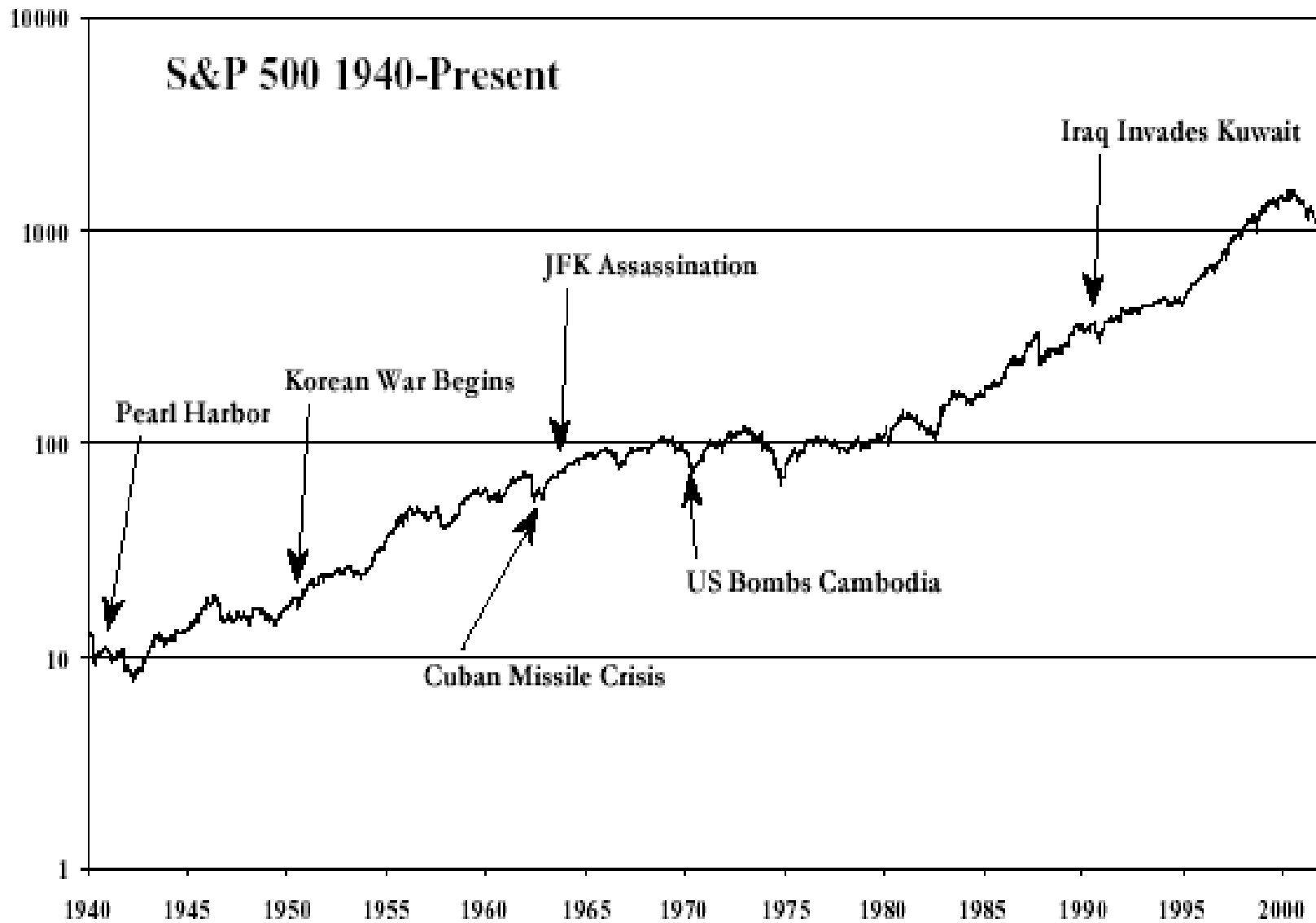
2000: -9.10%

2001: -22.30% thru
Sept 20th.

<u>YTD</u>	<u>Year</u>
3.94	1970
14.30	1971
19.00	1972
-14.69	1973
-26.47	1974
37.23	1975
23.93	1976
-7.16	1977
6.57	1978
18.61	1979
32.50	1980
-4.92	1981
21.55	1982
22.56	1983
6.27	1984
31.73	1985
18.67	1986
5.25	1987
16.61	1988
31.69	1989
-3.11	1990
30.47	1991
7.62	1992
10.08	1993
1.32	1994
37.58	1995
22.96	1996
33.36	1997
28.58	1998
21.04	1999
-9.10	2000
-22.30	2001



S&P 500 1940-Present



P/E's Past & Present



What makes this one different?

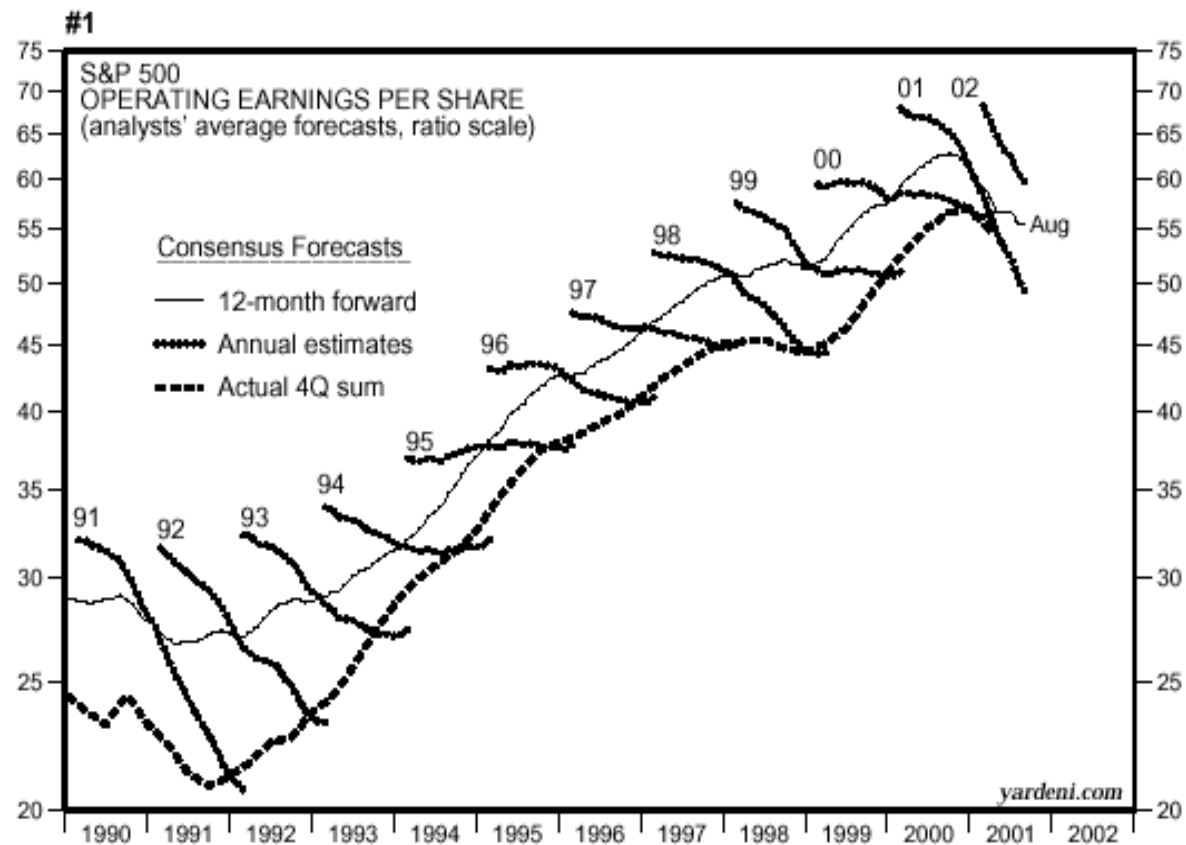
A look at *GDP*...

- ❧ Economy already slowing.
- ❧ August Industrial Production Report: .08% decline, 11th straight month, longest string since 1960.
- ❧ Capacity use fell to 76.2%.
- ❧ Technology production dropped 1.4%, following 2.2% drop in August.
- ❧ Unemployment increased, approaching 5%.
- ❧ Consumer confidence levels declining.

2001 expected Operating Earnings: From \$45 to \$30-\$40

- S&P 500 -

S&P 500 forward consensus expected earnings was \$55.38 in August, down for the ninth time in eleven months. Analysts currently expect 2002 earnings to be \$59.66 per share, or 20.8% above this year. We expect \$55 per share next year.



Source: Earnings Squiggles at yardeni.com™

Fair Value now estimated at just below 21, the reciprocal of the bond yield of 4.7%

S&P 500 forward P/E was 20.8 in August, down from record level of 24.5 during July 1999. Long-term consensus earnings growth rate was 15.2%, well below August 2000 record peak of 18.7%. It is still unrealistically high.

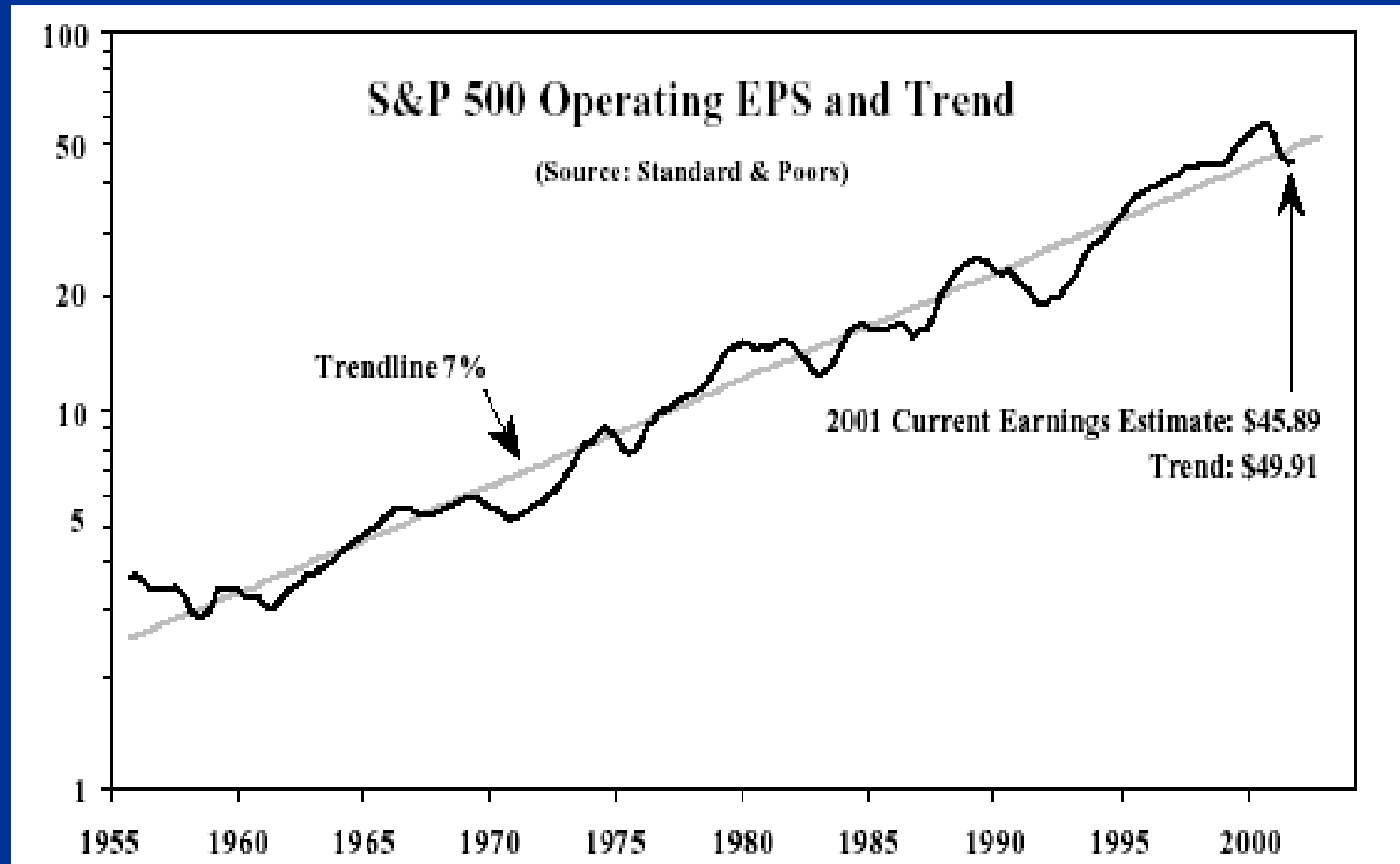


* Price divided by 12-month forward consensus expected operating earnings per share using mid-month data.

** 5-year forward consensus expected earnings growth. Percent annual rate.

Source: Thomson Financial

As earnings fall below trend, PE will rise,
based on investor expectation that earnings return to trend





- S&P 500 has fallen from 1550 to 988, a decline of 33%.
- If floor at 900, we're playing out the last 10%.



Fixed Income



3-Month T-Bill Yield (\$IRX)

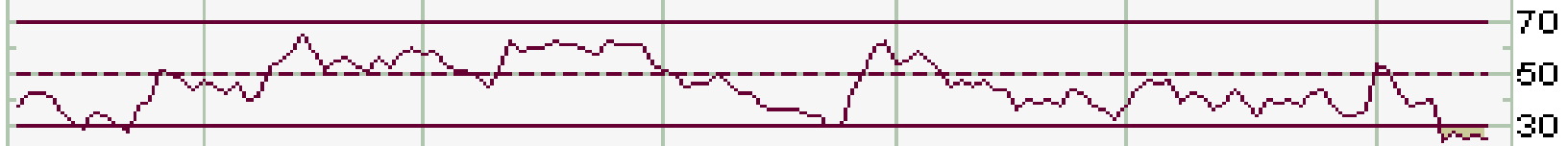
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Five Year Treasury Yield (\$FVX)

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RSI(14) 25.2



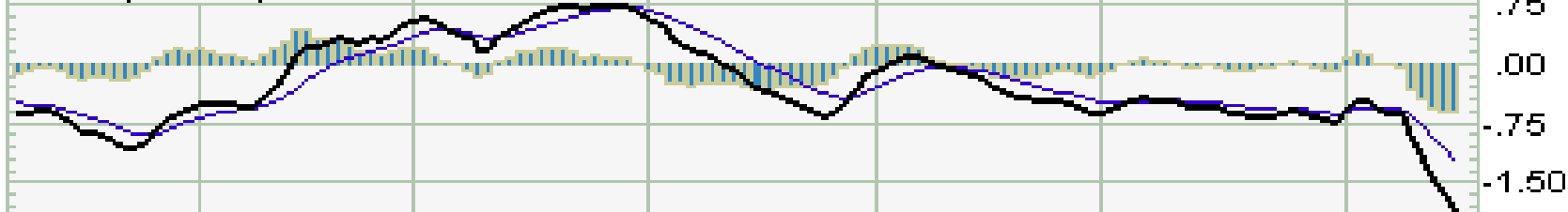
\$FVX daily 21-Sep-2001 09:41 ET O:37.36 H:37.73 L:37.36 Last:37.73 Chg:-0.52

MA(50) 44.71

MA(200) 47.37



MACD(12,26,9) -1.83



Apr

May

Jun

Jul

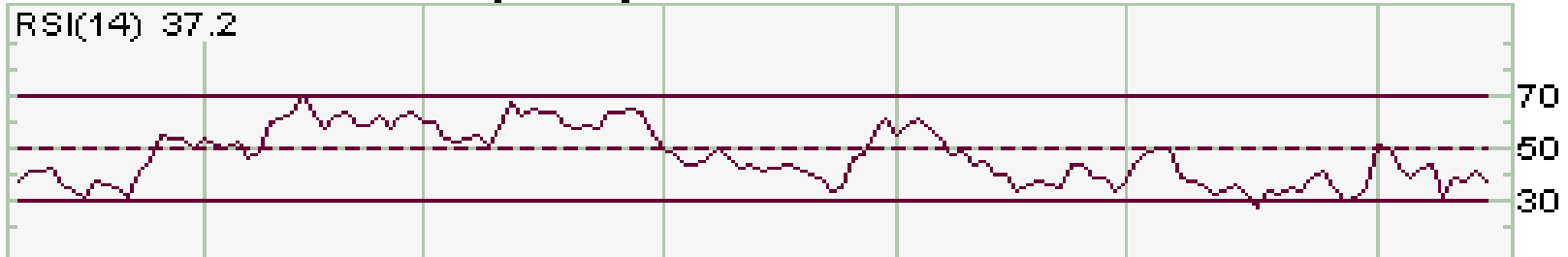
Aug

Sep

10-Year T-Note Yield (\$TNX)

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RSI(14) 37.2



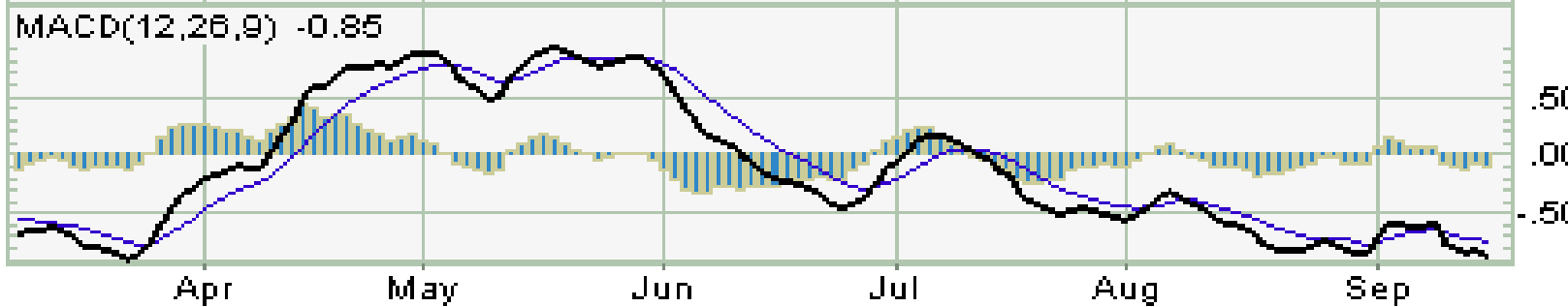
\$TNX daily 21-Sep-2001 09:40ET O:46.77 H:47.28 L:46.49 Last:46.49 Chg:-0.79

MA(50) 49.83

MA(200) 51.17

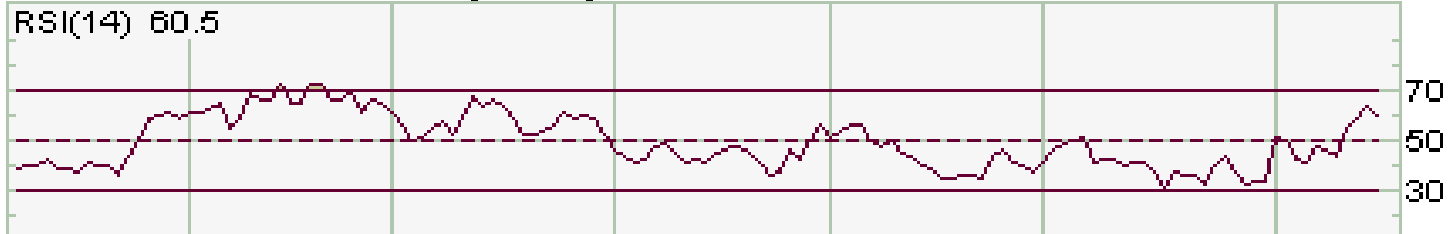


MACD(12,26,9) -0.85

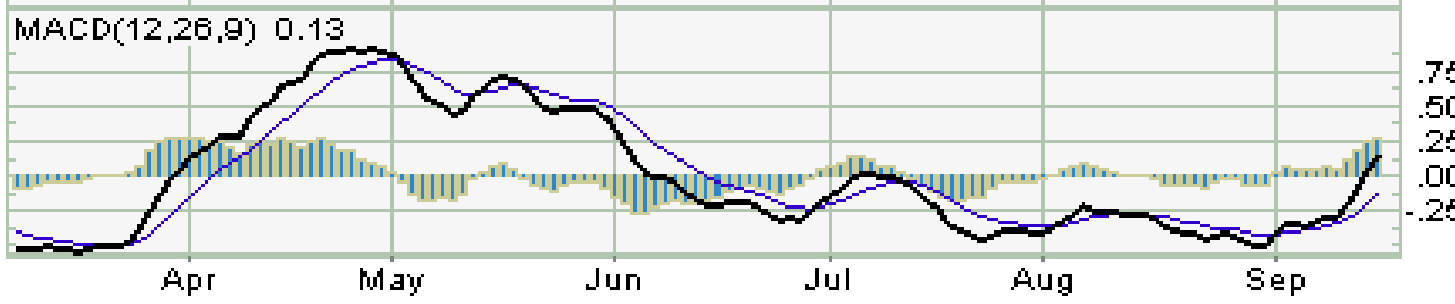


30-Year T-Bond Yield (\$TYX)

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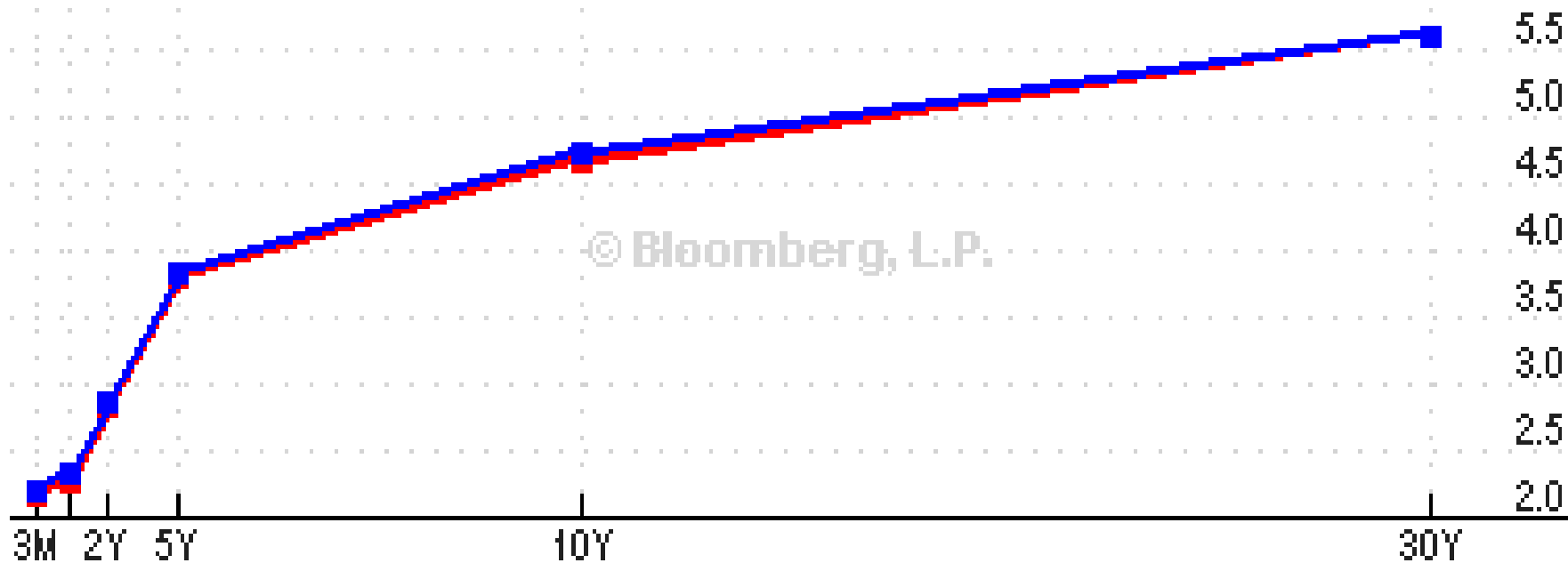
\$TYX daily 21-Sep-2001 09:41 ET O:56.04 H:56.33 L:55.95 Last:55.95 Chg:-0.31
MA(50) 55.10
MA(200) 55.50



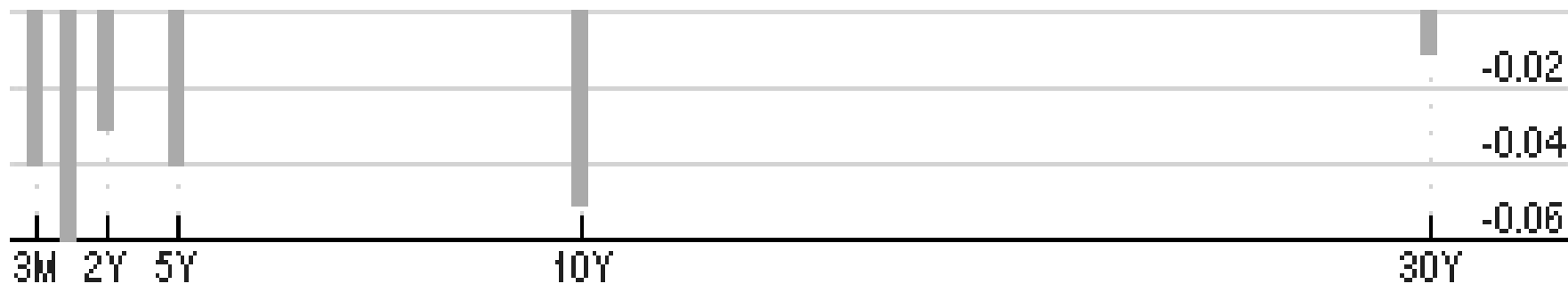
Current

Previous

%



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Worst Case

- ❖ Tragedy is “The Perfect Storm”
- ❖ Economy tips into recession, probably since 1st quarter...
- ❖ Consumer confidence crisis, as more cutbacks, layoffs, etc. Increase in savings.
- ❖ Earnings continue decline in first half of 2002
- ❖ Normal recession of 15 to 18 months, ending summer of 2002.

Worst Case

- ❖ Market falls to lows around 900 over next few months, as operating earnings fall to \$30's.
- ❖ At 900, market priced at recession P/E of 18.
- ❖ Aggressive Fed cuts short rates to 2%, long term yields can go to 4%.
- ❖ By September '02, market back to 1100, discounting 2003 recovery.
- ❖ “Do nothing” = 0% on stocks, modest gains on bonds.

Best Case

- ❖ Oversold market plus aggressive easing plus “American Spirit” = market reaches lows faster, sooner.
- ❖ Consumer spending continues, placing demand on manufacturing, and layoffs recede.
- ❖ Bottom in the third quarter for economy and earnings.
- ❖ Market begins to discount a recovery.
- ❖ Target S&P 500: 1350, 24% gain from current.

Other “Kinks”

❖ The politics are tricky

- Possibility of more attacks
- Enemy is embedded in global community

❖ The economics are tricky

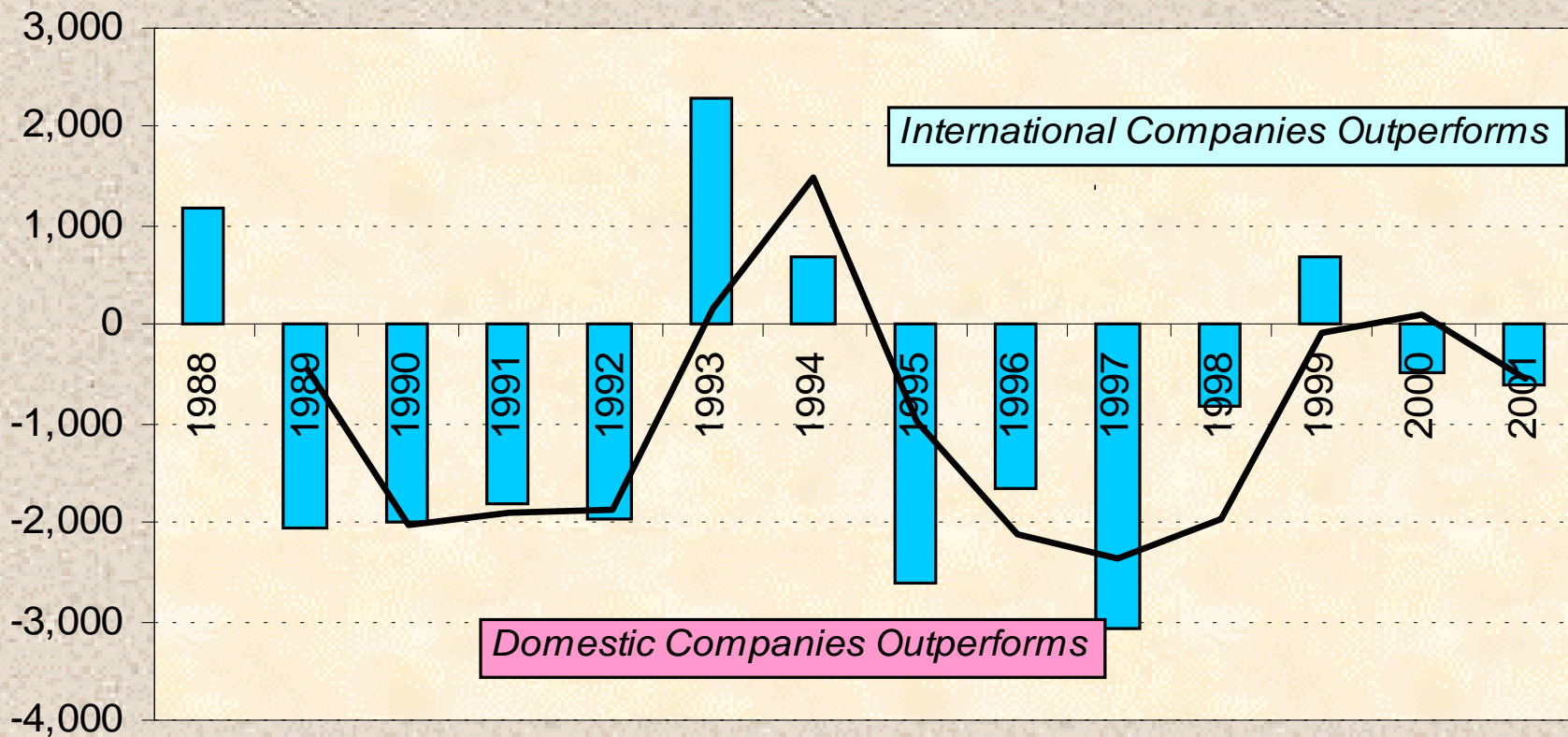
- Japan
- Europe
- USA
- Where's inflation????

What to do?

- ❖ Immediately revise short and long term objectives
- ❖ Cash Flow requirements
 - May need to sell into rallies
- ❖ Asset Allocation
- ❖ Style rebalance
- ❖ Continue recurring investment strategy.
- ❖ Pay attention to the events: military, intelligence, alliances, all important right now.

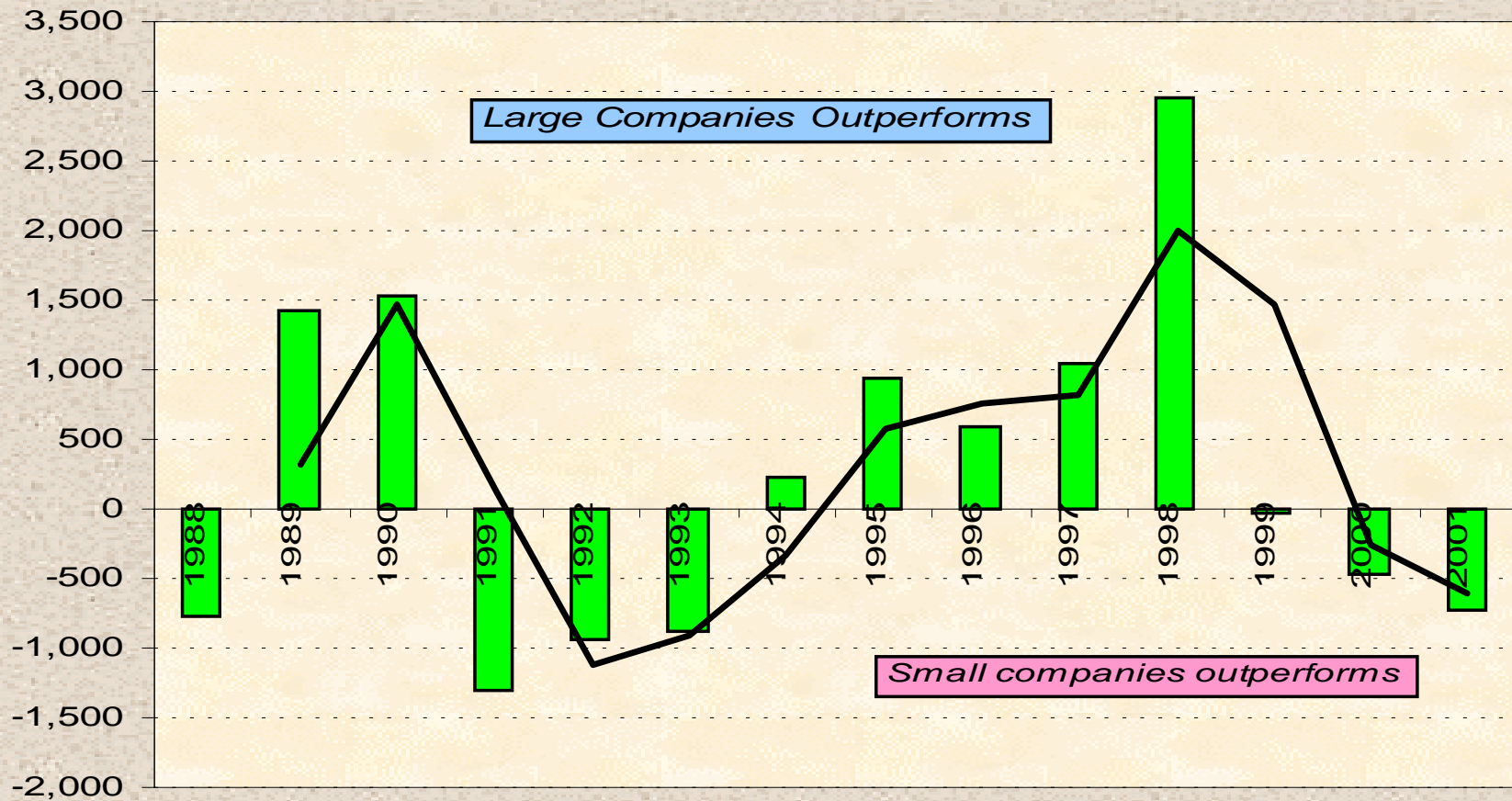
Style Cyclicity

Domestic versus International Companies



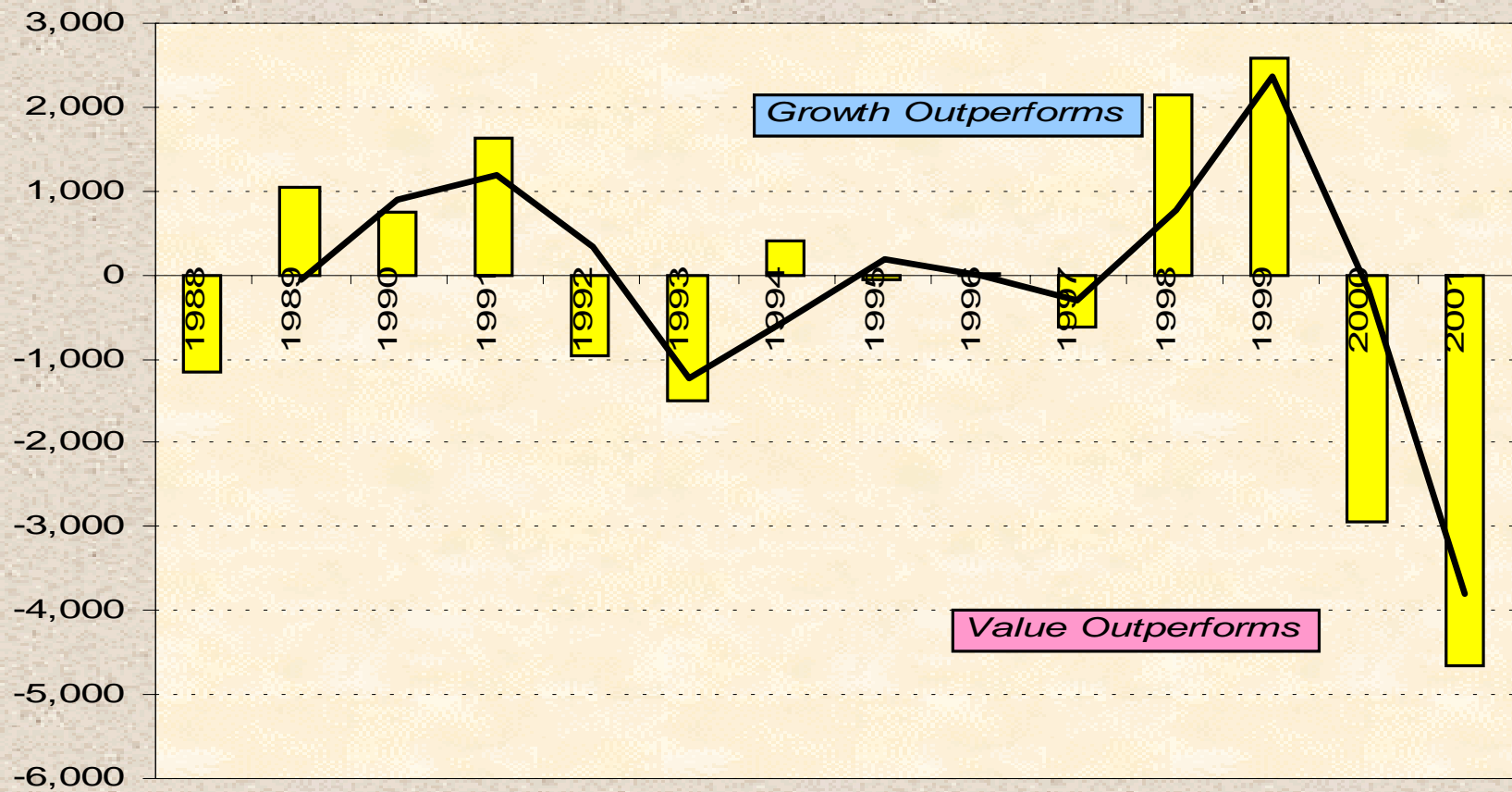
Style Cyclicality

Large versus Small Companies



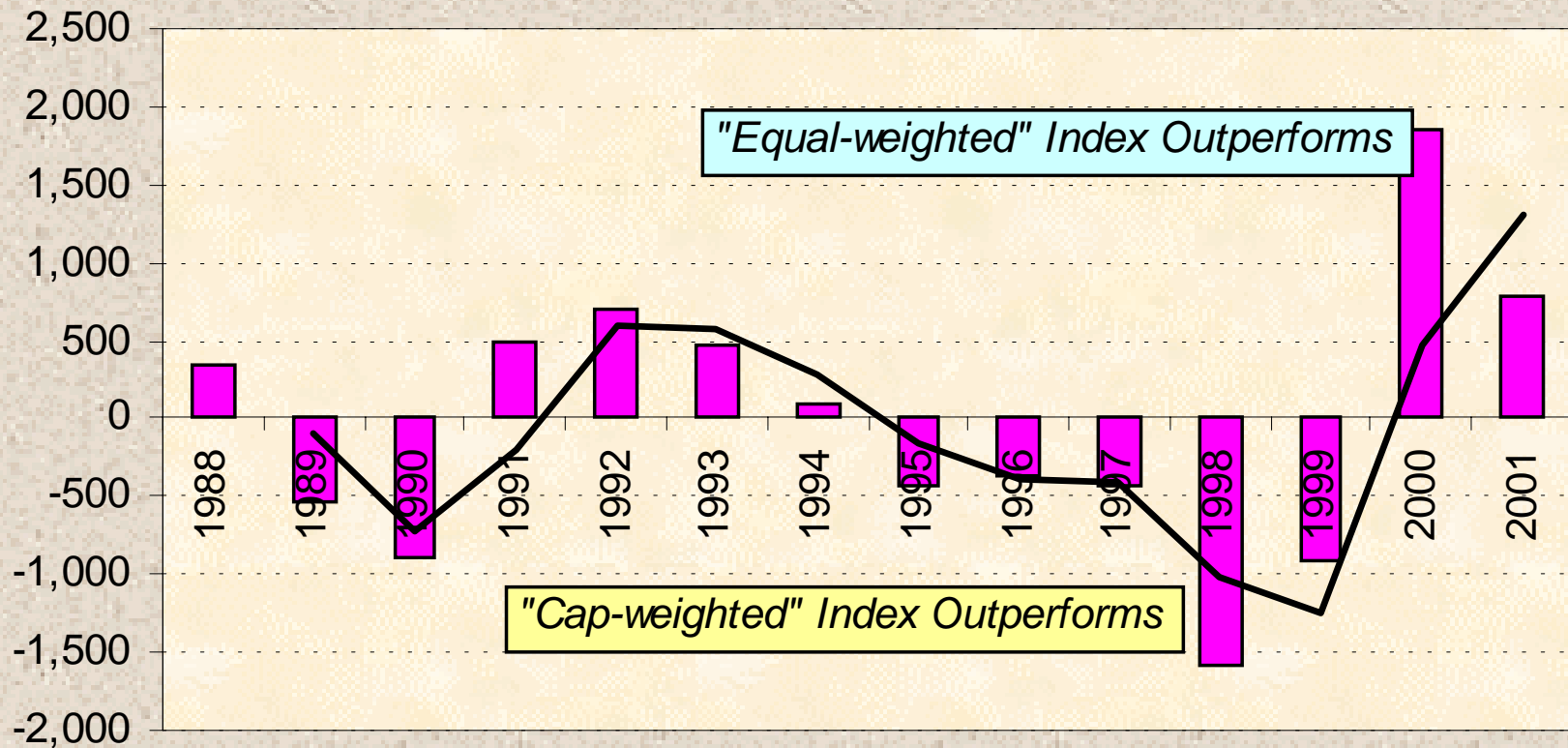
Style Cyclicity

Value versus Growth Companies



Style Cyclicalty

S&P 500: Equal versus Cap Weighted



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Managing Risk in Volatile Times: the
Lessons of 2001

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