

TO: ALL CLIENTS  
FROM: Victor Levinson and Nicholas Levinson  
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### SPECIAL EARLY AUGUST COMMENTS

Due to the recent extreme short-term volatility of the stock market --mostly down, with sporadic bursts on the upside-- we are writing again on two crucial subjects: (1) Is Your Allocation to Stocks Appropriate?; and (2) The Short and Longer Term Impact on Stock Prices of Recent Weaker-than-Expected Economic Data.

#### Is Your Allocation to Stocks Appropriate?

The most important factor is whether you are using money from your investment portfolio currently, or are likely to need money over the next few years, to maintain your life style. If the answer is no, and if you can tolerate the emotional impact of the downside to stock prices, then your allocation to stocks can be substantial (70% or more).

However, if the answer is yes, then it is most important to determine how much you are likely to need, and when the need is likely to begin. In determining what is needed, consider all other non-portfolio sources of funds, such as part-time work, Social Security, and rental income from real estate. Also, consider non-liquid assets that could be sold to generate additional funds.

As an example, assume a current annual need from your investment portfolio of \$100,000. Your portfolio asset allocation should have at least three years, or \$300,000, and preferably more, of short and intermediate-term fixed income investments. This allocation allows you to withdraw money from the bond portion of your portfolio, leaving the stock portion intact, with the expectation that the history of stock price recoveries from declines will recur in the time frame relevant to your spending needs.

In most situations, some reasonable allocation to stocks, with their long-term record of significantly higher returns compared to bonds, is appropriate, even in times of sharply declining stock prices. To abandon a reasonable stock allocation after a significant decline in prices, and then to reinvest the proceeds at historically low interest rates, removes the chance to participate in the stock price recoveries that have consistently occurred after declines. (This point does not address the strategy of market timing, which was discussed at length in our most recent July Comments; see also page 3 of these Comments). As long as your allocation provides a cushion of fixed income investments of at least three years of current spending needs (or there are non-liquid assets available to sell to create this cushion), you should be able to maintain some reasonable allocation to stocks (30% to 50% of your portfolio). Of course, your emotional tolerance to the downside is an issue, but history suggests you should try hard to overcome that sickening feeling when stocks decline and maintain your allocation to stocks so as to participate in the anticipated recoveries.

**This asset allocation discussion does not take into account the possibility that spending may have to be reduced so as to make all the pieces of your financial plan work properly.**

The Short and Longer-Term Impact on Stock Prices of Recent Weaker-than-Expected Economic Data

During the first few days of August, there was a host of real economic data that indicated the US economy was not recovering as rapidly as was previously thought. In addition, revised data identified a mild recession had occurred during the first three quarters of 2001, followed by positive growth in different amounts from the fourth quarter of 2001 through the second quarter of 2002. The big question raised by the current weak economic data is whether the US economy is going back into another recession (the “double dip” recession), or whether the economy is going to pick up again from here. Interestingly enough, falling stock prices are now cited as a prime reason why the double dip may occur, as people begin to curtail certain spending based in part on the declining values of their investment portfolios.

There is no doubt that the weak economic data is bad news for stock prices in the short term. How much further prices are going to fall to account for this new unfavorable information will be known in the coming days, weeks, and months. Note that stock prices this time are responding to real economic fundamentals, as distinguished from earlier explanations for stock declines ranging from threats of terrorism to corporate accounting scandals that, while significant, are still limited in number. Weak economic data bears directly on levels of employment, income, and business sales revenues, which in turn directly affect the corporate earnings on which stock prices are based.

But what of the long-term impact on stock prices? (For an excellent article on what the “long-term” really means, see the attached NY Times article from Sunday, Aug. 4<sup>th</sup>, “Believe It or Not, 2 \_ Years Is Not the Long Term.”) To this question, we continue to believe that the history of stock price recoveries following declines is not likely to be altered by the magnitude of whatever economic slowdown lies ahead. Some reasons to support this view are:

- (1) Interest Rates, which are already at historic lows, are likely to decline further if the economy continues to weaken. Low interest rates reduce the cost of doing business, put more money in the hands of consumers, and make the stock market look more attractive as a place to invest when compared to the continuing declining interest received on fixed income investments (see point (2) which follows).

- (2) At some price level, stocks become cheap, and buyers emerge to try and earn returns far in excess of the current yields available on fixed income investments.
- (3) Economic growth has always come in cycles. While the current cycle may be slow growth, or even modest negative growth, there is no current, credible economic forecast that calls for a serious recession. The Monday, August 5<sup>th</sup> Wall Street Journal article reporting on the recent disappointing economic data contains some pertinent statements: “While few economists said they believe the economy will slip back into recession, many now said ...it won’t grow fast enough in the months ahead to create new jobs.” The article cites two Federal Reserve officials; one said that “recent signs of economic weakness likely represent just a pause in the overall economic recovery,” and another said that “the greatest probability is we will continue to get moderate growth of 2% to 3%, accelerating next year.” The article states that “because the recession itself was relatively mild, Fed officials never expected a booming recovery...so the recent soft spots, while disappointing, aren’t altogether surprising.”

Therefore, even as current stock prices continue to fall, this time related to real, disappointing economic news, there is still reason to be hopeful for the recurrence of the long-term outperformance of stocks. In a properly allocated investment portfolio, stocks can be held through periods of significant declines, while the fixed income portion provides positive returns and a source of funds as money is needed (refer to discussion on first page of these Comments). For additional discussion of Asset Allocation decisions, see a second attached article from the Sunday, Aug. 4<sup>th</sup> NY Times.

While there is always the alternative of trying to time the market (see July Comments), the recent few days of sharp price increases reinforce the danger of missing substantial parts of the recovery when it actually occurs (see NY Times Asset Allocation article). Since the stock market is always trying to predict the future (not what is already known), what appears obvious at any moment can quickly turn in another direction. In any event, we continue to advocate the “Long-Term Hold” strategy for the portion of your portfolio allocated to stocks, but we remain available to discuss with you any efforts at market timing in which you wish to participate.