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Sharp Investing

Gloom and Doom in the Markets: Overdone or Justified?

By Daniel R. Sharp, Ph.D.

It is an excellent time to be buying companies with solid earnings prospects – they are cheap and their multiples will expand at the first sign that the economy is getting better.

The combination of an economic slowdown and an overheated stock market has resulted in a very pessimistic outlook by most investors, whether professionals or individuals. Eighteen months ago, when the NASDAQ was over 5000 and the Dow was near 12,000, greed and optimism ruled. There was unlimited optimism about the "new economy" (there's a term you don't see much anymore), and investors thought it their birthright to double their money every few months in new, untested companies.

How times have changed. The economy is barely staying out of a recession, there have been some "70's style" energy scares, the NASDAQ now trades at 60% less than in early 2000, and the Dow has been stuck in the same general area for almost three years now. Many investors are sitting on portfolios that reflect the large drop in the NASDAQ and despair at the dismal long-term predictions made by experts concerning "the market".

So is all this doom and gloom a signal that it is time to put your money under your mattress and wait until investors become optimistic again?

To answer the question, we need to take a look at recent market history. *The first point is that no market correction has lasted more than five quarters over the last 25 years.* The last

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Socking it Away: 401k's, SEP's and SIMPLE's

(Part two of a two part series – discussing employer retirement plans such as SEP's, SIMPLE's and 401k's)

Last issue we discussed the various advantages of individual retirement plans, such as IRA's and Roths. This article will address the advantages of employer retirement plans,

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time this happened was in 1973-74, when the economy was in deep recession, inflation was ramping up, energy prices were out of control, the real estate market was horrible, and the economy in general was in much worse shape than it is today. By comparison, in today's economy we are experiencing a recession in the technology area (4% of GDP), an earnings slowdown in most of corporate America, no signs of inflation, no recession (so far so good), still strong consumer spending, and a healthy real estate market. Not to mention a Federal Reserve Committee that is committed to jump-starting the economy as evidenced by the numerous interest rate reductions over the past year. The kicker is that we are in the fifth quarter of a market correction, and the *effects of the interest rate cuts are just starting to filter into the economy.* The gloom and doom may be somewhat justified for those investors tied to market averages (i.e. growth stocks), mainly because their still excessive valuations cannot be justified in today's weaker economic backdrop. Holding stocks trading at 50+ times earnings growing at 1% *will* give you 20 years of underperformance. It's not that the economy is so bad, it's that these stocks that rule the NASDAQ were priced for a perfect economy, and anything less than perfect cannot justify their high prices.

We don't have to have a booming economy, as we did in the late 90's, in order to make money in the markets. Low valuation companies with decent earnings prospects have always done well in flat or low growth economies because investor demand increases for these types of investments when growth stocks aren't doing the job. Right now, the odds are very good that small companies will do very well over the next five years. The small-caps have explosive growth potential coming out of an economic slowdown. There are many excellent companies at single digit PE ratios, and the smallcaps have not had a period of superior performance since the post-gulf war period of '92-'94 (i.e. the last time we came out of an economic slowdown).

The smallcap value segment is by far the best long-term bet based on historical analysis, and will likely do very well even if the "market" stays flat for the foreseeable future. $

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The Dow is down over 20% in the past 12 months
The NASDAQ is down over 60% in the past 12 months
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Investing styles run in three to five year cycles. We are only in year two of a strong value cycle. Over long periods of time no strategy has produced better returns than investing in undervalued companies. Learn why and what it can mean for you!

Presented by
Daniel R. Sharp, Ph.D.
Registered Investment Advisor

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specifically SEP's, SIMPLE's and 401k's. There are other employer retirement plans such as Money Purchase and Profit Sharing plans, but the 401k, the SEP and the SIMPLE are probably used by over 95% of all employers.

Most employees of larger companies are eligible to contribute to a 401k defined contribution plan (or its non-profit equivalent, the 403b). Most 401ks are too good to pass up - there is a triple benefit to the employee. First, the employer usually matches 50% or more on the first 6% of salary deferred into the 401k, giving an instant 50% return on every dollar the employee contributes to the plan. Next, the tax-deferral of the ordinary income into the 401k can save another 35%+ in taxes on each dollar contributed. Last, the money grows tax-deferred, and so there is virtually a 100% annual return on each dollar you put in for at least the first 6%. After 6% you may lose the matching benefits, but the tax deferral still makes maxing out your 401k an attractive option.

The downside to 401k's are that they are usually limited in terms of investment choices, and therefore when an employee either retires or leaves their current employer, they have an opportunity to roll the 401k proceeds, in a tax-free transaction, to another qualified plan, such as an IRA. An employee can choose to roll the 401k proceeds to a self-directed IRA at a discount broker and can then make their own investment choices or hire a professional - but then the choices are almost limitless as compared to the half dozen or so choices available in the typical 401k.

From an employer standpoint, 401k's are fairly expensive to run because of all the administrative requirements, and are usually offered to employees as a part of an overall comprehensive benefits plan designed to be competitive with other large employers. Sometimes small employers will use a 401k as their plan of choice, but it is always more expensive than some of the following options. It is only appropriate in very special circumstances where an employer is willing to bear the higher costs of this plan in order to achieve some specific goal.

If you are an employee or owner of a business with 50 employees or less, generally a retirement plan means choosing between a SEP or a SIMPLE. The reason for this is that neither of these plans require the extensive reporting to the IRS and the Department of Labor (ERISA laws) that most defined contribution plans (like 401k's) require. The SEP and the SIMPLE plans can be implemented at no cost, often with just a single page document, and no further administration is required. This is very attractive to the busy business owner.

The SEP allows a higher overall contribution ($25,500 for 2001) but the SIMPLE minimizes the employer's required contribution

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Is Your Portfolio or Fund full of Busted Technology Stocks?

We can help you determine whether you should sit on a down portfolio waiting for your tech stocks to rebound or whether you are better off diversifying away from technology stocks during a market rally. Analysis of the companies, the levels at which they were purchased, and their future prospects and reasonable expectations can all be beneficial in getting you back on a steady path to creating wealth. A complimentary investment consultation can be arranged at your convenience in person or over the phone. Fax or mail us your current account statement and our Portfolio Managers will discuss your goals & risk tolerances, and analyze your portfolio.

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(either 2 or 3% of employee's salary up to $6500). The employer makes the entire SEP contribution for employees, and all employees are given the same percentage of deferred compensation based upon salary, up to the 15%/$170,000 salary limit. Basically, all employees with over two years service are eligible for the SEP and since it is completely employer-funded, there is no opting out of the retirement plan.

If you, or you and your spouse or other family members are the only employees of the company, the choice becomes very "simple". If your w-2 reported income is above $54,000 (for 2001) you can contribute more with a SEP, below $54,000 and you can contribute more with a SIMPLE. For 2001, a SEP has a top end of $25,500 while a SIMPLE has a top end of $13,000. If you have non-family employees, the choice becomes a tradeoff between the owner's desire to fund their own retirement plans versus the owner's expense in funding employees retirement plans.

The tax benefits to the plans are exactly the same: The business or the employee defers ordinary income, essentially providing an instant return of 35% or more if the employee or business is in the 28% federal + 9% state brackets. Another distinction between a SEP and a SIMPLE is that with a SIMPLE employees can opt out of the plan – and thus the employer only has to make the 2 or 3% match for employees that participate in the plan. With a SEP, if you as the owner wants to put in 15% in your SEP, you have to contribute the same for each eligible employee.

Regardless of which plan is the best fit for your business, taking advantage of the tax breaks and capital gains deferrals make employer retirement plans a must for both employers to offer and employees to participate in as a primary source of creating wealth. **$**

Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

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