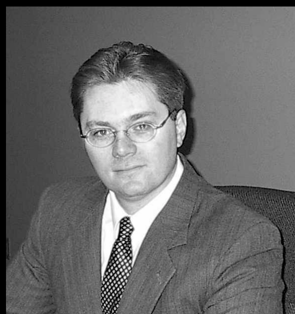
November 2002 Issue 33



www.sharpinvestments.com

Inside this Issue

Sharp Investing is a quarterly publication focused on investor education. For a subscription, contact us at:

13160 SW Butner Road
Beaverton, OR 97005

Phone 503-520-5000
or 888-760-9046

Fax 503-520-0530

Dsharp@Sharpinvestments.com

Sharp Investing

Let the Buyer Beware!

Being a Better Business Owner

By Daniel R. Sharp, Ph.D

The average investment portfolio has taken a huge hit over the past 30 months, causing concern among investors, especially investors that are close to retirement. The average investor, who bought hook, line, and sinker into the “get rich quick” greed of the 90's, now views investing as a fixed game with insiders, celebrities, and the powerful benefiting at the expense of the little guy. The playing field can be unfair, especially in the area of IPO's, momentum stocks, and hard to understand businesses (anything that involves a "get rich quick" flavor). It is very difficult for you, the public owners of a corporation, to control management, given the decentralized nature of public ownership. Boards of directors are supposed to supervise management, but all too often end up in collusion as CEO's serve on one another’s boards and give each other stock options as party favors. Mutual funds remove the public owner further yet from control of management. Government regulation is meant to control fraud, but bad business decisions generally go unpunished because of the insulation of management from their public owners.

When indexes were returning 20% a year, no one cared about exorbitant management salaries, high mutual fund expenses, or ridiculous business plans - "A rising tide lifts all boats". The stock market now has the full attention of the investor. Given that investors need to use this flawed system to create wealth “let the buyer beware” becomes an extremely important philosophy.

continued on page 2

Market Update November 2002

As we predicted last quarter, the market remained weak over the past three months and reached new lows during the quarter. Yet there have been signs of improvement in October, known as the “bear killer” month. The markets moved up in August recovering from the July accounting panics and then dropped hard in September and

continued on page 3

Let the Buyer Beware.. cont. from page 1

How do you protect yourself with all these obstacles to being a good public business owner?

> *Sharp Investing* will be moving from print to email in 2003 for readers that have email access. Beat the rush and drop us your email at:
>
> **info@sharpinvestments.com**

Successful investing in an unfair playing field involves *strict discipline over your human nature and a historical understanding of how you can benefit*. Most investors quickly give in to their human nature, even the power elite. Understand that the stock market is about two things: historical averages and regression towards historical averages. **Get scared, and conservative, when stock prices and company valuations get above historical averages. Conversely, get greedy, and aggressive, when stock prices and company valuations go below historical averages.** A good company is not necessarily a good investment, and a poor company is not necessarily a poor investment.

Diversification is important. Don't make huge sector bets, such as technology, especially when the sector gets elevated above historical averages. **Diversification means owning a basket of investments that represent all sectors of the economy, not a mutual fund with 500 technology names in it.** Know your investments or pay someone to know your investments. Mutual funds make it nearly impossible to follow the companies you own.

Understand your business and its valuation relative to its competitors, sector, historical averages, and the market in general. **Watch management, their patterns of insider stock sales, their board of directors, and whether their financial incentives are tied to the long-term creation of shareholder wealth.**

In spite of an unlevel playing field, stock returns have never been outperformed by any other investment class over any 25-year period. As an individual investor, you have no control over corporate accountability, but you do have a tremendous amount of choice over which corporations you choose to own. Given that there are over 10,000 publicly traded companies, you can afford to be a very picky business owner in selecting a dozen or so companies in diversified industries that you can reasonably follow. The key is buying them when they are

Let the Buyer Beware ..cont. from page 2

out of favor, i.e. going against human nature.

By paying attention to detail and controlling your human nature (or hiring someone to do this for you) you can participate in the wealth creation process without being a member of the power elite. While the system needs an overhaul, and corporations do occasionally defraud investors and misuse power, to work within the system individual investors have to look out for themselves. Being a good public business owner means letting the buyer beware. **$**

Market Update… cont. from page 1

early October on economic concerns. By Halloween the averages were almost back to where they started the quarter, with small cap value stocks actually providing positive returns even though the larger blue-chip stocks continued to decline slightly.

This environment provided an excellent buying opportunity in September and the first half of October, and we put a lot of cash to work during this 45-day stretch. With history on our side in terms of October stopping bear markets, it does indeed appear that the bottom was set this quarter, and we expect to see considerable strength in the markets over the next several quarters. Although prices remain weak, the favorable conditions are stacking up for a strong rally. A classic sign of a market bottom is when the market ignores bad news – and over the past four weeks the market has ignored a variety of weak economic reports, additional accounting issues at several companies, and eroded consumer confidence. It climbed a wall of worry from early October when the Dow nearly touched 7000 to nearly 8800 as I write on November 6. That is 26% in less than 30 days and reinforces the historical 73% average rebound the first year out of a bear market. History continues to repeat itself yet again.

Over the past week, Republications took firm control of Congress (good for the stock market regardless of your politics), and the Federal Reserve cut the Federal Funds rate by another fifty basis points to 1.25%, the lowest interest rate in over forty years. After eleven rate cuts in 2001, this was the first in 2002, and analysts say this signals to consumers and firms that the Fed is encouraging them to spend money, and should aid the slow recovery from last year's recession. While we currently have a very slow economic recovery rather than the classic "V" shaped recovery, we also have: extremely low interest rates, an undervalued stock market, a ton of cash on the sidelines, a President with added power from the Republican victories, and a scared-straight corporate America (which by now should have squeaky-clean operations and reporting). On the pessimistic side, we have continued threats of war and

continued on page 4

PRSRT STD
U.S. Postage
PAID
Portland, OR
Permit #3300

SHARP INVESTMENTS

13160 SW Butner Road
Beaverton, OR 97005
503-520-5000

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.

Market Update …continued from page 3

terrorism, concerns about consumer confidence, and fairly high-energy prices.

Believe it or not, when investors have some optimism and some pessimism, value stocks prosper. Many investors pulled all the way out of the market to cash due to a lack of optimism over the past six months, severely affecting all stocks. But as the money creeps back into the market along with the good news, it is directed at what is perceived as more conservative, practical, prudent investments, i.e. value stocks. When a market gets overly optimistic, the money flows from value to growth stocks until you get a bubble and then the cycle repeats itself again. Low valuations and low interest rates will lure the money off the sidelines over the next several quarters, and most of it will go into low valuation companies with decent earnings that pay strong dividends.

There may be a buying opportunity in the first half of December as most individual investors do their own tax loss selling during this timeframe (mutual funds do it in early October, which is why the bottom of many bear markets is reached in early October).

It has been a difficult six months (three years for growth investors). But, with history on our side for a strong recovery, we are confident that the next six months should resume the trend that has prevailed since the internet bubble popped back in March of 2000 – where established companies in a diversified number of industries are the beneficiaries of investor interest and receive valuations that historically have been received during other low interest rate environments. **$**