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Don't Worry: The Old Economy Will Save the New Economy

By Daniel R. Sharp

Last year at this time I was scratching my head trying to understand the "New Economy" business model. Technology and internet companies were going to drive "Old Economy" businesses into obsolescence, apparently through their Superbowl advertising. As most investors bought into this "sound" business plan, I was unable to join in the mania because of two unanswered questions: When will any of these New Economy companies actually turn a profit while changing the world? Doesn't anybody notice that most of the big companies that *do* turn a profit are also deploying the same technology and internet tools as the New Economy companies?

Now, twelve months and 800 dot-com failures later, the answers are obvious. Make no mistake about it – New Economy companies have definitely changed the world's way of doing business. But the change has come as a result of older, established, profitable firms aggressively adopting high technology and effectively using the massive structural shifts unleashed by New Economy forces. The New Economy forced the Old Economy to realign distribution channels and avoid the usual excesses of a high growth economy. Companies changed their behavior in ways that prevented the usual excesses of over-investment, over-hiring, over-paying and over-spending that usually occur in economic expansions.

This economic boom never produced the conditions to let companies indulge in excess. They were too busy trying to keep up with the powerful competitive forces unleashed by

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Smallcap Stocks: Is it Finally their turn to Shine?

Over long periods of time, no group of stocks has had higher returns than smaller capitalization stocks. This is the mantra repeated over and over by smallcap investors as they have watched their smallcap stocks underperform for six long hard years from 1993-1999. The public markets in the late '90s were all about liquidity, and no self-respecting mutual fund manager was going to take a position in a company that they could not quickly back out of – and thus the smaller

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the New Economy. So now that the economy is slowing down to a more normal pace (2%) from the supercharged 6% growth of the past two years, Old Economy companies are in a much better position to weather the slowdown than previous economic contractions.

The American economy is entering an economic downturn. But even as the New Economy implodes, the old economy will sustain us. This means that the downturn will likely be short and shallow, after an impossibly long expansion.

Most economists agree that we are going into a mild slump for a quarter or two, followed by a slower, but healthy growth rate somewhere between 2 and 3%. Much of the credit for this “soft landing” belongs to Greenspan and the Federal Reserve, and they have the tools to prevent a more severe downturn; loosening credit and lowering interest rates. The new administration’s tax cut, if passed, will be another way to stimulate the consumer to pad the slowdown. So why are consumers running so scared? Why does this slowdown *feel* so bad? The answer lies in the behavior of the Old Economy versus the New Economy over the past several years. Previously the case was made that Old Economy companies, which are most U.S. companies, behaved quite prudently during the expansion. New Economy companies did exactly the opposite, indulging in every excess successfully avoided by more established companies. High profile technology companies paid the price of going overboard, resulting in huge waves of layoffs, destroyed employee stock options, and 800 dot-com’s closing their doors. This is what has grabbed the business headlines over the past year.

But here’s the key point – while at one point technology and internet companies held almost one dollar of out every three invested in the U.S., they contribute less than 3% to national GDP. Imagine that, 3% of the economy representing over 30% of the stock market. That is virtually the definition of a bubble. Now that the high growth of high tech has slowed, the ridiculous valuations granted to start-up internet and established tech blue chips alike are rapidly coming back to earth.

A slowdown in growth of the technology sector has very little effect on the overall economy. In fact, the “wealth effect” resulting from plummeting technology stocks has a far greater impact on the economy than the actual slowdown of the sector itself. Many who had invested in

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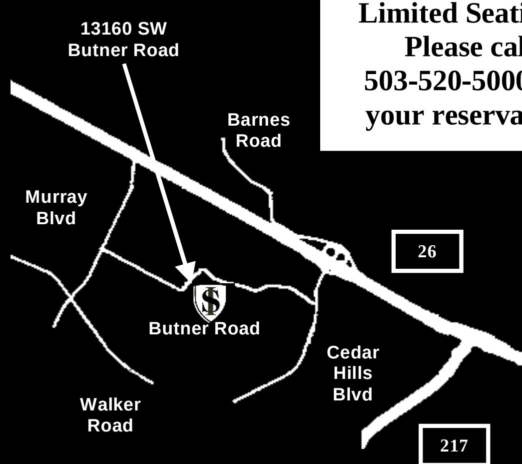

Investing styles run in three to five year cycles. We are only in year one of a strong value cycle. Over long periods of time no strategy has produced better returns than investing in undervalued companies. Learn why and what it can mean for you!

Presented by
Daniel R. Sharp
Registered Investment Advisor

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internet and technology stocks are now feeling "poor" as their dot-com's are now dot-gone, and as a result they put less money back into the economy.

But even if technology investors change their extravagant ways, the tools of the Fed should offset any consumer spending slowdown resulting from the "wealth effect". Technology investors will still be looking for places to invest their money, and the concentrated demand for tech stocks will spread to other sectors of the market.

For an investor that buys into the soft landing of the economy because of the restraint of Old Economy stocks over the past several years – opportunities abound. Industrial America is slim, trim, and ready to handle the short slowdown and emerge on the other side intact courtesy of technological improvements.

We've come full circle. The Old Economy has absorbed the New Economy, becoming yet more effective, productive, and efficient as once again we are simply left with The Economy.

Many of these industrial companies have seen their stock prices rise as money fleeing the technology sector has spread out to the Old Economy sectors of the market. However, there are still many, many companies attractively priced that would fit well into any long-term diversified investment plan. The bubble has burst, but the long-term trend of investing in corporate America remains intact and full of opportunities. **$**

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stocks were completely ignored by the bull market. Individual investors were being instantly rewarded for chasing the largest stocks, and they also ignored smaller stocks regardless of how undervalued they appeared. Once the mania for large stocks was over near the end of 1998, technology and internet stocks were the recipients of investor dollars as smallcap stocks took on their lowest non-recession valuations ever measured.

This vicious cycle seemed destined to continue indefinitely – because there was no demand for smallcap stocks, they declined in value, and because they declined in value, the demand eroded further as well. Many sound, financially strong, profitable companies were seeing their stocks priced as if they were at the verge of bankruptcy. In 1999, a year that both the Dow and NASDAQ were up big, over 80% of all stocks *declined*. All the demand of the market going into a small subset of the market (internet and technology) created a dangerous imbalance.

Everyone knows what happened from there, the year 2000 saw a record decline in the NASDAQ, the wipeout of most internet stocks, and severe pain for investors that had piled most of their money into the 20% of stocks receiving all the attention. What happened to the smallcaps? Excluding internet and technology smallcaps, the smallcaps were *up* almost 20% in 2000 and the trend of 1999 was exactly reversed – most stocks were up in a big down year for the "averages". Why? Two reasons: Mergers and acquisitions and just a tiny increase in investor demand.

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The woeful undervaluation of the smallcaps allowed corporate America to take over more than 200 companies last year at bargain prices, and already this year it looks like last year's totals will be surpassed. The wipeout of the most overvalued sectors of the market sent investors scurrying for safe havens, and while largecap value stocks were the primary beneficiaries of this flight to safety – a little demand leaked through to the smallcaps.

This trend appears to be picking up steam over the first month of 2001 – a very strong month for smallcaps in a flat to declining market. The advance/decline line (number of stocks moving up versus number of stocks moving down on a daily basis) has made a sharp increase over the past two months – for the first time in over five years. Corporate mergers put a floor under smallcap valuations, but investor demand will light the fire. The market looks about six months ahead, and the economic slowdown is expected to be over by the end of the second quarter of 2001, meaning that today's market prices reflect July's economic activity. Traditionally, smallcaps have exploded after an economic slowdown, and in fact had their last big years of great performance coming out of the 1990 recession, 1991-1993. Higher risk money that has come out of internet and technology stocks is looking for the next quick buck. Right now, smallcap value stocks are the leading candidates. The economic backdrop is right, the corporate support in terms of mergers and acquisitions are there, and now with the silliness of the dot-coms a thing of the past – the path is cleared for some investor demand to kick in. Most importantly, the smallcap value universe has grown very undervalued over the past several years. Even in a flat or declining market, there should be years of great performance out of this group just getting it back to comparable valuations with the larger stocks. Small stocks have a lot of catching up to do even if the economy or market takes a breather.

It's been a long time for those of us that have been patiently waiting – but all the signs are there that the wait has ended. I believe that the 20% increase in smallcaps in 2000 will be dwarfed by the returns coming from this group over the next several years. $

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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