WIAD Newsletter

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First Half Overview 2001	June	2Q 2001	YTD
NJL	-0.42%	+7.22%	-2.01%
S&P 500	-2.43%	+5.85%	-6.70%
Russell 3000	-1.84%	+6.88%	-6.11%

What I Am Thinking - Big Picture:

Until the Fed's interest rate cuts begin to positively affect the economy, I expect the domestic equity markets to go sideways to negative for the near to intermediate term. That being said, stocks (particularly the technology and telecom sectors) that go into the 4th quarter at lower prices than they started the year may suffer significant downward pressure due to institutional mutual fund (October) and individual investor (December) tax loss selling.

I expect to use this time before the 4th quarter begins to do all my tax loss harvesting (before everyone else does) and to take the opportunity to modify and refine my portfolio asset allocation. While I will be moving some money around, net/net, in the 3rd quarter I expect to be raising some cash. I believe there will be better investment opportunities in three to five months than there are now.

For the remainder of the year I expect to significantly decrease my exposure to the international and emerging equity markets, slightly decrease my exposure to the domestic technology and telecom sectors while initiating an exposure to the electric utilities sector and opportunistically adding to my core REIT holdings. Surprisingly, I have added a small investment grade corporate bond fund to the tax-deferred portfolio (my rationale is described below). Additionally, I expect to continue holding my existing energy, energy service and financial services positions with no major allocation changes planned for the rest of the year.

What I Am Selling:

International & Emerging Markets

I am in the process of lowering the allocation to international equities from 15% to under 10% of my equity holdings. Additionally I am minimizing my emerging markets exposure. While to some this may seem like selling at the bottom, to me it is just selling a sector and an asset allocation/diversification concept that just hasn't worked. As I've always said, "hope is a poor strategy" and with the historical performance of these sectors, hope is all there is left. Over the last 5 to 10 years, international equity investments, particularly in Japan and the emerging markets, have been disappointing. It seems for every one year of extraordinary returns, there were three to five years of disappointing results. I am harvesting all my losses in this sector now and will maintain the bulk of my remaining international exposure in taxable accounts via low fee, tax-efficient vehicles like the Vanguard index and tax managed funds.

TnT (Technology & Telecom)

Obviously my TNT allocation has decreased in 2001 because prices have fallen (quite dramatically in some cases). While it is unclear where the bottom is for these once high-fliers, I feel it is essential to harvest the losses for tax purposes when available. What I am doing is selling loss positions and buying technology-oriented indexes such as QQQ/XLK/IYZ so I can realize the losses on individual positions (such as LU and T) for tax purposes yet maintain some general level of exposure in the TnT sector. As

I've said earlier, I am trying to raise some cash in the 3rd quarter, so I am not using all the proceeds of the TnT sales to buy these sector specific indexes.

While the correlation between individual TnT stocks and these indexes is not perfect, these "swaps" serve a purpose as they effectively allow an investor to side-step the 30 day wash sale rule and realize losses to offset capital gains and/or raise the basis on a low-basis position.

<u>What I Am Buying:</u>

Electric Utilities

As many of your know, I have started to build a position in electric utilities. My rationale is that the Senate Banking Committee has recently voted (19 to 1) to repeal Public Utility Holding Company Act of 1935 which is a law that that restricts ownership and operations of electric utilities. Some investors have said they expect large amounts of capital to flow into the utility sector if and when this law is repealed by Congress. One of these investors is Warren E. Buffett who has publicly stated he has $10 to $15 billion to invest in the electric utility market if this law is repealed. Mr. Buffett acquired MidAmerican Energy (76%) in 1999 and this law currently prohibits him from owning more than 5% of any other electric utility. He has taken at least one 4% position in another electric utility and it is expected that he will take positions in others if this law is repealed. With California's power crisis, President Bush has supported the repeal of this measure, and overturning this law is expected to be central element of national energy strategy that Vice President Dick Cheney is drafting. I am taking my exposure to electric utilities via IDU and GPU (WEB's 4% holding).

Investment Grade Corporate Bond Mutual Funds

A lot depends on whether you want hold bonds for the income or for peace of mind from a portfolio asset allocation perspective. If you need the income, then you have no choice but hold the bonds in a taxable account and get taxed at your current income tax rate (in this case you may want to consider munis). However, if you don't need the income and want to hold bonds for piece of mind from a portfolio perspective, holding them in your tax-deferred account is the way to go.

Investment grade bonds are boring, they are conservative by nature. The volatility of an investment grade bond portfolio is much lower than stocks; holding bonds rarely results in a loss of capital. This reason alone makes bonds a preferable tax-deferred account investment as capital losses in a tax-deferred account cannot be used to offset gains from a tax perspective. Additionally, if you hold taxable investment grade corporate bonds in a taxable account, the interest payments are taxable at your current income tax rate; this is highly tax inefficient.

When I looked at the historical performance of my international equity holdings, particularly in Japan and the emerging markets over the past 5 to 10 years, I was surprised at how poor the results were. To add insult to injury, most of these holdings were in tax-deferred accounts so the loses could not be harvested for tax purposes. This got me thinking about what kind of investments should be held in a taxable vs tax-deferred account.

Obviously, the investments you put in your tax-deferred account should be viewed as conservative, long-term investments. While tax-efficiency is not particularly important, overall price volatility must be considered. For example, volatile equity sectors like international and emerging markets equities (or technology-oriented growth stocks) are not the best investments for tax-deferred accounts. If you hold a high volatility/growth-oriented stock in your tax-deferred account, when you liquidate the position for distribution at retirement, any gain will be taxed at your *income* tax rate at the time of distribution. For most people that rate will still be north of 30%. If you hold that same high volatility/growth-oriented stock in a taxable account and hold it for the same period, at liquidation, you will be taxed at the long-term capital gains rate (20%) which is less than what most of us can reasonably expect to have as our income tax rate at retirement. Additionally, if at any time during the holding period the value of the high volatility/growth-oriented stock goes down, the taxable investor can sell the position and use the loss to offset capital gains in his or her portfolio; the tax deferred investor just has to live with the loss and the decision/motivation to sell has no tax effect.

In comparison, taxable investment grade bonds are great investments to hold in a tax-deferred account for the similar reasons. The interest/dividend payments are tax deferred until retirement distributions are required. At retirement it is likely you will be in a lower tax bracket then than you are currently. Additionally those tax-deferred interest payments can be reinvested to compound your return. If you hold taxable investment grade corporate bonds in a taxable account, the interest payments are taxable at your current income tax rate. It makes no sense to own taxable investment grade bonds in a taxable account unless you need the income.

In summary, as a taxable investor keep your high volatility/growth-oriented positions in your taxable account (pay tax at the capital gains rate and take capital losses to manage your taxes) and allocate your low volatility, income producing assets in your tax deferred account (defer paying *income* taxes until retirement and a lower income tax rate, and have a lower risk of unusable capital losses).

This is a rather long-winded explanation of why I bit the bullet, took the unusable losses, and used the proceeds from the sale of all the international equity and emerging markets positions in my tax deferred account and bought a domestic intermediate investment grade bond fund (FSIBX). All my taxable investment grade bond exposure will be taken in the tax-deferred account going forward.

What I Am Holding:

REITs

As may of you know I have liked this sector very much as an alternative to bonds, however it has become extremely expensive. Obviously, there are new and perhaps non-traditional buyers in the market. While I am not a seller of REITs here (it would be impossible to replace the income at the same level of risk), I am not a buyer at current levels either. If the non-traditional/hot money buyers exit the market, I am a buyer of all the names in my existing REIT holdings if prices decrease 10% to 20% from here. In the meantime, I am considering hedging my existing REIT position with a short position in a REIT exchange traded fund (ETF). The dividend distributions on the ETF are surprisingly low compared to my holdings so it could be a great $ price hedge for the aggregate REIT position.

Summary:

This newsletter is meant for taxable individual investors who are, or plan to be, full time investors for their own account. As you may know, studying the market and working from home can be very isolating from an investment management and idea standpoint. To be a good investment manager, I think it is important to talk to people with different opinions and views on the markets. I hope the distribution list for this newsletter reaches a diverse group of investment viewpoints and opinions. Tell me what you agree and disagree with.

WIAD means "What I Am Doing". This newsletter is intended to be an overview of my thoughts on market conditions and investment portfolio strategy and is meant to generate discussion, input and ideas from those of you who care to share your perspective.

In this issue we began to discuss taxable vs tax-deferred asset allocation, tax efficiency and sector allocation fine-tuning. In future issues I expect to discuss these topics more deeply as well as topics such as active vs passive investment management, the impact of taxes, fees and expenses on investment returns, estate planning and other topics relevant to the taxable individual investor.

If you like these initial efforts, please let me know. Any and all feedback would be appreciated and encouraged. However, if you do not find receiving this newsletter useful, please tell me and I will take you off the distribution list.

Let's hope for a negative split in 2001.

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