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SEMPER AUGUSTUS
Investments Group LLC

CLIENT LETTER July 12, 1999

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Large Cap Stocks Still Overvalued: Some Bargains in Small Caps and Mid Caps

The U.S. capital markets ended the June 30, 1999 quarter with the Federal Reserve raising its Federal Funds rate by ¼ percent and with the popular large cap stock indices surging to all-time highs.

The most recent four-and-a-half years have been unprecedented in terms of wealth creation relative to the size of the output of the domestic economy.

A staggering $11 trillion has been added to the total market capitalization of the U.S. stock markets (NYSE, NASDAQ, and Amex). The value of all publicly traded stocks has passed $16 trillion and is nearly twice the size of U.S. nominal GDP ($8.5 trillion). Until the recent bull run, the value of all U.S. stocks has never exceeded the value of the economy. In fact, prior highs established in 1929 and 1968 valued stocks at 87 percent and 77 percent of the value of GDP, respectively. Both periods represented major secular peaks in stock prices as stocks declined 89 percent from September 1929 to June 1932 and dropped 48 percent from November 1968 to December 1974.

Contrary to popular belief, the tripling of the stock market wealth in the last four-and-a-half years did not result from the majority of stocks leading the market higher. During this period of 20-plus percent annual returns for the "markets", more stocks have declined than have advanced. The real "Phantom Menace" is in stock prices, not in the movie theaters. At Semper Augustus Investments Group LLC, we track the breadth of the markets on a daily and weekly basis for a number of exchanges and indices. Breadth simply measures the number of stocks moving up less the number moving down. A healthy bull market would be characterized by the "market" making new highs confirmed by healthy breadth. Today's market has bad breadth.

The Dow Jones Industrial Average and the S&P 500 do not reflect returns for the vast majority of stocks over the last few years.

Breadth on the major exchanges and indices was fairly strong until the Spring of 1998. From May 1998 through October 9, 1998, stock prices across the board collapsed with the average stock dropping over 35 percent. Breadth during this stretch was horrible as decliners outpaced advancers by a large margin. With the Fed's three rate cuts last fall, the "markets" rebounded significantly. The Dow Industrials and the S&P 500 rose over 50 percent from their October lows.

Eerily, over the last 9 months, breadth has not improved. The advance has been contained to a mere handful of very large cap stocks and a basket of internet stocks. The collapse in breadth has erased the average stock's gain since 1994. We attribute the narrowness of the advance to a number of factors.

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Rear View Mirror Asset Allocation

Investors, both institutional and individual, tend to be rear view mirror allocators of capital. They review lists of the best performing mutual funds in newspapers or the best performing managers as ranked by consultants, and then allocate money to those managers. S&P 500 index strategies have been the best performers in recent years and have thus attracted the most capital. Individuals are now investing 60 percent to 70 percent of inflows in index and large cap growth funds and are pulling money out of under-performing small and mid cap funds. Small cap funds had inflows of $20 billion in 1996, $15 billion in 1997, $4 billion in 1998 and have actually experienced outflows of $12 billion through the end of May.

Institutional investors have invested the same way as the retail fund buyers. Pension fund consultants, for example, are notorious for recommending the replacement of under-performing managers. Those same consultants had initially recommended hiring the manager now being fired. Managers get hired *after* good performance and fired *before* good performance, all to the detriment of long-term performance for the client. As money flows to large cap indexers or quasi-indexers, the prices of index components generally rise. To the extent that money flows out of under-performing funds or styles, those underlying stocks experience selling pressure.

Size Matters

The second reason for market narrowness is the enormous size of today's pools of capital. Big institutional managers are too large to practically buy smaller companies. Warren Buffett, one of the most successful investors of all time, currently sits on $15 billion cash at Berkshire Hathaway, waiting for reasonable prices to buy good companies. Buffet acknowledges that he has too much money to buy attractive small cap stocks without overdiversifying and diluting his good ideas.

Investment styles come in and out of favor.

As an example of size dictating a narrowing market, a pension system with $10 billion in assets might have been half that size five years ago with 50 percent ($2.5 billion) in stocks and 50 percent ($2.5 billion) in fixed income securities. The $2.5 billion in stocks may have been diversified among 10 managers (judiciously chosen and recommended by the consultants, of course), with each manager representing a different style and each entrusted with $250 million.

Now assume a statutory or policy-driven 60 percent cap on stocks where distributions from the fund equal income on plus contributions to the fund. If the pension's 10 equity managers (representing index, large cap value, large cap growth, small cap value, small cap growth, etc.) averaged 25 percent returns for five years, the system would have grown from $5 billion to $10 billion and would now have $7.5 billion in stocks and the same $2.5 billion in fixed income securities. The pension by statute or by policy would be required to rebalance back to no more than 60 percent in stocks. The pension will be required to take $1.5 billion from its equity managers and invest the proceeds largely in bonds.

A couple things have happened. Because of the aversion of investors to place more than, say, $250 million with a single active manager, the new equity allocation of$6 billion would require 24 managers. Too many. Most systems have utilized S&P 500 indexation as a core with a handful of active managers at the fringes. The system could still have 10 managers at $250 million each with the remaining $3.5 billion indexed. Effectively, this takes gains from active managers (easy decision because they've grossly under-performed from 1995 to the present) and transfers the proceeds into the index components. Result: index members, especially the largest components, up; and the more thinly traded small and mid cap stocks down.

Impact of Rebalancing on Other Markets

An interesting sidebar to this virtuous tragedy has to do with the "rebalanced" cash from stocks to bonds. Assuming the pension system in our example does not change its policies or statutes to increase the allowed stock allocation then that money has to go largely into bonds. An enormous amount of money "rebalanced" in recent years.

We have not seen any discussion in the financial press, but believe the sums are awesome. It is startling that the US government has theoretically balanced its budget and is no longer a net borrower. That means the US Treasury is not sopping up the excess capital from rebalancing. Corporations and US government agencies are. The credit stock on the corporate and mortgage side of the nation's debt books have ballooned.

As this discussion is focused on the stock market we won't get into the implications of the massive growth in debt or the credit worthiness or economic viability of what is being financed. Suffice it to say, however, that the next recession, probably kicked off by a sustained and substantial decline in the stock market, may be one heckuva doozie.

The third reason few stocks are participating on the upside and many on the downside is the nature of the indices themselves. The most popular U.S. stock market, the Dow Jones Industrial Average (DJIA) is an index of 30 very large and historically industrial companies. The components have evolved as financial, drug, and technology companies are more represented than in the past. The index, while widely quoted and followed, does not have much of a practical use. As a price-weighted index, the highest priced stock in the index represents the largest component. As such, index funds do not often replicate the DJIA. However, the various stocks included in the DJIA are well represented in the Big Kahuna of indices: Standard and Poor's 500 index.

The S&P 500 is the most benchmarked and indexed index. As a market cap-weighted index the largest companies by market cap (price of stock times number of shares outstanding) have the largest representation in the index. The top 10 companies currently account for 21.8 percent of the index.

As of July 12, 1999 the top weightings include:

STOCK	COMPONENT WEIGHTING
Microsoft [MSFT/NASDAQ]	4.0 %
General Electric [GE/NYSE]	3.3
Int'l Business Machines [IBM/NYSE]	2.1
Wal-Mart [WMT/NYSE]	1.9
Cisco Systems [CSCO/NASDAQ]	1.9
Lucent Technologies [LU/NYSE]	1.9
Intel [INTC/NASDAQ]	1.9
Exxon [XON/NYSE]	1.7
AT&T [T/NYSE]	1.6
Merck [MRK/NYSE]	1.5

The top 50 companies represent 56.2 percent of the value of the S & P 500. Microsoft, the largest component has a recent market cap of $470 billion, giving an implied market cap to the S&P 500 of roughly $11.6 trillion. This means the S&P 500 represents about 73 percent of the value of the entire stock market with over 11,000 traded companies. In addition, Microsoft represents 11.6 percent of the NASDAQ, giving the OTC market an implied value of $4 trillion. Sales at Microsoft in 1999 should be close to $18 billion. That's a fairly small number relative to its market value, despite roughly $7 billion in projected net income.

The cap-weighted nature of the index is significant given the substantial flows to index portfolios. For every $100 invested in an S&P 500 index fund, $4 *must be* invested in Microsoft, $3.30 in General Electric, $2.10 in IBM, etc . . .

As more and more money flows into index funds, the majority of that capital is allocated to fewer and fewer stocks regardless of the investment merit of those companies. We would expect the best performing stocks to have been the largest components of the index.

COMPONENT OF S&P 500	RETURNS FOR 1998
Largest 10 stocks	+38.5 %
Largest 100 stocks	+31.4 %
Next 100 largest stocks	+13.8 %
Middle 100 stocks	+7.1 %
Smallest 100 stocks	-3.6 %

If the component members of the S&P 500 were equally weighted in the index instead of market cap-weighted, the return of the index would have been only 10.8 percent versus 27.7 percent. In 1998, the twenty-five largest companies accounted for 15 percent of the 26.7 percent gain. Without the twenty-five largest the index gain would have been a mere 11.7 percent. Results have been similar over the last four and a half years. Other cap weighted indices (that are also replicated by index funds to some extent), such as the NASDAQ composite and the Frank Russell indices, have had large component outperformance as well.

By allocating capital away from those stocks we find grossly overpriced and into companies that meet our stringent criteria, we think our investors and clients will be rather happy and prosperous over the long haul.

Recent Discussions:

Energy/Energy Services

March 23, 1999 Letter:

Diamond Offshore

Schlumberger

Transocean Offshore

In This Letter:

Broad Market Profile

HISTORICAL IMPLICATION OF BREADTH

The astonishing tiering of the markets has happened before. Breadth was extremely negative in the two years prior to the 89% decline from 1929 to 1932. Most investors crowded into stocks that continued to gain in the later stages of the advance. Those same stocks experienced the brunt of the decline when the leaders became losers.

The tiering was pronounced in the late 1960's and early 1970's during the heydays of the "nifty 50." The theory advocated buying the 50 fastest growing companies and holding forever, implying investors could pay any price and ultimately be okay.

During 1966 the DJIA traded as high as 1000 (995 to be exact) and fell to 577 in 1974 and 776 in 1982. These declines, of 42% and 22% over 8 and 16 years respectively, were devastating. In light of the erosion of purchasing power due to the high inflation of the 1970's which averaged over 9% for many years, an investor owning the "nifty fifty" in the late 60's lost nearly 80% of purchasing power over 16 years. That decline of purchasing power was actually worse than the 89% decline experienced by stock-market investors from '29-'32 because the cost of living (CPI) declined by 25% from '29-'33. Either way you slice it, an investment needs to grow fivefold to tenfold to recoup 80% to 90% losses, respectively.

The erosion of breadth and the woeful relative underperformance of small and mid cap stocks can not continue forever. In fact, we are quite happy about the tiering in the marketplace. We are finding opportunities. Excellent companies are priced rather reasonably.

OPPORTUNITY EXISTS TODAY

For all the reasons described above, many stock prices have dropped significantly despite healthy business prospects and solid fundamentals. These fundamentals drive our estimation of the intrinsic value of a business. We are currently buying smaller companies whose stocks are trading below our estimates of intrinsic value, or our estimate of the price a private investor would pay for the company in a private transaction.

By allocating capital away from those stocks we find grossly overpriced and into companies that meet our stringent criteria, we think our investors and clients will be rather happy and prosperous over the long haul.

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