MEMO

From the Desk of Robert Zevin

Re: Investment Policy Review

Date: 2/8/99

In early October, I was still moving your portfolio away from stocks. In retrospect, starting exactly then, it would have been best to be 100% in stocks. The reasons stocks rebounded are clear although my mind was slow to grasp the entire picture. The Federal Reserve Bank and the central banks of Europe were providing ample amounts of new money at lower interest rates to ease panic in financial markets. Japan was well on its way to achieving reform of its banking system and initiation of Keynesian stimulus of its economy. China had clearly weathered the storms all around it without a setback to its rapid growth or a devaluation of its currency. Korea and Thailand were already exhibiting powerful growth in exports as a consequence of their devaluations. The U.S. economy was growing robustly with no more than a nod to the obstacles presented by the rest of the world's distress.

Perhaps even more to the point the discussion by leading multinational agencies, governments, central bankers, economists and journalists was about the threat to the world from deflation and depression and the urgency of addressing it. Many of the good outcomes observable by early October were a consequence of this kind of thinking. By contrast, in 1929-1931, the analogs of all these participants were generally still concerned about holding the line against inflation and about adequately punishing and discouraging excessive speculation.

Inflation remains low. Interest rates are lower than they were in the first half of 1998. The demographics of the populations of most developed countries remain quite favorable for savings over consumption for another nine or ten years. These have been the strongest supports for the entire market increase of the past ten or fifteen years. Prices of large multinational American growth stocks are now about as high as they were when I expressed concern in July. The passage of time, the resolution of some problems and lower interest rates all support higher values today. Which is not to say that today's values are still not too high. The one area that appears to be caught up in a speculative mania beyond question and well beyond rationality is the group of Internet stocks.

In July I suggested that the stock market had not yet reflected the collapse of the American model for global development. That claim no longer appears tenable. Hong Kong, Russia and Malaysia have already rejected the model with vigor and financial market approval. And just recently Brazil brought cheer to its own and global equity markets by doing the same. Those countries that never followed the model in significant ways, notably China, have increasingly been recognized for their success.

I conclude that some stocks are wildly overpriced. Many of the most important U.S. companies are certainly quite generously priced, so that they are unlikely to earn much more than the 5% available from bonds over the next ten years. Finally, there are still attractive opportunities in Asia, Latin America and Europe and among smaller companies in the United States. Many of these stocks are not selling at extraordinarily high prices although they offer participation in economies and industries that are growing much faster than U.S. national income.

Since late October, I have been increasing the proportion of your portfolio in equities. New investments have been concentrated in the healthcare and telephone industries, since both have prospects of rapid global growth relatively independent of a possible recession. Many new purchases are in Asia or Europe and quite recently South America and many are in smaller U.S. companies with extraordinary growth potential.