STELLAR
CAPITAL MANAGEMENT, LLC

Economic & Market Commentary

Out with the Old and in with the New?

The financial markets have effectively divided companies into two categories: "New Economy" and "Old Economy." In short, the New Economy represents technology, and the Old Economy represents most everything else. For the last six-months they have moved in opposite directions, and with the exception of the last week in March, New Economy stocks have gone up while Old Economy stocks have gone down. This phenomenon is especially evident when one looks at the performance gap between the technology heavy NASDAQ and the Dow Jones Industrial Average. So then, why not dump all the Old Economy stocks in favor of the New Economy stocks that are currently so hot? Well, although the markets and media would like us to believe that these New Economy stocks are impervious to business cycles, Federal Reserve action, or any of the other perils that affect Old Economy stocks, they in fact are not. When the hype of old versus new dies down, the investment merits of a company will be determined by tangible measures.

One reason behind the quick run-up of some of the big winners, is momentum. That is, investors chasing winners and fleeing losers. This type of action exaggerates price moves in each direction, and increases the underlying volatility of individual stocks. When money flow is redirected from large companies to small companies or when investors sell stock in a large company to buy a stock in a small company, you get a disproportionate effect on the price of the two stocks. Since the real money flow as a percentage of total capitalization for these firms is different (i.e., a lower percentage for large companies and a higher percentage for small companies), the money flow has a larger impact on smaller companies. The change in money flow has a less dramatic effect on larger companies, but as you might expect, when sellers outnumber buyers, stock prices have a tough time going up. That explains in part why we have seen tech stocks soar while non-tech stocks wither.

An article I recently wrote for a publication called *Media Investor* titled "Momentum Investing," highlighted this issue, and drew attention to the fact that momentum is like a double-edged sword...it cuts both ways. Imagine a crowded popular restaurant with only one entrance. On a normal day, no one thinks there is a great risk in being in this environment. However, if a fire broke out, everyone would run for the same door at the same time. As you can imagine, not everyone may be able to get out on time. Such is the case when momentum moves against an investor, it can get ugly.

In our opinion, the rapid price gains in some areas of the stock market have been based on hopes and dreams, with the prospect for profits decades down the road. In the past, when stock values have discounted sales and earnings this far into the future, disappointments have typically followed. With that in mind, we have controlled our exposure to stocks in the New Economy to companies with higher quality balance sheets and income statements. We have participated in the success of those industries, but in a more conservative manner, and as part of a prudent diversification strategy. There are many fine companies classed as Old Economy that will help shareholders earn respectable rates of returns over longer periods and many are selling as cheap as the New Economy stocks are rich.

With the exception of oil prices, which seem to be settling down, and the unrelenting nature of Alan Greenspan's Federal Reserve, I am optimistic regarding opportunities in the investment markets. We have a healthy flow of money into the financial markets, and with the exception of a few industries, share prices remain at attractive levels.

Steve Taddie
President
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