December 2000

Since the November 7th U.S. presidential election the Nasdaq stock market has been in a virtual free fall. While the contested (and as yet unresolved) election triggered the decline, the basis for the market collapse was rooted in the combination of the extreme overvaluation of leading technology stocks plus three major fundamental developments within the technology sector:

1) the deceleration in the growth rate of demand for personal computers
2) the overbuilding of capacity and services within the telecommunications sector
3) the collapse in the IPO market for internet-related companies

In order to most accurately assess the effects of market declines such as this our analysis begins with a factual look at what has happened:

- The Nasdaq began a bear market in March of 2000, about eight months ago.
- The Nasdaq index is dominated by very large cap technology stocks.
- The S&P 500 and the NYSE index have suffered declines typical of corrections (declines of 20% or less).
- The IPO's associated with the Internet and the telecomm buildup have been smashed.
- The rate of growth in the U.S. and world economies is clearly slowing.
- The Federal Reserve is maintaining a tight, anti-inflation monetary policy (however Fed Chairman Greenspan's testimony on December 5th hinted at a change in policy).
- The U.S. dollar remains strong.
- Worldwide energy prices have increased sharply this year.

Earlier this year the Nasdaq entered a bear market, as defined when the index declines by 20% or more. The Nasdaq has now declined by about 50% from its high reached only nine months ago. While no one seriously disputes that the Nasdaq has entered a bear market, the central question is now whether the bear market is cyclical or secular.

Cyclical or Secular?

This issue is of major importance for investors. A cyclical bear market typically lasts 6 to 12 months while a secular bear market can last 3 to 5 years. A secular bear market in the Nasdaq would have profound implications for the U.S. economy and the stock market. The primary reason concerns the makeup of the Nasdaq, which is dominated by those companies which have been at the forefront of wealth creation in the United States and the world over the past decade. These companies include but are not limited to Microsoft, Cisco, Intel, Worldcom Inc., Oracle, Sun Micro, Dell, Yahoo, and many others. If these stocks enter a secular bear market this would strongly suggest that the U.S. economy is entering a period of slower growth. Further, the leading Nasdaq stocks are great companies not only in terms of products but also in terms of management execution and employee stock ownership. The progress of the technological revolution would be slowed, perhaps halted. It is hard not to overstate the importance of these stocks/ companies to the world economy and the stock markets.

While the severity of the decline argues that the Nasdaq bear market is secular, there are numerous other data which suggests it is simply too early to make such a forecast. There is little question that the present decline is a severe one; the last such decline occurred in the late stages of the great bear market of 1973-1974. The key factors mitigating against a secular case are the lack of validation by other leading indexes, such as the S&P 500 and the NYSE index, the quality of the leading Nasdaq companies, the ability of the Federal Reserve to cut interest rates from here, and the nature of the decline itself. So long as the market decline is contained primarily to the Nasdaq and the economy does respond to likely easing by the Fed, the Nasdaq bear market is likely to remain cyclical.

The pattern of the decline so far suggests a cyclical bear market. The speed of the decline since November 7th reflects highly disruptive market conditions, including margin calls. Last Thursday, November 29th, had most of the characteristics of a selling climax, including the second-highest daily volume in Nasdaq history and an extreme up/down volume ratio. A selling climax occurring in the eighth month of a decline is within the time frame of a cyclical bear market.

There are three epicenters of the decline. Each of these is relatively narrow in scope and may not cause lasting effects on the rest of the market. First, the initial public offering (IPO) market has collapsed. As reported on December 4th in the Wall Street Journal, 70% of the 439 new IPO's issued this year are now trading below their offering price. Last year, only 20% of the 534 IPO's fell below their offering prices by year-end. Second, the marquee names in the Internet sector have collapsed. Internet Capital Group and CMGI, two leading Internet investment holding companies, have seen their market capitalizations collapse from a peak of $56 billion and $52 billion to current values of $1.5 billion and $3.2 billion, respectively. Yahoo's market value has collapsed from a peak of $138 billion to $21 billion currently. Priceline.com has collapsed from $17.7 billion to $411 million. Third, the telecomm sector has been smashed. The most notable declines have occurred among the data-oriented CLEC's (competitive local exchange carriers). Covad has seen its market cap decline from a peak of $11.9 billion to $373 million, Northpoint Communications from $4.7 billion to $71 million, and Rhythms Netconnect from 3.9 billion to $87 million. (See *Exhibit A*.)

We recall declines of this breadth and magnitude in 1974 and 1983. It is not necessarily true that these declines poison the investment environment in the following years. In 1974 many small cap stocks suffered similar percentage declines; yet the seven years after 1974 were among the best ever for small cap stocks. If the careful investor avoided the carnage in 1983 by remaining clear of the most egregiously overpriced stocks, the following several years offered one the opportunity to identify and invest in truly great technology companies.

Debt Levels are a Key Factor

The key to whether the catastrophic declines cause market disruptions beyond the direct effect lies in how much debt was accumulated against the equity market values. The reason debt levels are so important is that debt must be repaid; the collapse in equity values means that this repayment may be in doubt. In this there are two areas for analysis: debt against the companies themselves and debt against the shareholders of the companies. Clearly the high debt levels are centered around the telecomm equipment and service companies. In two years mighty AT&T's debt has gone from $6 billion to $60 billion and threatens to disrupt the pending breakup of the company. The lenders cannot yet decide which piece of AT&T should take which amount of debt. We expect numerous CLEC's and equipment makers to file for bankruptcy reform. This could precipitate a credit cycle, in which the process of lenders upgrading credit standards causes an economic dislocation. Debt is also created by individual shareholders borrowing against their stock holdings which is referred to as margin debt. Margin debt can be easily quantified. Margin debt has been rising rapidly over the past two years; the practical effect of the recent wave of margin calls (forced selling of securities to cover margin debt) has been to rapidly and painfully reduce excess margin debt. The other source of shareholder borrowing has been pledging of stock as collateral with lending institutions for housing and large luxury items such as jets. We believe this could significantly depress economic activity but are unable to quantify it at this time.

The Federal Reserve and U.S. fiscal policy will play a major role in containing the damage from the market this year. The question is no longer if the Fed will ease but when. The Fed must move to ease before a full-blown credit crunch develops. Market conditions are already moving ahead of the Fed; short-term Treasury Bill rates are beginning to decline to levels below the Fed Funds rate. Fiscal policy, in the form of tax cuts, may also be necessary to offset the depressing effects of stock market losses, a credit squeeze, high-energy prices, and rising budget surpluses.

Disciplined Growth Investors' Strategy

Our strategy during this period of uncertainty has two elements. We have looked at each of our holdings. Where the stock has an above-average valuation we have verified the current business strategy of the company. Where the company may face deteriorating profitability due to macroeconomic conditions we have looked for downside protection in the form of balance sheet assets and/or extreme low valuations. We are also continuing to evaluate whether the Nasdaq bear market is cyclical or secular. If the Nasdaq bear market is cyclical then the low reached on November 29th should serve as the selling climax. The technological revolution will continue and provide investors with opportunities to exploit individual stocks.

Exhibit A

Technology Companies

Company Name	Symbol	12/1/00 Mkt Val ($Mil)	Peak Mkt Val ($Bill	% Decline	Loss in Mkt Val ($Bil)
INTERNET CAPITAL GRP	ICGE	1,588	56.1	-97%	54.5
CMGI	CMGI	3,230	52.3	-94%	49.1
RED HAT	RHAT	1,055	24.4	-96%	23.4
ENGAGE	ENGA	368	18.6	-98%	18.3
PRICELINE.COM	PCLN	411	17.7	-98%	17.3
VA LINUX SYSTEMS	LNUX	468	16.9	-97%	16.4
MARCHFIRST	MRCH	221	12.6	-98%	12.4
PSINET	PSIX	239	11.7	-98%	11.4
VENTRO	VNTR	89	11.2	-99%	11.1
DIGITAL ISLAND	ISLD	287	10.9	-97%	10.7

Telecommunications Companies

Company Name	Symbol	12/1/00 Mkt Val ($Mil)	Peak Mkt Val ($Bil)	% Decline	Loss in Mkt Val ($Bil)
COVAD COMMUN GRP	COVD	373	11.9	-97%	11.6
GLOBAL TELESYSTEMS	GTS	233	7.1	-97%	6.8
TELIGENT	TGNT	129	6.4	-98%	6.2
NETRO	NTRO	503	6.1	-92%	5.6
ADELPHIA BUS SOLUTNS	ABIZ	288	5.0	-94%	4.7
FOCAL COMMUNIC	FCOM	553	5.2	-89%	4.6
NORTHPOINT COMMUN	NPNT	71	4.7	-98%	4.6
RHYTHMS NETCONNECT	RTHM	87	4.0	-98%	3.9
NETWORK PLUS	NPLS	232	3.9	-94%	3.7
VIATEL	VYTL	246	3.8	-94%	3.6

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