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I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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MARKET CYCLES

Growth Versus Value

Stock market indicators such as the Dow-Jones Average and the Standard & Poor's Index often obscure well-defined trends within the market. The rotation between growth and value segments is one of the most documented trends. The growth segment, comprised of companies with above-average earnings growth and price-book valuations, currently include large capitalization companies such as General Electric, IBM, Intel, Microsoft, Pfizer, and Wal-Mart. The value segment, on the other hand, consists of more mature companies with moderate earnings growth and below-average price-book ratios. Financial and industrial companies such as American Express, Bank of America, Boeing, Chevron, General Motors, and Honeywell dominate the value segment.

Over time the composition of each segment can change. A number of today's value stocks were yesterday's growth stocks and vice versa. This occurs when growth stocks experience periods of decelerating growth with contracting valuations and shift into the value category. Conversely, when a value stock's earnings accelerate and its valuation expands, it can become a growth stock. Since 1926, when investment returns were first documented, the value segment has generated higher returns than growth with 12% average annual returns compared to 10% for growth.

This was not the case, however, during the last market cycle, which began October 1990 and ended September 2001 (See Chart I). Even though both segments rose in tandem during the first six years, a disparity developed in 1997. During the next several years, the disparity became quite pronounced (See Chart II). Between January 1998 and March 2000, the Standard & Poor's 500 Index rose 57%. The growth segment, led primarily by technology stocks, expanded by an incredible 91% while the value segment increased only 24%. This aberration at the end of the 20th century created an unprecedented imbalance between the two sectors. As a result, growth stocks became extraordinarily over-valued relative to both the balance of the stock market and the value segment.

CHART I
Growth & Value Stocks
Oct 1990 - Sept 2001

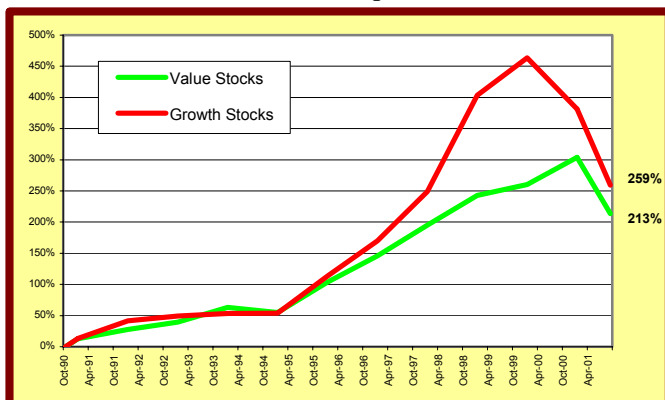
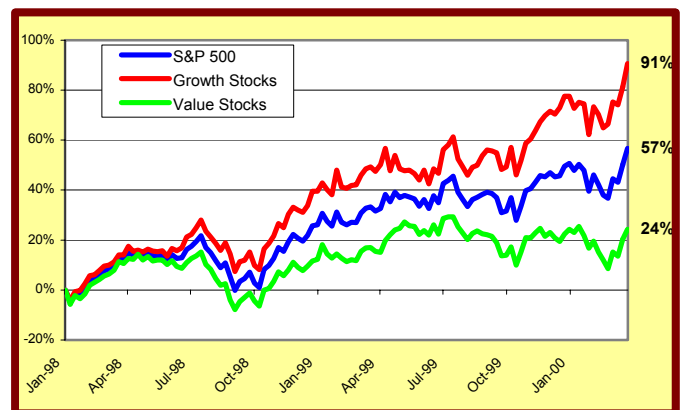
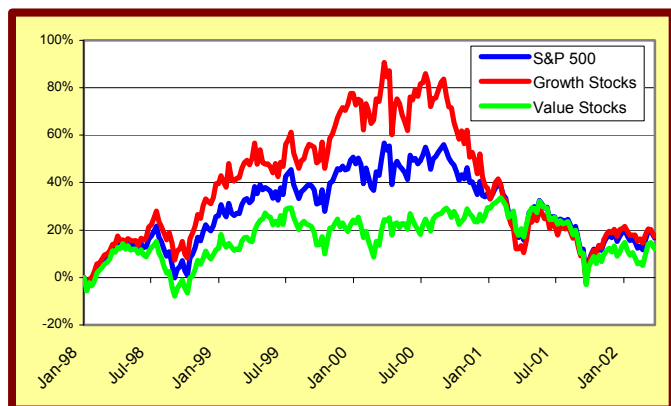


CHART II
S&P 500, Growth & Value Stocks
Jan 1998 - Mar 2000



The ensuing bear market that began in March 2000 fell to a trough in the aftermath of the September 11th attack and undid most of the excessive valuations that developed in the growth sector. It is interesting to note that from January 1998, when this speculative bubble in growth stocks was exacerbated, through March of this year, the cumulative return for both the growth and value segments was similar (See Chart III). Thus, it appears that a good deal of the excesses in the growth sector that developed in the 1998-2000 period has been removed.

CHART III
S&P 500, Growth & Value Stocks
Jan 2, 1998 - Mar 26, 2002



INVESTMENT STRATEGY

Balance between the growth and value sectors needed to be restored in order to set the foundation for the next cyclical advance in stock prices. This process began during last year's fourth quarter. Further stock market gains are expected as confidence builds in a recovering economy.

Why, then, in the recently completed first quarter, did the stock market's recovery lose so much momentum? First, as pointed out in last quarter's *Newsletter*, it is normal for successive quarterly gains off a market trough to decelerate.

Second, stock valuations were unusually high at the outset of this market recovery. Over the last four-plus years, stock prices advanced 17% while corporate profits remained essentially unchanged. As a result, the Standard & Poor's 500 Index is selling at 23 times earnings projected for this year and 21 times projected earnings for 2003. This compares to a normal range of 15 – 23 over the last ten years and a high of 22 coming out of 1991's recession level earnings. Also, investors should be aware that a good part of this year's earnings result from a change in accounting rules.

Third, profit recovery in 2003 is expected to be more moderate than that experienced in prior economic expansions. Next year's projected 11% advance in earnings is quite modest compared to the 20% gain in 1992's profit recovery.

With that said, stock market gains should resume during the balance of the year as investors gain confidence in the economic recovery. As a matter of fact, economists have already made a number of upward revisions to the business outlook for this year. This should also lead to upward revisions in earnings projections, and current valuations should become less of a concern.

Nevertheless, expectations for 2002 should be realistic. Investors should not expect the market's recovery to be as robust as in prior market rebounds. The gains will be tempered by modest profit growth and concerns that the Federal Reserve may raise interest rates later in the year. This could impact the overall stock market, and in particular, the more interest rate sensitive sectors.

Therefore, trends within the stock market and valuations relative to earnings growth should be more important in 2002 than the magnitude of the overall stock market advance. Diversification amongst industry sectors may need adjustment from time to time to respond to sectors that become under-valued or over-valued as the economic recovery broadens. While earnings prospects for industrial companies should improve, valuations should still be monitored for becoming extended.

Technology stocks have become just as "out-of-favor" in 2002 as they were "in favor" during their 1998-2000 rise. There continues to be excess capacity in this sector, and its recovery will require patience. Nevertheless, technology should have above-average earnings growth in 2003, and adding to this sector in anticipation of next year's growth could be timely.

TABLE II
Market Performance Comparison
(Including Interest and Dividend Income)
*Year to Date**

MARKET INDEX	12/31/01	3/29/02	Return
Standard & Poor's 500	1,148	1,147	.3%
Dow Jones Average	10,022	10,404	4.3%
NASDAQ	1,950	1,845	-5.4%
EAFE Index	1155	1156	.1%
3 Mth U.S. Treasury Bill	1.7%	1.8%	.4%
10-Yr U.S. Treasury Bond	5.0%	5.4%	-1.4%
10-Yr AAA. Tax-Exempt Bond	4.4%	4.5%	.4%

*Estimate

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