

FORECASTS & TRENDS

STRATEGIC ANALYSIS OF THE ECONOMY & INVESTMENTS

Issue 289

December 2000

INSIDE :

1. **The Economy -- GDP Cools To 2.4% Annual Rate In The 3Q. No Evidence Yet That A Recession Is Imminent Or Even Likely In 2001.**
2. **Fed Set To Ease -- Alan Greenspan Says Fed Bias Is Now Toward Lower Rates.**
3. **Stocks In A Freefall? -- With The Nasdaq Down 50% At One Point, Is This A Bear Market? Or Are We Near A Major Bottom?**
4. **ProFutures Dynamic Allocation Program -- The Professional Way To Invest In Mutual Funds (pages 6-8).**
5. **Futures Funds -- The Diversified & Alternative Funds A Had Strong Month. Long/Short Growth Fund Resumes Trading.**

Gary D. Halbert,
Editor

Subscription Rates:
1 year-\$197-12 issues

Internet:
mail@profutures.com
www.profutures.com

ECONOMIC & INVESTMENT OVERVIEW

The U.S. economy continues to slow down. The latest report from the Commerce Department put GDP growth at an annual rate of only 2.4% in the 3Q, as compared with 5.6% in the 2Q and 4.8% in the 1Q. Elsewhere, durable goods orders fell 5.5% in October to the lowest level in more than a year. Consumer confidence fell by 1.7% in November. These and other reports confirm that the economy has finally slowed down to a pace that is well within the Fed's non-inflationary target. However, there is still no reason to believe that a recession lies ahead.

It is now widely expected that the Fed will lower interest rates soon after the first of the year. I would expect this to be the case, but only if there is more confirmation that the economy is growing at a slower, non-inflationary pace. There is also speculation that we could have a new Fed chairman next year, especially under a Bush administration (possibly Lawrence Lindsay). It will be interesting to see how this plays out.

The stock markets continue in turmoil with the tech sector in a virtual freefall. The Nasdaq Index plunged 50% from its all-time high on November 30th. As troubling as the recent selloff has been, the tech sector had been extremely over-valued, and the latest decline has gone a long way toward correcting the excesses which occurred during the upward blowoff period in December - March. The Dow Jones and the S&P 500, by comparison, are only down 11% and 14%, respectively, from their peaks. It will not surprise me if we are witnessing a great buying opportunity in stocks as you read this. In this issue I will discuss a strategy for getting back into the stock markets and mutual funds now that values are more reasonable.

With the economy slowing down, and with the Fed expected to lower short-term rates soon after the first of the year, bond yields would now appear to have more room to fall. However, with 30-year yields down to 5.6% or below, I would not chase this market if you are not already in it.

The Diversified and Alternative Funds gained approx. 2½% and 2%, respectively, in November. The Long/Short Growth Fund resumed trading on December 1st under the management of three new Trading Advisors.

Stocks: Buying Opportunity Or Bear Market?

Cautious Group

If the phone calls and letters I've been receiving lately are any indication, most ProFutures clients believe we are now in a bear market in stocks. Most also believe we are headed for a recession. Many of these same people have believed we were headed for a recession and a bear market for several years and as a result, missed out on the historic advance in equity prices over the last few years.

Each year we survey 500 randomly selected clients and ask many questions about their likes and dislikes, their investment criteria, their objectives, etc., and we ask for their views on the economy and the stock markets. Generally speaking, and based on these surveys our clients are a cautious group. More expected an economic slowdown or recession for the last several years, as opposed to a continuation of the current economic expansion. More also expected a serious correction or a bear market in stocks to unfold, as opposed to a continuation of the bull market as we have seen.

Not surprisingly then, the surveys showed that most of our clients are significantly under-invested in equities. Most have had a sizable portion of their portfolio in cash (money markets) or in bonds, waiting for what they felt was the inevitable serious correction or bear market in stocks. As a result, many clients have been waiting on the sidelines for several years for an opportunity to get back in the market.

Is That Opportunity Unfolding Today?

There are those clients who are going to be perennial bears, no matter what I might argue to the contrary, and no matter how cheap stock prices might become. However, in this issue I am going to make a case that the current downturn in stock prices, while perhaps not over yet, offers a great opportunity to reposition your portfolio with a more normal allocation to equities and mutual funds.

Picking bottoms in market corrections or bear markets is virtually impossible, and I am the first to

admit that. However, anytime we have a significant move down in a market, such as we have seen since April and especially over the last two months, I believe it is imperative to at least consider that a major bottom could come in the period just ahead. And I believe that you should develop a specific plan of action that you will implement should there be indications that the latest correction is over. This is especially important for clients who are significantly under-exposed to equities and have been waiting for an opportunity to invest at more reasonable values.

In the pages that follow, I will discuss the outlook for the now slower economy, the current status of the stock markets and a strategy for re-entering the stock market should you decide to do so.

The Economy: Soft Landing Or Recession?

Most economic forecasters have predicted that the US economy would slow down for over a year now, but it continued to surprise on the upside. While the economy has proven to be much stronger than most economists forecasted, the latest report on Gross Domestic Product is definitive - a slowdown has finally occurred.

The Commerce Department's preliminary estimate put 3Q GDP growth at a 2.4% annual rate. That follows annual growth rates of 5.6% in the 2Q and 4.8% in the 1Q. The latest GDP report was actually a bit lower than the advance estimates. While the preliminary report will undergo two additional revisions, it is clear that the economy has slowed to a rate well within the Fed's target for non-inflationary growth.

You would think that the latest GDP report would have been welcomed in the financial markets as great news, given that so much attention has been focused on the idea that continued above-trend economic growth would lead to higher inflation and more onerous monetary policy by the Fed. Yet the response to the latest GDP report was largely one of a defacto recession. In the span of just a week or so, talk went from welcoming the slowdown to fears of a recession.

Frankly, I attribute much of this negativity to the fact that the presidential race is still undecided and all the pandering that has gone on since the election, and the current widespread discontent with our future in the post-Clinton era. It is not clear how public sentiment about the economy will fall once it is decided who will occupy the White House next year. However, there is no compelling evidence yet that we are headed for a recession in 2001.

The Economy Had To Slow

Following five consecutive interest rate hikes by the Fed, an inverted yield curve at times, and a near blowout in the stock markets (especially the high flying tech stocks), the equity-driven economy had to slow down. Yes, it took longer than expected, but then this was the longest and strongest economic expansion in history. In retrospect, it should have taken longer to slow down. Now that it finally has, let's look at the most likely scenario for going forward from here.

The "soft landing" (no recession) crowd believes the Fed has done a good job of slowing the economy and keeping inflation in check. With the latest report showing that GDP rose at a pace of only 2.4% in the 3Q, they believe the Fed has completed its job and can now begin to lower interest rates. This group now expects the economy to settle into a 2-4% annual growth path with inflation remaining in the 2-3% range. And for the most part they believe the economic expansion will continue for several more years or even longer. They do not see a recession in 2001.

The economic naysayers, on the other hand, point to a variety of indicators and conditions that they believe will lead to a recession next year. They correctly point out that the phase of easy money has ended, and that banks continue to tighten lending standards. They point to the fact that bank liquidity is at the lowest level in nine years, and warn that loan losses (bad loans) will most surely move higher in this highly leveraged economy. The chairman of the FDIC recently stated, for example, that there has been a worrying deterioration in the quality of bank loan portfolios, especially in commercial real estate loans which have often been the catalyst for recessions in the past. These points should not be taken lightly.

The recession crowd has seen more ammunition fall on the side of their argument with the latest implosion in the tech stocks. As they have warned for a very long time, the technology sector finally succumbed to the inevitable selloff. This, the bears argue, puts the already stressed financial system at extreme risk of a financial accident, especially if stocks continue to fall.

Finally, the recession crowd argues that consumer demand, the engine of the economy, is set to fall significantly just ahead. As noted on page one, consumer confidence has peaked in the last few months. This fact would seem obvious, even to those who are not economists, in that consumer demand had to slow for economic growth to ease from a 5.6% growth rate to 2.4%. The question is, will consumer spending retrench to the point that it causes a recession?

Too Early To Tell & Too Early To Declare That A Recession Is Inevitable

While you may be prone to take a negative view of the economy and the stock markets, I would advise you to keep an open mind. The fact that the economy has finally slowed from its blistering pace of the last several years is no assurance that a recession will follow. In fact, The Bank Credit Analyst continues to believe that a soft landing in the economy is the most likely scenario, although they caution that a further blowout in the equity markets would undermine that view.

At the same time I would advise you not to assume a recession is inevitable, I would also recommend that you not assume the latest downtrend in stocks is going to turn into a long, severe bear market. In my view, the only thing we can conclude about the stock markets at this point is that a much needed and long overdue correction has now occurred in the technology sector. Some powerhouse companies can today be bought for a fraction of their value a year ago. Who would have thought you could buy AT&T for less than \$20 per share, down from \$61, or General Motors for \$50 per share, down from \$95, or Dell Computer for \$19 per share, down from \$60?

My point is, this may be a great buying opportunity in the weeks ahead, and there is, as of yet, no compelling evidence that a recession is imminent.

Mistakes Investors Make When Buying Stocks Or Mutual Funds

Getting Back In The Game

If you come to believe, as I do, that we are seeing a great buying opportunity in stocks, there are some very common and well documented mistakes that you can avoid. Numerous research groups have conducted indepth studies on the patterns and practices of mutual fund investors. I have reported some of these studies in the past, but the updated results are well worth noting, especially if you plan to get back in the equity markets in the weeks or months ahead. The facts stated below come from studies by Morningstar and Dalbar, both of which publish data on mutual funds and investor behavior.

Not Making What The Indexes Make

We've been in the greatest bull market in history, and more people are invested in stocks and mutual funds than ever before. With all the access to information, with the Internet and with round-the-clock financial shows on television, you would think most people have made a fortune in the last 5-10 years. You would probably think that most mutual fund investors have made at least as much as the market indexes, or even more. But the fact is that the average mutual fund investor has not even come close to making what the relevant market indexes have during the bull market.

The latest Dalbar study analyzed mutual fund cash flow data from 1984 through the end of 1998. Over this 15-year period of time, the S&P 500 Index averaged 17.90% per annum, while the average equity mutual fund investor averaged only 7.25%. This difference of over 10 percentage points per year in average annual returns is huge!

What makes this figure even more astounding is the fact that many equity mutual funds beat the S&P 500 during this 15 year period. Had you invested in one or more of these funds that beat the S&P, and had you stayed in it for the entire period, you could have made even more than the 17.9% average annual gain in the S&P 500 Index. Many funds did that or better.

Chasing The Latest "Hot" Funds

What the various studies have consistently shown, however, is that most investors do not hold their mutual funds for the long-term. Instead they tend to switch from fund to fund with increasing frequency. There are many reasons for this, but among them are: 1) the barrage of financial information we have today; 2) the armies of so-called "experts" in the media; 3) the ease of switching; and 4) the desire to beat the market.

As a result, most investors are continually chasing the latest "hot" funds. Unfortunately, today's hot funds may well be the laggards in the months or years ahead, especially with the now common "rotation" among the various market sectors. Many investors find themselves on what I call the "mutual fund merry-go-round" or the "fund of the month club" where they are continually changing their holdings, often buying high and selling low. But as the studies repeatedly show, frequent switching has resulted in the average investor making less than half of what the S&P 500 made.

Another 10-year study by Dalbar revealed that investors who bought "load" mutual funds outperformed their counterparts who bought only "no-load" funds. This study showed that over the 10 year period, the load fund investors gained a cumulative 20% more than those who bought similar types of no-load funds. This study dispelled a long-held belief that no-load funds significantly outperform load funds, but had another even more important conclusion: investors tend to hold onto load funds longer than no-load funds. Because they paid a load in, they tended to stay with the fund and earned better returns on average.

Buying Only For The Long-Term

If you believe that we are seeing a great buying opportunity in the markets, and if you plan to get back into the market sometime soon, I would strongly advise you to do so only with a long-term view of these investments. No one can tell you when the current correction will end, and you should assume you will be either a little late or a little early when you make your deci-

sion to get back in or bring your portfolio back to a normal allocation of equities. In my view, which is supported by the various studies, you should plan to hold your selected mutual funds for several years at least, and not bail out at the first sign of trouble.

Let me be clear, however, that there is nothing wrong with making periodic changes in your mutual fund portfolio. Sometimes changes are in order, especially in instances where the fund manager leaves or the fund takes on a new strategy. In fact, I think it is wise to review your holdings at least annually and make changes when necessary - but only IF they are necessary. You definitely don't want to be on the mutual fund merry-go-round!

You Need To Have A Plan

If you are under-invested or not in the market, and you intend to get back in soon, above all you need a well thought out - and written - plan to follow. Write down the details of what you wish to accomplish, and in what time frame, and what amount of risk you are willing to take to get there. If you have a plan and you follow it, you always know what to do, you will not fall prey to the fund of the month club, and you should see the results you want over the long-term.

If you are uncomfortable in doing this on your own there is no shortage of professionals who will help you create a financial plan. In fact, we have several people at ProFutures who are qualified to help you.

Finding The Right Funds For You Is A Daunting Challenge

If you've been out of the stock market, or significantly under-invested for the last several years, it is difficult enough just to pull the trigger and get back in. But once you've made that decision, then comes the task of selecting a group of funds that have delivered the kind of performance you want. There are over 10,000 mutual funds to choose from and more arrive almost every day.

On the surface, selecting the right funds for you would seem easy. Walk into any airport newsstand, for example, and you will likely find at least a dozen

investment related magazines, most of which regularly feature their "Top 10" (or 20 or 30) mutual funds. But what you will also find is that none of them agree on which funds are the best and, even worse, their top recommendations continually change.

I used to subscribe to a bunch of these magazines, thinking I needed to peruse them to stay current on the mutual fund world. But what I concluded after a few years is that these publications, with their constantly changing advice, are certain to put you in the fund of the month club if you follow their advice! I have long since let my subscriptions lapse, and I rarely even pick one up when I am looking for reading material in an airport. Obviously, I don't recommend that you rely on these publications, or what you hear on television, when selecting your mutual funds.

What Criteria Is Right For You?

We all have different investment objectives and risk tolerance based on our ages, income, dependents, retirement goals, etc., etc. The magazines and the talking heads on television, while purporting to be "experts," cannot know if the funds they tout would be suitable for you or not.

When choosing what funds are right for you, one of the first things you have to do is decide how much performance history you will require. Will you narrow the field by only looking at those funds with a 10-year track record, or would you be comfortable with funds that have only 5 years or 3 years? This is especially challenging in the current market environment because many funds with outstanding 10-15 year or even longer records have faltered in this year's very difficult market. As a result, some investors are now looking only at funds which have done well this year. This is what I call the "what have you done for me lately" crowd. While this year has been extremely difficult, I believe you should stick with funds that have a good long-term record, generally at least five years and preferably 10.

Even if you narrow it down to only those with 10 years of history, that still leaves you with thousands of funds to choose from. And this is precisely where most investors throw up their hands and simply buy index funds, or worse do nothing at all.

Announcing: ProFutures *DYNAMIC ALLOCATION* Program

A New Service You Asked For

As I mentioned earlier, each year we survey a representative sampling of our client base. In analyzing these surveys, it is clear that many of our clients would like help in selecting and managing their mutual funds that they intend to hold long-term. Unlike our ADVISORLINK program where "active" managers buy and sell mutual funds and time the market, these clients were looking for help with their other "passive" mutual funds which they intend to buy-and-hold long-term. Very few companies offer both active and passive management of mutual funds.

Over a year ago, and after many requests, we decided to look into providing an investment product to meet this need. But before we would attempt to expand into this area, we wanted to be sure that we could bring you a first-class, professional service that would both suit your needs and deliver the kind of performance we know you want.

Thus, for almost a year now, we have been investigating and researching the various methods for selecting mutual funds, the latest hardware and software available to help in this process and relationships with several large brokerage firms that offer very competitive services in this area. We have spared no expense in this process and have made a substantial investment in what we have called our Dynamic Allocation Program.

Admittedly, almost every brokerage firm offers some form of asset allocation program, and there are numerous Internet websites that have similar services. We researched many of these services in our effort to design an asset allocation program that would be: different, very personalized and better.

[By the way, I definitely would NOT recommend that you use a website service for selecting your mutual funds. With these services, you have to make all the decisions yourself. You can't talk with an experienced professional about your needs, and they don't call you back if their recommendations change.]

Experience Within

Fortunately, when it came to designing our own program I had to look no further than our own three professionals - Brad Unruh, Phil Denney and Spencer Wright - who all came to ProFutures after working for large brokerage firms. They could not only relate to the practices at their old brokerage firms, but also had detailed knowledge of how other firms' asset allocation programs worked.

Unfortunately, they told me that many brokerage firms' asset allocation programs are more driven by commissions than by what is best for the client. In some cases, the only products the brokers can recommend are the firm's own mutual funds, etc., which often aren't the best for the clients. Also, some brokerage firms do not offer dollar cost averaging for clients who would like to ease into the market, since that would delay the realization of commission earnings. Well, in my opinion, that's just wrong!

Building a Superior Program

Most asset allocation programs are based on software that incorporates "Modern Portfolio Theory." (Be sure to read this month's Professional Investing for more information about this important topic.) The objective is to maximize the "risk-adjusted" return over the long-term.

The software analyzes the stated objectives and risk tolerance of the investor, and then creates a recommended allocation of the investor's funds among various asset classes. The more expensive programs, such as we selected, are loaded with the historical performance data for a wide variety of asset classes including stocks, bonds, real estate, foreign investments, venture capital and other alternative investments.

This all sounds great, but the idea of a computer generating a rather automatic allocation recommendation isn't nearly enough in my opinion. For one thing, many investors will give very different answers about their objectives and risk tolerance when they fill-out a

standardized questionnaire than they will when they actually talk to an experienced professional they can trust. So, as we built our program, we emphasized a very personal, very hands-on approach that utilized both the vast resources of the software programs AND our own years of collective experience.

While the software programs are impressive, there is a great deal of fine tuning that must be done. One of the most critical areas is that of determining the specific criteria to be used in selecting the various mutual funds to be considered for the allocation recommendations. To do this, we purchased Morningstar's mutual fund evaluation software. We then spent many long meetings, with all of our collective experience, to decide the selection criteria we would use for the mutual funds that would be a part of our allocation program.

As a general rule, our selection criteria only permitted funds that had a minimum of a 10-year track record. A long track record alone, however, is insufficient. We also wanted the funds to be in the top 25% of its asset class for the 10-year and 5-year time windows. Wherever possible, we also required the funds to be in the top 25% of its asset class over the past 3 years. Many funds have good long-term numbers due to spectacular performance early in their history, but have not done well in recent years. Others have great performance in the last three years but lackluster results prior to that. To be included in our Dynamic Allocation Program, the funds had to have consistently good performance over the past 10 years or so.

After months of research was done, we had pared down the list of thousands of possible choices to a relatively short list of mutual funds in each asset class. Once we got the list down to a workable number, we then delved further into the details of the funds' operations, managers, portfolio holdings, availability, turnover, etc., etc. to make the final selections.

After months of research, hundreds of hours of manpower and a substantial investment in software, the result is that we now have a recommended list of 2-3 outstanding mutual funds per asset class. These are all excellent funds, from several different fund families, that I am very confident in and feel very comfortable putting my own money into.

We Don't Stop There

However, just because we have a final list of superior funds for each asset class, we won't stop there. We will continually monitor each of the funds in our program to insure that their performance stays within the parameters we have established. What's more, we'll monitor other factors, such as manager changes, etc. that can affect the performance of a fund in the future.

Should any of these factors make us change our recommendation of any fund, we will let you know immediately and suggest a replacement.

How Do You Get Started?

The best way for you to learn more about our Dynamic Allocation Program is to call Brad, Phil or Spencer. These fellows have years of experience in helping investors choose mutual funds and allocating their assets. They all have experience in financial planning as well. This is precisely why I convinced them to join ProFutures over the last couple of years, and I could not be more pleased that they are on our team!

They will send you one of our Confidential Investor Profile questionnaires that will give us the initial information needed to help develop a portfolio suited to your risk tolerance and future goals. Once they have that, they will call you to talk about your answers and determine if there are any special needs or preferences you may have that are not covered in the Profile questions. A proposal will then be prepared and sent to you. All of this is FREE of charge, by the way, with no obligation on your part.

The proposal will contain a description of the advantages of asset allocation, along with our customized recommendations for your particular portfolio. Our Representative will call you a week or so later to discuss the recommendations, and help you with any final changes or adjustments you may want. As always, there will be no pressure to do this should you decide not to; high pressure is not our style, and our Representatives do not work on commission.

Once you approve of a final recommendation, you complete the paperwork to establish your account and

name us as the Advisor. You send us the paperwork along with a check made payable to our custodial brokerage firm, T.D. Waterhouse, and we will take it from there. We will get your account established, see that the selected mutual funds are purchased in the account, and in the correct amounts, and we will monitor the account thereafter. All along the way, your Representative will be there to answer any questions and help you make any adjustments if needed.

The minimum investment for the Dynamic Allocation Program is \$50,000.

Our research tells us this minimum is necessary to get a sufficient diversification of asset classes within your portfolio which, after all, is the primary purpose for entering into an investment program like this. For those of you who are nervous about the stock market, we offer a flexible dollar-cost-averaging feature that will let you ease into the market in stages over a period of time.

Special Report On Professional Asset Allocation

Very shortly I will have a Special Report discussing the value of investing in a professionally-designed asset allocation program. This Report should be available later this month. If you would like a copy of this Report, please call one of our Investor Representatives (Brad, Phil, or Spencer) at 800-348-3601 and request your copy. Along with the Special Report, you'll also receive one of our Confidential Investor Profile questionnaires for your review. If you complete that questionnaire and return it to us, you can start the process of allocating your assets in a diversified portfolio of top-notch mutual funds. Remember, it costs you nothing for us to prepare a customized proposal for you.

Conclusions

As we worked long and hard on our Dynamic Allocation Program for most of this year, one over-riding thought continued to occur to me:

There is NO WAY most investors could do this on their own.

When I consider how many hours it took us to develop the program, to decide on the selection criteria for the funds, to research the funds we ultimately selected, it is clear that it would be next to impossible for an individual investor to do this. We have had as many as seven people at ProFutures working on this project at times during the year. And I don't even know how much money we spent on it - I don't think I want to know! The point is, we have put a lot of effort into developing what I consider an excellent service for you. I hope you will take advantage of it.

To do so, you will have to get comfortable about being in the stock market with a long-term perspective. As discussed earlier, I believe the markets are nearing a major bottom. On December 5th, for example, we saw the strongest one-day advance in history in the Nasdaq Index. That, of course, does not mean that a bottom has been reached, but it adds to the argument that the recent correction may be ending soon. Additionally, Alan Greenspan said this week that the Fed has now moved away from its tightening bias - interest rates could start to come down soon. This, too, should be good for the markets.

If you have been under-invested in equities, or out of the market altogether, this may be your opportunity to get back in the hunt. While I don't expect the stock markets to return to the 20-30-40% gains of the last several years, I do believe the long-term uptrend will resume at some point. If I am correct, the timing of our Dynamic Allocation Program may be excellent. Call us at 800-348-3601 to get your free proposal.

* * * * *

Let's hope we have a President soon!

HAPPY HOLIDAYS EVERYONE!!

ProFutures Forecasts & Trends is published by ProFutures, Inc. Gary D. Halbert is the president and chairman of ProFutures, Inc. and editor of this publication. Information contained herein is taken from sources believed to be reliable but cannot be guaranteed as to its accuracy. Opinions and recommendations herein generally reflect the judgement of Gary D. Halbert and may change at any time without written notice. Market opinions contained herein are intended as general observations and are not intended as specific investment advice. Past results are not necessarily indicative of future results. This newsletter does not constitute the offer of sale of any securities. ProFutures, Inc, its officers, directors and/or employees may have investments in markets or programs mentioned herein. Reprinting or reproduction prohibited without prior written consent from ProFutures, Inc. © Copyright 2000.