

March 2001

Pay No Attention To That Man Behind the Curtain Or, Cisco to Crisco

A common notion is that there is a lot of science involved in the stock market. Somewhere, somehow, someone is sitting behind a curtain, logically analyzing the economy, pulling levers and directing future market movements. (Many think he looks a lot like Alan Greenspan.) In contrast, we have come to the conclusion that short-term market movements are pure emotion, the equivalent of a Judy Garland concert. In a seemingly unrelated development, about this time a year ago, we noticed that just about everyone we spoke with about the bipolar behavior of the market pointed out the virtues of Cisco Systems.

It wasn't all that long ago that we had never heard of Cisco Systems, but a year ago, this paradigm of the new paradigm had become the dominant company in the technology boom. The future growth of Cisco's stock price was an article of faith among investors. This piqued our curiosity. After all, had we ever even seen a Cisco? We remembered in *The Wizard of Oz* when the guardian of Emerald City denies Dorothy entrance to see the Wizard, stating "The wizard? But nobody can see the great Oz, nobody's ever seen the great Oz, even I've never seen him!" to which Dorothy replies "Well then, how do you know there is one?"

***If everyone thinks alike,
how much thinking
is going on?***

When we investigated and discovered Cisco made routers, our thoughts drifted to the basement woodshop of the dad of one of our friends in elementary school. We asked our network administrator to show us a Cisco router. Now then, we are really, really sure that Cisco makes a fine product, but the router we were shown looked suspiciously like the circuit boards manufactured by a bunch of companies that disappeared after the piercing of the technology bubble of the early 1980's.

As we were pondering this, Ned Davis Research, Inc., a leading institutional investment research firm, pointed out that Cisco's stock price valuation was about the same as the combined value of 25 other large, "blue chip" companies. With some slight modifications, we updated this study in the enclosed chart, showing the market values as of mid-March. We replaced one company on the original Ned Davis list with a similar company due to a merger and replaced Eli Lilly with Procter & Gamble. A big drug company seemed a little glamorous to include in the analysis, while Procter & Gamble, manufacturer of Crisco, seemed to exemplify the old era.

The table compares the stock market value and net earnings of Cisco Systems to the combined stock market value and net earnings of the 25 large "old economy" companies. A year ago, the market valuations were approximately even, even though the combined earnings of the blue chip companies were about 14 times that of Cisco.

As of March 15, 2001, Cisco's earnings had gone up about 20 percent, while the combined earnings of the old economy dinosaurs had gone down almost 22 percent. But Cisco had lost over 72 percent of its value, while the value of the boring companies had increased a little over two percent. Why? Well, Cisco was selling at 213 times its earnings a year ago, but had fallen to about 50 times earnings. To put this in perspective, the Standard & Poor's 500 index has, on average, sold at about 15 times earnings over the past several decades. The dinosaurs were selling at less than 15 times earnings last year, about 19 now. So, while Cisco may be more exciting, value still matters. I might be holding a really tasty-looking milkshake that you would love to drink, but you are unlikely to pay me \$25 for it. Investors a year ago were paying the equivalent premium for Cisco, ignoring the valuation rationale they apply to milkshakes, cars, televisions or any other tangible item.

***"Some people without brains do an awful lot of talking ... don't they?"
-- The Scarecrow***

Josh Peters of Morningstar.com estimates that the value lost in Cisco's stock between March 24, 2000 and March 12, 2001 is enough to buy every man, woman

and child in the United States a new personal computer. Given the market performance since March 12, maybe we now get a printer or DVD player as well.

None of this is meant to pick on Cisco. We are happily using Cisco products (or so we're told), and it's not as if we really understand how our refrigerator works, either. We could have played the same game with Intel, Microsoft or any of the other technology stocks that have been driving the market up and down in the last couple of years. This should also not be read as a blanket endorsement of old economy stocks, many of which have their own disappointing history. We *are* encouraging you to remember that investing does not take place in a casino. You are buying pieces of businesses when you invest in stocks. If you own a business and are acquiring a competitor, you are unlikely to pay 50 or 200 times its earnings.

To those whose love of technology stocks in 1999 and early 2000 proved unrequited, we'll quote the Wizard: "Hearts will never be practical until they can be made unbreakable." To comment on the financial industry gurus who abandoned asset allocation to concentrate on stocks like Cisco, we'll quote the Scarecrow: "Some people without brains do an awful lot of talking... don't they?" And to the investors who scoffed at any rational approach in favor of chasing the new era, we'll quote the Tin Man: "What have you learned, Dorothy?" If you are tired of wondering if your current adviser (or your wizard behind the curtain) has a brain or a heart, call us.

Table 1

Finding Balance...

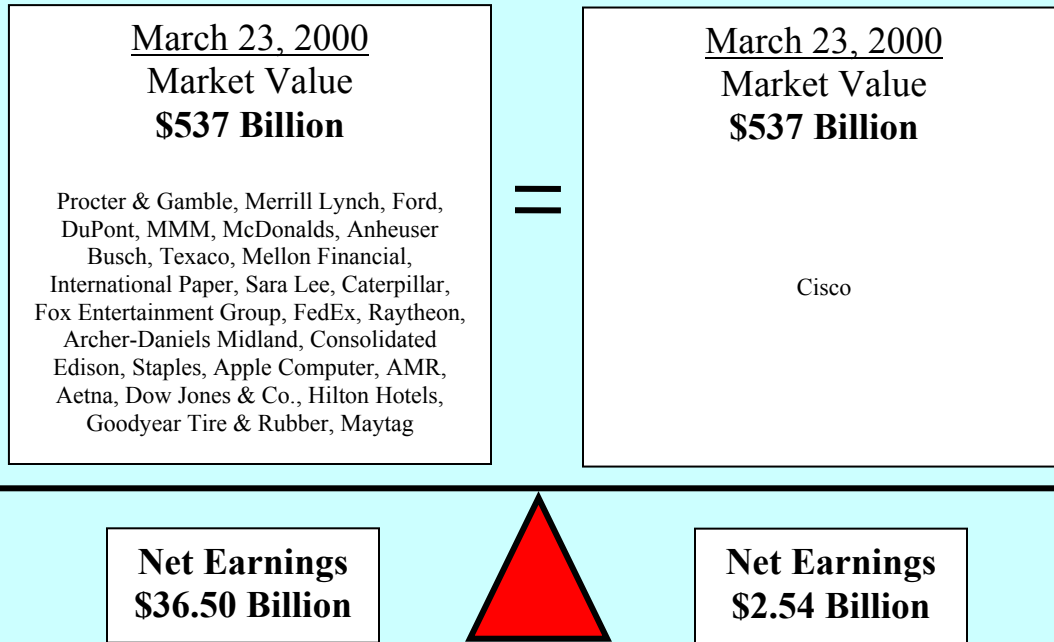
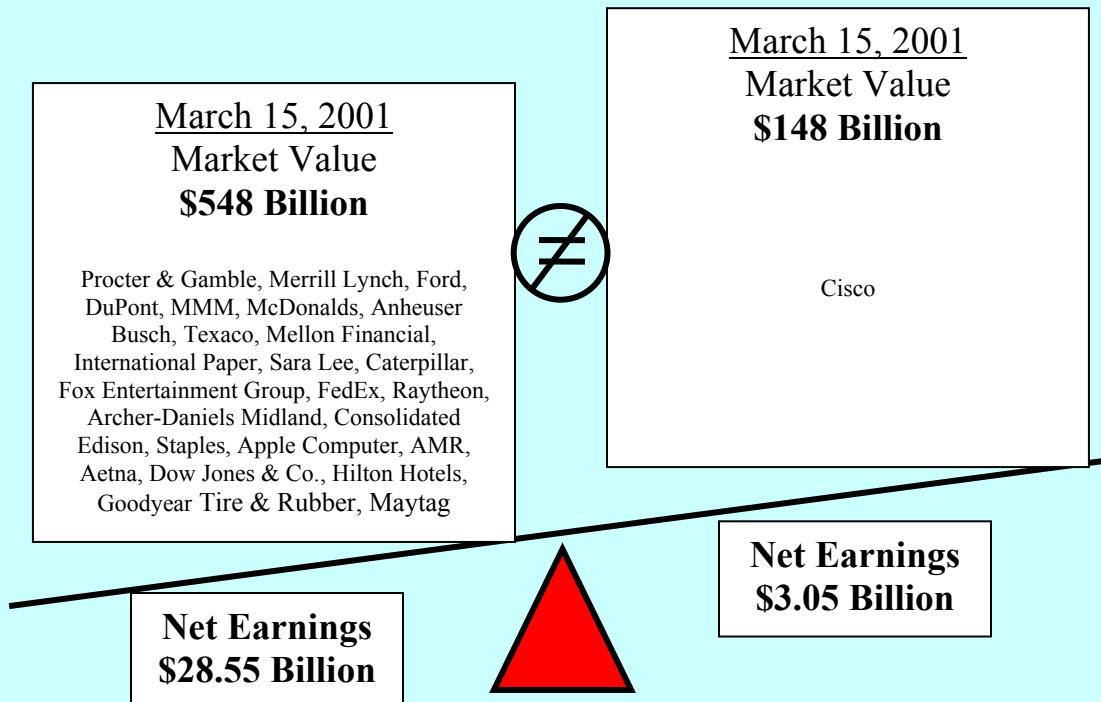
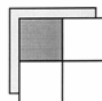


Table 2

In an Unbalanced World



Data Source: Ned Davis Research, public filings.



SIGMA
Investment Management Company
Knowledge plus Discipline