

# THE NAVIGATOR REPORT

CLARK  
CAPITAL  
MANAGEMENT  
GROUP INC.

FIRST QUARTER 2002

## The Perfect Storm

The Perfect Storm is a story about a one in a hundred year weather pattern. That pattern evolved into an unthinkable weather system from which an incredible storm, the perfect storm, was born. Severe storms cause severe damage but there is nothing more refreshing than the clear blue sky that appears after even the worst storms.

The past two years, 2000 and 2001, could be looked upon as the perfect storm that hit the financial markets. Several factors combined to cause the pattern of destruction that ensued. Huge money flow from the Federal Reserve in anticipation of Y2K, six interest rate increases designed to slow what the Fed believed was an overheating economy, record margin debt, the dot.com mentality, and a pattern of rampant speculation that caused one of the most overvalued market environments in history.

*A contributing factor was the perception by the investing public that there would never again be a market correction in excess of 10%. As it turned out, that perception was wrong!*

The bear market (perfect storm) that ended on September 21, 2001 was a good one if you can call any bear market decline "good." The Dow Jones peaked on January 14, 2000 at 11,723

and declined 29.8% to 8,239 on September 21, 2001. The S&P 500 peaked on March 24, 2000 and declined 36.8% to a bottom at 966, also on September 21st. The Nasdaq peaked at 5,049 on March 10, 2000 and declined 71.8% to 1,423 and the Nasdaq 100, which peaked on March 27th declined 76%, also bottoming September 21st. There have been ten prior times since the great depression that the stock market, as measured by the S&P 500, has declined in excess of 20% (the traditional defini-

tion of a "bear" market). The average decline was 32% from top to bottom and lasted 16 months. The most recent decline was 36.8% and lasted 18 months, which was surprisingly close to average. The decline in the Nasdaq, however, totaled 72%, and was far from average. **The combination of market loss stripped over \$5.8 trillion from investors' pockets, which is by far the largest loss for a bear market in history.** The 72% decline in the Nasdaq almost equaled the decline of 1929. An interesting comparison shows just how drastic the decline was in some stocks. An investment of \$1,000 in Nortel Networks at the market top is now worth \$40! You could just as easily have purchased \$1,000 of Budweiser beer (not the stock but bottles of beer), enjoyed it, and still have \$79. That represents the value of the bottle returns. This is not even mentioning problems such as Enron etc. No wonder the investing public is questioning the rationality of the stock market!

"Please find me a  
one-armed economist  
so we will not always hear  
'On the other hand...'"

HERBERT HOOVER



## The Perfect Recovery?

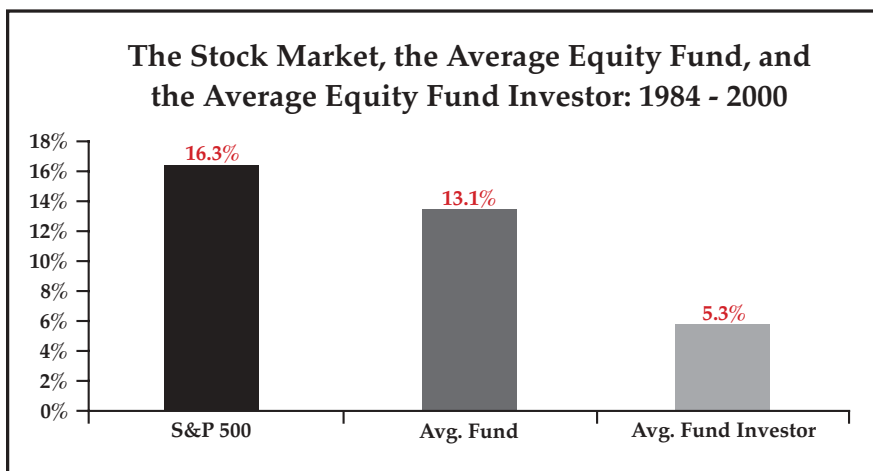
Since the perfect storm ended on September 21, 2001, can we now look for the blue sky ahead? Isn't that what is supposed to happen after a severe storm?

To try and understand if the current recovery can become a "perfect recovery" lets examine the stock market rebound first and then look to the basis of the whole thing, the economy. *Don't forget that the stock market is a very good predictor of what is to become of the economy.* You may recall that the market peaked long before the economists admitted that we were experiencing a "recession" and the market bottom of September 21st occurred long before we were told that the "recession" was over. Of course we all know to take what economists say with a grain of salt. Herbert Hoover once said **"Please find me a one-armed economist so we will not always hear 'On the other hand...'"**

Since the bottom of September 21st, the S&P 500 *jumped 21.4%* while the Nasdaq moved *higher by 44.7%*; both reaching recent peaks on Jan. 4th. The Dow Jones jumped 29.1% to the recent peak on March 14 while the Nasdaq 100 topped them all by *jumping 52.71%*. The Nasdaq 100, usually considered a proxy for technology stocks, peaked recently on December 5th. **What has caused the recent skittishness by investors are the pullbacks since those recovery tops.** The S&P 500 pulled back 7.9%, the Dow Jones 4.1%, the Nasdaq 16.65% and the Nasdaq 100 by 21.8%. These pullback percentages are almost reminiscent of a new bear market. What is going on???

The stock market has always been a very perverse creature. It entices all who will listen to pour their money into market

Source: Dalbar Study



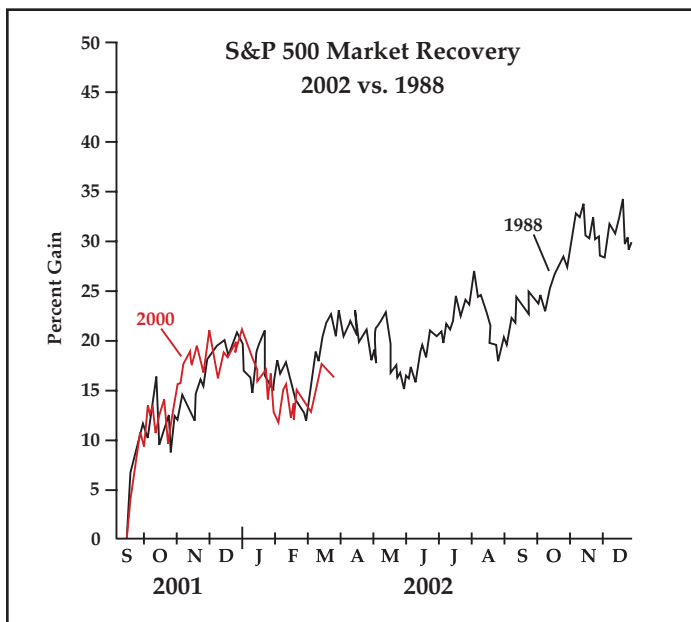
tops. Witness the 2000 top! It will then do it's best to make weak holders, i.e. the public, sell to stronger holders, i.e. institutions, before a truly meaningful recovery ensues, thereby denying most the opportunity to get even. That is why the chart below says so much. **Why did the average investor earn 5.3%/year while the market, as measured by the S&P 500, returned 16.3%?** Because the market entices the masses to buy at or near market tops and then to sell near the bottom or during the first run up. Millions of investors are now, and have been, saying, "Just let me get out even." Of course this will not happen. Most will become frustrated, sell far too early and never recoup their losses. It is a vicious circle. Of course, you, as our client, did not suffer the full brunt of the bear market and you will not be enticed to sell now before the recovery truly begins.



So, as we see, the markets are having a correction of the substantial moves from the bottom. *Perfectly normal action! Do not be discouraged! As you will see this recovery has only just begun.*

How does this recovery compare to the other ten bear market recoveries since Mr. Hoover presided over the 1929 crash? The ten subsequent gains from the market bottoms averaged 55% for the S&P 500 over 22 months. The largest gain was after the 1942 bottom and was 150% over 33 months. But that was during a time of war. The next largest recovery was after the 1973-74 bear and was 95% over 67 months. Interesting that the bear market of 1973-74 was the last major bear market before the recent experience. Should we be looking for the same type of rebound? I don't think so and neither does Mr. James Stack who writes the excellent publication "Investech". The accompanying chart shows how closely this recovery follows that of 1988. That recovery in the S&P 500 gained 61% in price and 72% in total return over 21 months. The total return here includes dividends, which as you can

see, were substantial then. If we equaled that situation, the Dow Jones would reach 13,265 and the S&P 500 1,575 (61% plus about 2% for dividends). The Nasdaq always goes its' separate way and if the rebound equaled 1988 it would move higher by 66% to 2,360. At this point you must be saying, **"Is that all there is?"** That would leave the S&P 500 at about the same as the high in 2000 and the Dow Jones only 13% higher. The Nasdaq will still be 53% below the high of 2000. But this is normal! From the S&P 500 peak in March 2000 to the point of break-even, in about June of 2003, means no return for over three years. *During the 1973-74 decline and recovery, an investor had to wait 8.5 years for the market to return*



Source: InvesTech Research

to the level of 1973. If you want to get really sick, look back at 1929 when it took 27 years to break even. The average time to break even after all bear markets of the past century was about 5 years. If this market recovers to the former high in three years it will be an above average recovery. Of course the recovery might happen faster than during the 1988 recovery. Considering that the initial rebound from the September 21st bottom was 21% in only a little over three months, it would not surprise me if the recovery happened quickly.

## First Quarter 2002

Describing the first quarter can be done in one word; difficult; no, maybe impossible is better! The aftermath of the 2000-01 bear and the subsequent recovery has been a sideways market that has been impossible to fathom. The only thing that makes this challenge bearable is the knowledge that things will get better. I, and you I am sure, just wish it would hurry up. During the run-up in the market in late 1999 and early 2000, only technology was moving higher. Everyone had to be fully invested in technology! Now, just the opposite is occurring. Everything except technology is moving; especially small-cap stocks. Following the 1987 bear market and brief recovery, the market moved sideways for several months. The same thing occurred following the 1990 bear market and recovery. In both of those instances our models gave us fits. Buy one day and the market goes down; sell another day and it goes higher. It is enough to make your hair go gray! The only saving grace is that we know this will come to an end and the market will

eventually have another good upward move. *Patience may be a virtue but it surely is frustrating.* During the quarter we lost on almost every index and in most cases we lost more than the index. For instance, while the Nasdaq 100 lost 7.9%, we managed to lose 10.5%. Discouraging at best, we did considerably better in small, mid-cap and value indicies. But we know that in a sideways market you must keep probing for the right buy spot because when you find the right time, the profit will be very rewarding.

**The fourth quarter of 2001 was a very good one and it is not unusual to give back some of the gain in this situation. There will be substantial gains to come.** I saw an interesting listing recently in the New York Times. This listing was of the top 20 stocks held by the largest number of accounts at Merrill Lynch and portrayed their performance from January 1st to March 31st this year. Of the 20 stocks listed, three had profits, Exxon, Johnson & Johnson, and Pfizer. The average gain of these three was 6.6%. The other 17 had losses ranging from a maximum of 47.1% for Tyco Int. to a minimum of 2.6% for Merck. **The average loss was 17.3%!** These are not junk stocks but the cream of the crop and mostly blue chips. Some names are Citigroup, AT&T, AT&T Wireless, GE, IBM, Microsoft, Oracle, Verizon, and Intel. It is hard to believe that of these 20 blue chip stocks the average loss over all 20 is 13.7%! This means that if you invested \$100,000 on January 1st (not including commissions) your account is now worth \$86,300. It will be interesting to see where this list is in 2008. The problem is, as you know, many Merrill clients will see these results, panic, and sell out. Of course that would be the very worst thing to do.

Another interesting list was published recently by "InvesTech Research" titled "Shooting Stars 2000." This was also a list of 20 stocks that Mr. Stack had selected as representative of the mania that was gripping Wall Street in March of 2000. And, by



the way, this list of 20 can in no way be compared to the list above from Merrill Lynch. The Merrill Lynch list is blue chip, this list, as it turned out, is just the opposite. The average price of these 20 securities in March 2000 was \$156.49/share. The average price today is \$7.59 with 5 pricing at less than \$1.00. *The average loss of these 20 beauties is 95.1%*! Some of these 20 might survive but I doubt if more than two or three will. One, eBay, only declined 48.5% and probably has the best chance to survive.

Unfortunately, the above discussion does not scratch the surface of problems that have come forth recently. I saw another disappointing story about another major Wall Street firm. An analyst at this firm recommended that his clients sell Enron last September at \$37. When the firm heard about the recommendation, it sent letters to clients reaffirming their buy recommendation. Three months later, at a price of .61 per share, they said to sell Enron. And by the way, the analyst that said to sell at \$37 was fired! It is hard to be right sometimes.

In another situation the Attorney General of New York is investigating what seems to be conflicts between one of the New York Stock Exchange's largest brokerage firm's research and investment banking arms. The attorney general said that the firms stock rankings were "biased and distorted" and that "this was a shocking betrayal of trust by one of Wall Street's most trusted firms." The A.G said that other firms would also be investigated. No wonder the investing public has little faith in Wall Street.

## Cast In Stone

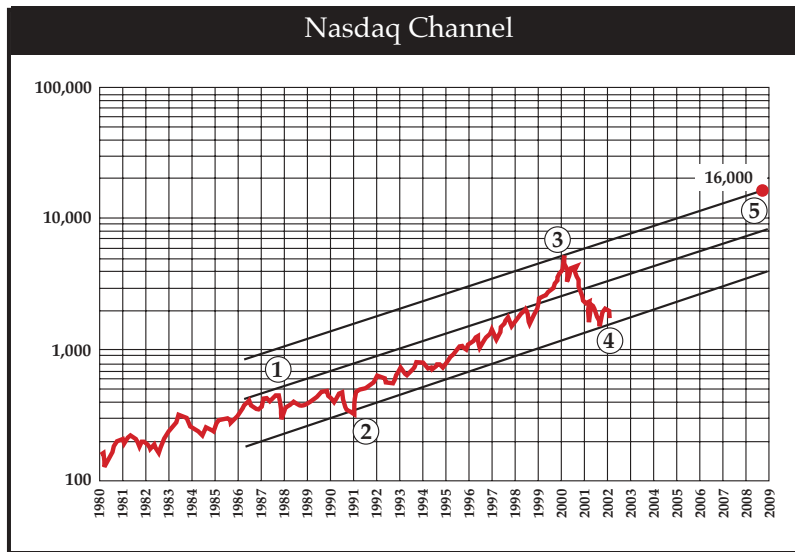
After reading the above, if your head is not swimming in figures you are probably a mathematician or economist. Sorry for all the numbers. Unfortunately, the only way to discuss the past and to try to get a handle on potential movement

going forward is with the numbers. So here are some more numbers! **In the year end Navigator Report was included a look ahead at the remainder of this decade.** There were two perspectives. One was from Ned Davis Research (see chart on next page), a highly respected institutional research firm, and one was from Harry S. Dent of the Dent Foundation. The outlook from Ned Davis shows a massive rise into 2008-09 and then a market peak. He arrives at this projection using various techniques such as decennial patterns, election year cycles, and other investment cycles.

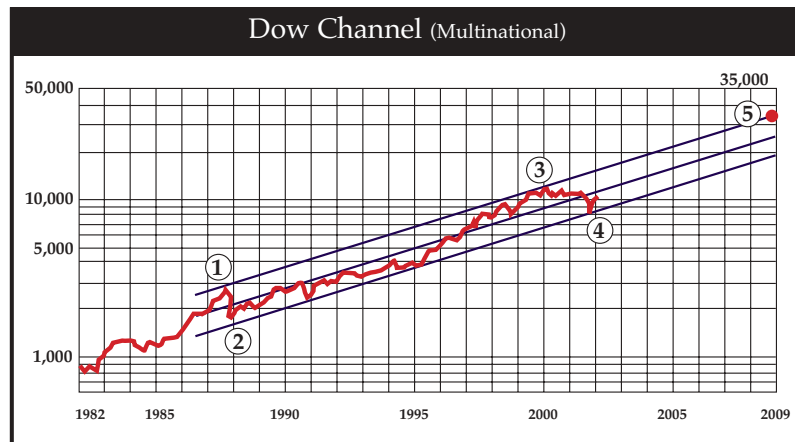
Harry S. Dent is a noted "demographic" economist. Demographics deal with population levels and how people spend their money throughout their lifetimes. At a recent conference in Houston, Texas, Mr. Dent said "90 million baby boomers will do what is predictable in their spending; it is not a random walk." **He said that long-term trends are highly predictable and that the later part of this decade will see tremendous growth.** He has compared the later part of this decade to the roaring 20's. As you can see from the chart below, Mr. Dent's target for the Dow by late 2008

or early 2009 is 35,000 (now pick up this report since you probably dropped it after reading that projection). If you calculate the rate of return required to reach 35,000 by that date it is 18.75%/year. Is this possible? Definitely! From 1991 where the market bottomed at 2365 on the Dow Jones, to the top of 11,723 in January 2000, the Dow returned 17.4%/year. Over a several year period Magellan fund earned over 25%/yr. As an aside, the average investor in that fund actually lost money.

While the likes of Warren Buffet and Sir John Templeton are forecasting mostly flat to down markets for years to come, how can Mr. Dent forecast such a strong growth market? The



Source: H.S. Dent Publishing



Source: H.S. Dent Publishing

answer is productivity! He believes that the next several years will be very similar to the 20's where productivity increased at almost 4%/yr. At that time the consumer was accepting radical new technologies. Automobiles were moving from a 50% to a 90% penetration of the marketplace. As commonplace as the automobile is today, it was not in the 20's. But as the automobile penetrated into all aspects of life, and as literally hundreds of other manufacturers dropped by the wayside, GM caught the investing public's fancy. During those years General Motors grew by 57%/yr while the overall market grew 23%/yr. As the technologies of today move from 50% to 90% penetration, productivity should approach or even exceed the 4% level. **The combination of baby boomer spending and productivity growth will push the markets to levels that we can not imagine today.**

The projected Dow level of 35,000 was mentioned above but how about the Nasdaq? **The level predicted for the Nasdaq is 16,000!** Sounds preposterous doesn't it? But does it? Remember when the Nasdaq was at 355 on January 14, 1991. The peak in 2000 was 5,049. That equates to a gain of 34.3%/yr. From the 2000 level of today, to a 16,000 level in 2009 equates to a gain of 34.6%/yr. So you see that these targets are not unreachable!

When asked how confident he was in his forecast, Mr. Dent said "In order for this not to happen, Mars would have to intersect Venus and push it into Earth. Spending and productivity patterns are very predictable."

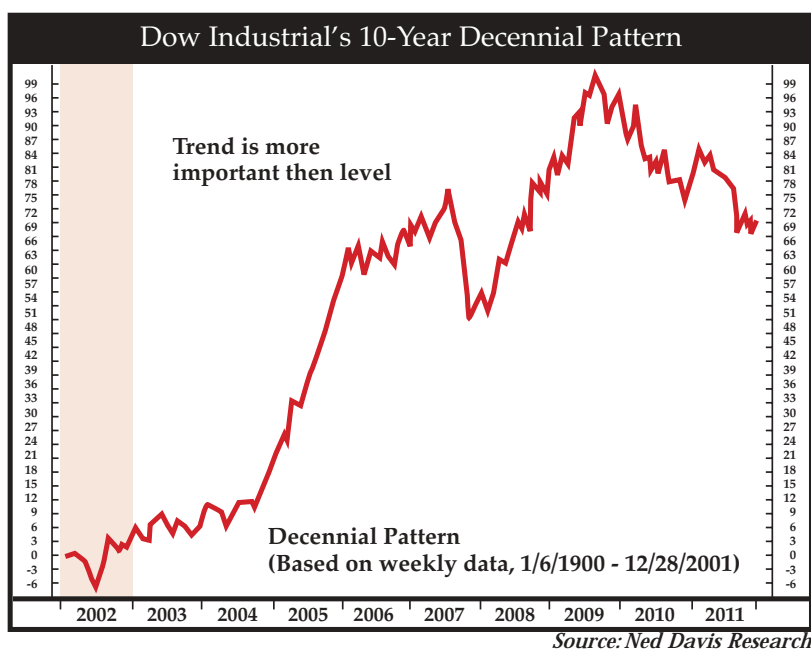
## The Economy

The economy, of course, is the underlying engine that drives the stock markets. It does this by making investors believe that individual stocks will earn more or less going forward. After all, the stock markets are only the culmination of everyone's knowledge as to whether to buy or sell individual company stocks.

The economy is performing in a surprisingly pleasing fashion. Most economists tell us that the recession is behind us. Earnings revisions have shown the largest upward revision in

20 years. Alan Greenspan, the anointed guru of all economic matters, said in late February that the economy "is close to a turning point." By March 7th he was saying, "Economic expansion is already well under way." (Please refer to the quote on the first page about economists).

Quarterly productivity in December rose by a fantastic 5.2%. Fourth quarter GDP was revised upwards to 1.7% following the 1.3% loss reported for the third quarter. For all of 2001 the economy grew at 1.2%, the slowest growth since the recession of 1991, but still growth. Still, corporate after-tax profits fell 15.9% for all of 2001. This was the first drop since 1982's 17.1% decline.



Ned Davis Research "Economic Composite Index" contains eleven different economic indicators. This Index is recording its highest reading in over fifteen years. In the past, readings this high have led to market advances of 17.4%/yr, a very positive sign.

Some people worry about a "double-dip" recession. Since 1950 there have been seven prior recessions as defined by two down quarters of GDP. In that time there has never been a double-dip in

the first year of a recovery nor has there ever been even one down quarter during that year.

All in all the economy seems to be recovering in good order. The risks to further economic recovery hover around three issues; the Mid-East situation, rising interest rates, and the price of oil.

But even these items would, if troublesome, in my opinion only cause the recovery to pause briefly. This economy will be flying by late 2002 or early 2003! Keep our fingers crossed that this economic recovery goes down in the books as "The Perfect Recovery."

## Summary

How can this market avoid eventually moving substantially higher when the backdrop is so favorable? There is \$4.3 trillion sitting on the sidelines waiting for the right opportunity

to enter the market. Inflation is non-existent. Corporate earnings will soon be flying higher as the consumers, particularly baby boomers, spend. Productivity has already picked up with a 5.2% December reading.

A client asked me recently “Do you guys know what you are doing?” This was a new client who had experienced some recent losses. My answer was, “Yes, most of the time!” In my opinion, no one ever knows if they are taking the right action with the stock market 100% of the time. The market is a humbling creature and we know that we will not get things right all of the time. Anyone who says otherwise is just putting you on. We know, from history, that our models are right 80% of the time. I reminded this client that they had selected us to manage their wealth based on our 21-year track record. Why were they even looking at a three or six month period when they had committed to at least five years? Historically speaking, we know that if our models miscue several times in the attempt to find a proper entry, we will have several indications that are exactly on the money to follow. All that is required is patience.



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