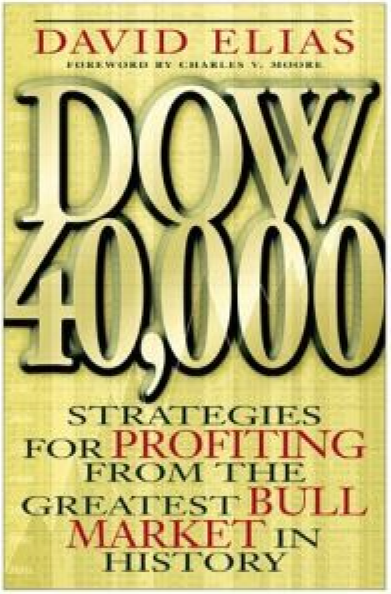

Book Dow 40,000

Strategies for Profiting from the Greatest Bull Market in History

David Elias
McGraw-Hill, 1999

Recommendation

Call David Elias an optimist. He expects the Dow Jones Industrial Average to hit 40,000 by the year 2016, and he stands by his prediction, even in the wake of the stock market downturn. His target doesn't sound so outlandish if you consider that, in order to hit 40,000, the Dow must rise by only 9% annually in the next 16 years. (Investors already have accustomed themselves to much grander annual returns.) However, Elias, an investment adviser, might strike some readers as a bit too cheery. He says interest rates and inflation will remain low for a decade, and he predicts that the developing world will goose profits by buying ever-increasing quantities of products from U.S. companies. Elias also argues that the much-feared backlash from Baby Boomers pulling out of the market after they retire will prove a myth. While Elias' outlook is relentlessly buoyant, *BooksInShort* recommends his information to investors and his book's ripe conversational fodder to futurists and analysts.

Take-Aways

- The Dow Jones Industrial Average will hit 40,000 by 2016.
- The global and technological nature of the new economy - with foreign investment in the U.S. and with more aggressive U.S. savings patterns - will fuel a rising Dow.
- The keys to a continued bull market are low interest rates and low inflation.
- Americans are among the most productive workers in the world, which translates to higher corporate profits.
- To maintain its productivity advantage, the U.S. must focus on educating workers to keep pace with technological advances.
- The Social Security system contains unintended disincentives to save. Privatizing Social Security would remedy these disincentives.
- Unit investment trusts offer a low-cost way for investors to diversify.
- America's aging population will require more health care and financial services.
- Investors should focus on three market sectors: technology, financial services, and health care.
- Investors should buy stock in a dozen Dow companies, including AT&T, Disney, Merck, United Technologies, and Wal-Mart.

Summary

40,000 by 2016 The Dow Jones Industrial Average will hit 40,000 by 2016. Why? A number of reasons - the benefits of the new economy, foreign investment in U.S. stocks and rising savings levels.

Charles Dow created the Dow Jones Industrial Average in 1896. He listed a dozen companies, including American Sugar, American Tobacco, and Chicago Gas. None of the original 12 stocks remain on the Dow, which now includes 30 companies that account for about a fifth of the market value of all U.S. stocks. The Dow is a price-weighted index, not an average.

> "American workers are among the most productive in the world. Compensation costs of American workers average $17.28 per hour, compared to Japan's $23.66 per hour and Germany's $31.88 per hour."

The Dow has grown exponentially since Charles Dow's days. A $100 investment in 1900 would have been worth $70 million by 1998. This trend should continue. In fact, for the Dow to hit 40,000 by 2016, the index would have to climb by just less than 9% a year, assuming a year-end 2000 close of 10,693.

What's Driving the Growth?

Several factors are driving the Dow's upsurge, including:

1. The New Economy - Commercial transactions take place in cyberspace and global competition is the rule, accompanied by low inflation and low interest rates.
2. Foreign investment - This flow of cash includes direct foreign investment (when a company spends money in another country through an outright purchase), infusion of capital, or other type of investment. Automakers such as BMW, Nissan, and Toyota have made direct foreign investments in the U.S. in the form of building new plants. In 1998, direct foreign investment in the U.S. totaled $101 billion. Meanwhile, European investors alone spent $70 billion on U.S. stocks in 1998. Foreign companies and investors will continue to send money to the U.S.
3. Domestic savings - U.S. citizens are saving more than they have in the past. Wages are rising, freeing up more income for investment. Those who are skeptical that Social Security will support them after they retire are buying stocks. A 1998 survey found that even low-income Americans participate in the market.
4. The balanced budget - The federal government's balanced budget agreement will lead to a stronger economy, leading in turn to stronger corporate profits and higher stock prices.

Global Growth

The Third World is becoming more affluent, which will boost the bottom lines of U.S. firms. International competition drives down inflation, and the emergence of new markets for U.S. goods will help profits. Eastern Europe has awakened economically after the Cold War. Asia and Latin America also have seen spending power rise. Still, the global economy's rise will include pitfalls. Poverty and income inequality are rampant in the developing world, and infrastructures need improvement. However, downturns have led fiscal policy makers to address the problems of emerging markets.

Social Security

Social Security has proven successful as a redistribution of wealth, but it also gives people a reason for not saving money. Workers who think they can count on Social Security are less likely to invest for themselves. Meanwhile, the system will struggle as longer life spans and lower birth rates mean fewer workers are supporting those collecting pensions. The solution is to privatize Social Security to encourage workers to save more aggressively.

Interest Rates

Interest rates and inflation must remain low for the Dow to reach 40,000. Every prolonged bear market is accompanied by high interest rates, which have a direct effect on spending. They provide a disincentive to consume.

> "The fundamentals of the American economy are far superior to those of other countries, a factor which is recognized by foreign investors."

Inflation is an important variable. For savers, there's an important distinction between the interest rate and the real interest rate, which is the difference between the yield on an investment and inflation. Interest rates will remain steady for another decade. Low unemployment threatens to increase inflation. However, technology is boosting productivity, and improvements in productivity can offset inflationary pressures.

Productivity

Worker productivity is key to a rising Dow. Improved productivity leads to higher profits. Compensation costs are less in the U.S. than in Japan, Germany, and many other developed nations. However, U.S. productivity could be hurt by insufficient investments in research and development, undeveloped talent, and inadequate math and science skills

> "Unfortunately, Social Security has created zero incentive to save. For example, those who properly prepared for retirement by saving and investing and now enjoy a decent income stream are penalized through taxation of their Social Security benefits."

Global competition helps boost productivity. Technology already has raised productivity. The rise of Internet shopping has helped to reduce time-consuming errands, while e-mail has made communication cheaper and easier.

Investing Strategies

The Standard & Poor's 500 index includes the following sectors:

- Capital goods/technology - This encompasses durable goods, or items that will last for at least three to five years (i.e. computers, software, electronics, aerospace equipment, etc.).
- Financials - This includes banks, insurers, investment brokers, and lenders.
- Healthcare - Pharmaceuticals dominate this sector, followed by medical equipment and hospital management.
- Consumer cyclicals - This involves mainly automobile and retail sales.
- Consumer staples - People buy these goods (food, household products) no matter what the economy is like.
- Utilities - This encompasses electric, natural gas, and telephone firms.
- Energy - This sector includes oil and gas producers, drillers, and distributors.
- Capital goods/industrial - This brings in the smokestack industries, such as manufacturers of machine tools.
- Basic industries - These industries sell raw materials such as aluminum, steel and paper to manufacturers and consumers.
- Transportation - The smallest sector encompasses airlines and railroads.

Super Sectors

Three of these sectors will provide investors with outsized returns:

- Technology crosses into all sectors, and any company or industry that doesn't upgrade its technology will become extinct.
- Healthcare will boom as Americans age and as preventive medicine replaces hospitalization.
- The financial sector also benefits from the aging of America. More affluent older consumers need more financial services. The Depression-era wall dividing banks, stockbrokers, and insurers has broken down, offering further opportunities for investors in financial service firms.

> "Every end to every great bull market in the history of the United States has been preceded by a major increase in interest rates."

Will Baby Boomers make the market crash when they begin withdrawing their money? No. Boomers won't withdraw all of their money at once. Some of it will go to their heirs, who plan to invest in similar patterns.

Investing Basics

Beginning investors should opt for mutual funds rather than individual stocks. It's nearly impossible for a beginner to diversify sufficiently by buying individual stocks. However, investors will have to pay taxes on capital gains realized by their mutual funds, unless they're owned in tax-deferred accounts.

> "If the leaders of the world continue to behave themselves, there is very little on the horizon that could end the greatest bull market the world has ever seen."

Investors should consider index-based financial products known as unit investment trusts, which include Diamonds, (American Stock Exchange investments that track the Dow), and Spiders (or the increasingly popular, Standard & Poor's Depositary Receipts), which track the S&P 500.

As an investor, you must consider how much risk you're willing to accept. Market or systemic risk is the unavoidable possibility that the market might decline. Inflation may eat away your return. If your time horizon is longer than 10 years, cash and short-term bonds are the riskiest investments, because they're unlikely to match the performance of stocks. Business or stock-specific risk is the danger that a single company will implode, or get eliminated through diversification.

> "Competition is so intense that companies simply cannot raise their prices and expect to remain competitive. As a result, price inflation will remain near zero."

Investors with longer time horizons can afford more risk. Investors with short-term horizons should put their money in short-term bonds and money-market funds. For time horizons longer then five years, buy large-cap blue-chip companies, the time-tested firms that survive market volatility. Market timing is very difficult, even for professional investors, and essentially amounts to gambling.

Stocks to Own

Investors should strongly consider buying:

- AT&T has cut costs and focused on providing low-cost long distance service. AT&T also plans to invest in new technology and equipment to boost its presence in the local, wireless, and global markets. Telecommunications has been growing at a healthy rate, and AT&T has strong management, a brand name, and financial strength. (NYSE: T)
- American Express aims to generate half its revenue from international markets. It has reversed its declining market share, and won the favor of employers who offer workers company credit cards. (NYSE: AXP)
- Citigroup came into being when Citicorp and Travelers merged in 1998. Citigroup is benefiting from globalization and the repeal of financial service barriers. (NYSE: C)
- Coca-Cola sells some 160 brands in more than 200 countries. Most of its sales come from outside the U.S. Coca-Cola is aggressively working to increase sales and market share. (NYSE: KO)
- Walt Disney makes movies and television programming, runs theme parks, and owns ABC and ESPN. It has the strongest brand name in the media and entertainment industry, and it is diverse enough to weather an economic downturn. (NYSE: DIS)
- Exxon Mobil focuses on cost control and shareholder return. (NYSE: XOM)
- General Electric no longer is just a manufacturer of durable goods. Most of GE's revenue comes from financial and information services. (NYSE: GE)
- IBM had a tough time in the late '80s and early '90s. But no other company has the hardware, software, services and people to run network solutions for clients. (NYSE: IBM)
- Merck is benefiting from the aging of the U.S. population, and it has promising drugs in its development pipeline. (NYSE: MRK)
- Procter & Gamble has the marketing muscle to keep increasing its worldwide sales. (NYSE: PG)
- United Technologies has spent heavily on research and development. (NYSE: UTX)
- Wal-Mart dominates its market and is focusing on technology to widen its advantage. (NYSE: WMT)

About the Author

Longtime financial adviser **David Elias** is president and chief investment officer of Elias Asset Management. He is a frequent source for CNBC, CNN, and *The Wall Street Journal.* He is a contributing editor to *Chief Executive* magazine and a member of the national board of governors of the Money Management Institute.