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The Retirement Letter

HELPING YOU BUILD AND ENJOY A RICHER RETIREMENT

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Issue #405

Dear Friend,

The arrival of the landmark year 2000 will mark a new beginning, not the end, for your retirement wealth. In this special all-investment letter to you, I'll help you lay the cornerstone for yet another year of low-risk wealth accumulation.

The investment environment remains quite favorable—but only if we're very selective. The challenges are significant. The Dow Jones Industrials, the S&P 500 and the NASDAQ 100 all reaped impressive gains for the fifth consecutive year in 1999. Many pundits continue to warn of a stock market "bubble" and investment "mania."

But the reality is that the average stock actually declined in value in 1999, and many stocks are at least 25% below their highs. So we're still in a bull market, but it's a very narrow one. Moreover, steadily rising interest rates over the last 12 months have made it difficult for income investors to protect their principal.

How, then, can you continue to grow and protect the assets you need to enjoy a rich retirement lifestyle? Simply by investing according to your needs in high-quality vehicles, in the New Year and beyond.

I'll give you the road map for the next leg of our journey to prosperity. We'll start with the "big picture"—the key economic, business and investment trends. Then we'll look at the stocks, bonds and mutual funds that will benefit from these trends and are best for your particular goals in or approaching retirement. You'll find a few new recommendations to complement the top-quality stocks and funds already in THE RETIREMENT LETTER portfolio (please see the enclosed Investment Update). We'll also sell several investments in order to strengthen our defense against the dangers of rising interest rates.

Bull Market in High-Quality Investments

When I look at the major factors that increase investment wealth, I can't help but be very optimistic about the long-term prospects for your retirement portfolio. Let me explain why.

Our economy is growing at a robust 4% or so a year (after inflation). We'll soon mark the longest economic expansion in U.S. history, and there's no hint of recession on the horizon. Even though the unemployment rate has dropped to a 29-year low, inflation remains virtually dormant at 2%. And interest rates are still moderate, despite 1999's rebound.

How can growth and low inflation coexist for so long? There are many interrelated reasons. The technology revolution has fueled rising productivity and reduced the cost of doing business in countless ways. Another key trend is what I call "economic globalization." Increasingly, the world is one big marketplace, in terms of potential customers and the flow of ideas and capital.

The Internet, still in early development, will accelerate the already rapid pace of change—and the potential for wealth creation. Internet usage is growing an estimated 7% a month. At its most basic level, the Net enables consumers and businesses to easily find any particular item and buy it at the lowest price. The bigger picture is that virtually any company will have to make the Net an integral part of its operations in order to survive, much less thrive.

Moreover, we're in the midst of the greatest merger wave ever. It's affecting just about every industry in America,

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from telecommunications to energy to financial services. This merger boom will continue because the technology revolution and economic globalization provide huge opportunities for industry leaders to achieve tremendous economies of scale and exploit new growth opportunities.

Companies that can make the most of the technology revolution and its related trends will lead the way in 2000 and beyond. By this, I mean (1) companies that provide high-quality technology products and services; and (2) companies that have the vision and expertise to use those products and services to grow.

In the environment I've described, the opportunities for large blue-chip companies with seasoned management to gain market share around the world are unprecedented. A surprising number of companies are generating fast growth of revenues and profits at a rate that would have been unimaginable only a few years ago. These companies often have low or no debt, lots of cash and large sales forces. In other words, the strong are getting stronger, at the expense of the rest.

The merger wave is also reducing the supply of stock that investors can buy—despite the large number of new stock issues in 1999. Meanwhile, people of all ages need and want to buy stocks for long-term growth. When supply is shrinking and long-term demand is solid, that's very bullish for stocks.

Finally, we can still find more than enough reasonably priced stocks to buy today. True, some two dozen high-quality companies trade at sky-high price/earnings multiples (as do a lot of promising but unseasoned technology companies on NASDAQ). Nevertheless, many other proven winners are reasonably priced relative to their growth.

But We Need to Be Careful Too

It's now evident that, after 16 years of declines, we've seen the rock-bottom lows in inflation and interest rates. There's a good chance that, rightly or wrongly, the Federal Reserve will continue to hike short-term interest rates in 2000. But inflation is still low. And any Fed hike(s) would slow down the economy, reduce the risks of recession and higher inflation—and preserve the bull market in high-quality investments.

This means two things for all of us. We need to be very particular about our investments in stocks and mutual funds. And we can no longer count on falling interest rates to fuel dramatic increases in P/E multiples, as they did in the 1980s and '90s.

Second, this new development means that long-term bonds will no longer generate the robust capital gains that they did from 1982 through 1998. In other words, those bonds are no longer such a safe investment.

Think "Long Term" for More Investment Profits

I want you to make the most of the opportunities that lie ahead while you minimize the risks that (1) you'll get trapped in unsuitable or inferior investments; or that (2) you'll fall prey to panic selling during normal declines.

In today's rapidly changing economy and volatile financial markets, sticking to a proven plan for long-term wealth accumulation provides both an essential focus and peace of mind. Be sure you're following my RETIREMENT LETTER program that enables you to build and protect your wealth as you approach or enjoy your retirement. Here are my four guidelines:

#1: Invest according to your needs. This simply means you should check when you'll want to tap your nest egg for living expenses. If you're retiring in a

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few years or less and will need income, you'll need to minimize your risk with that portion of your wealth. But keep the rest growing to be sure you'll always have enough for a comfortable retirement. If you have plenty of time until you need investment income, invest for growth and rest easy regardless of short-term fluctuations in value.

Keep in mind that investments that grow little or not at all in value actually increase the risk that you won't be able to enjoy your retirement. The purchasing power of that wealth is steadily reduced by inflation—and absolutely devastated by taxes on current income you may not even use. So make sure you evaluate your long-term needs and adjust your portfolio accordingly. (You may not need those bonds after all.)

#2: Stick with high-quality investments. The sure way to sidestep market mediocrity is to avoid average stocks. Shares of high-quality companies rise like clockwork during bull markets and recover the fastest from downturns. Of some 10,000 publicly traded companies, I consider no more than about 250 for possible recommendation.

I recommend only stocks of financially strong companies with sustained growth of revenues, earnings, cash flow and intrinsic value, year after year, regardless of changing economic conditions. The only mutual funds I recommend are run by managers who have proven that they can deliver consistently superior results while keeping your risk low.

#3: Buy only at bargain prices. By setting cautious buy limits for our stocks, we greatly reduce the risk of paying top dollar, only to suffer wrenching losses in a severe downturn. So we never chase stocks, not even of great companies.

#4: Stay broadly diversified. Spread your investments selectively among different types of stocks and equity mutual funds, as well as bonds and cash when appropriate. This enables you to avoid the possibility of large losses while continuing to make good money.

Our quest for quality keeps most of our investment wealth working for us here in the U.S., where we have so many great companies that are world leaders. Even so, spreading your wealth across several markets and types of investments—selectively—provides prudent diversification.

Stocks That Will Build Your Retirement Wealth

I want you to invest in high-quality companies that are willing and capable of embracing and adapting to change. But I caution you to do so only when the stocks are available at reasonable prices. This month, I'll highlight my current favorites among the RETIREMENT LETTER recommendations. As I write this, all of the stocks below are trading near or under my recommended buy limits.

In information technology, my top recommendations for superior growth are **Hewlett-Packard** (NYSE: HWP), **International Business Machines** (NYSE: IBM) and **Intel** (NASDAQ: INTC). All three are dominant hardware companies that are moving aggressively to exploit the huge developing growth opportunities in building, running and maintaining the burgeoning Internet infrastructure. Here are my current buy limits: **Hewlett-Packard**, $110; **IBM**, $114; and **Intel**, $83.

In telecommunications technology, **Lucent Technologies** (NYSE: LU) is my first choice. As I explained last month, the Internet, wireless communications and broadband are three of the many forces fueling heavy demand for the best telecom equipment. Buy **Lucent** for long-term growth up to $75. And in telecom services, **MCI WorldCom** (NASDAQ: WCOM) is the clear winner. It already dominates the most lucrative telecom market: business-to-business services. Its long-term potential in the other major service areas will get even better if its proposed acquisition of Sprint eventually goes through. My **WCOM** buy limit is $84.

Financial Services Will Continue to Grow

Another significant trend is the long-term growth of financial services. Banks, mortgage lenders, brokerage firms, insurance companies and others account for almost 20% of the world's economy, according to one estimate I've seen. That's up from

11% 20 years ago. Driving this growth is rising demand for financial products here and abroad. Financial services, long heavily regulated, are also benefiting from falling barriers, such as Congress's recent repeal of the Glass-Steagall Act, economic globalization and mergers.

Most financial stocks were lackluster performers in 1999. The reason, pure and simple: rising interest rates. In the long run, though, the dominant financial companies will benefit much more from strong demand and increasing market share than they'll be hurt by rate fluctuations.

A perfect example is my new recommendation: **Citigroup** (NYSE: C). It's the world's largest diversified financial institution—100 million customers in 100 countries. Citigroup has the potential to achieve stable annual growth approaching 15% over the long haul. Working in its favor are the recovering global economy; the ability to cross-sell banking, brokerage, insurance and other products and services; and declining operating expenses. Another key advantage: two leaders (Sandy Weill and John Reed) who know how to boost shareholder value, aided by former Treasury Secretary Robert Rubin.

➤ **What to do now:** Citigroup currently carries a modest P/E of 18, based on probable 2000 earnings. Buy **Citigroup** at up to $60 for conservative growth.

Among our other financial stocks, my favorites to buy now are **Fannie Mae** (NYSE: FNM), buy up to $67; **MBNA Corp.** (NYSE: KRB), $28; **Marsh & McLennan** (NYSE: MMC), $77; and **State Street** (NYSE: STT), $77. Each of these companies continues to deliver steady growth you can rely on, year after year. Please check the enclosed Investment Update for the right investment for your situation.

Get Good Income That Keeps Growing

The key to successful investing for retirement income is to focus on all three components of a superior total return: current yield, rising payouts and appreciation in the value of your holdings. The income investors among us are faring quite well on the first two counts. Unfortunately, 1999's sharp increase in bond yields eroded the value of high-income stocks of all types.

The good news is that each of our companies continues to deliver stable, growing earnings and rising dividends. I advise you to stick with the investments below if you need the income and you have a long-term perspective.

Spieker Properties (NYSE: SPK) is my top recommendation for maximum income at low risk. This real estate investment trust (REIT) is benefiting directly from the high-tech boom and overall economic strength on the West Coast. It continues to renew rents for its office and industrial tenants in California and the Northwest at significantly higher levels. The company's funds from operations (REITs' equivalent of earnings) continue to climb 15% or more each year, and dividends are increasing at least 8%. Current yield: a rich 7%. Buy **Spieker** up to $37.

Kimco Realty (NYSE: KIM) is another income winner. It's a leading owner/operator of shopping malls, with a diversified range of tenants. Again, FFO is increasing at a 15%-plus rate, and you can expect annual payouts to rise 8% or more. Current yield is 7.3%. Buy **Kimco** at $35 or less.

But I recommend that you now *sell* both **Health Care Property Investors** (NYSE: HCP) and **Nationwide Health Properties** (NYSE: NHP). Both REITs lease long-term care and other facilities to health-care providers. These businesses now offer little growth potential for earnings, dividends or stock prices. I suggest that you switch into Spieker and/or Kimco.

If dividend yields of 2% or so are enough for your needs, this is a good time to buy my two favorite energy stocks. The just-combined **Exxon Mobil** (NYSE: XOM) has embarked on an aggressive cost-reduction program that will strengthen its position as the industry leader and low-cost producer. **BP Amoco** (NYSE: BPA) is also adept at emphasizing its most profitable businesses while cutting expenses. It will do well regardless of whether or not its planned acquisition of Atlantic Richfield goes through. Buy **Exxon Mobil** up to $85 and **BP Amoco PLC** (NYSE: BPA) at $65 or less.

Our electric utilities, **Southern Co.** (NYSE: SO), **Duke Energy** (NYSE: DUK) and **NiSource** (NYSE: NI) continue to deal effectively with the four major industry

trends: increased competition; rate freezes or reductions by state regulators; heavy merger activity; and the shift to less-regulated businesses to generate more growth. For instance, NiSource is attempting to take over Columbia Energy, a large natural gas supplier. **TECO Energy** (NYSE: TE) is not doing as well with its core and unregulated businesses, but the company is a possible takeover candidate.

All four companies are financially strong, and the stocks are capable of generating good total returns from their currently depressed levels. I recommend that you hold them for now if you need the retirement income.

Growth Funds 2000: Your Best Choices

Our U.S. no-load growth-stock funds enjoyed yet another fine year in 1999: Many outperformed the Standard & Poor's 500 index, and most did much better than "average" in their particular categories. Let's do it again in 2000!

In today's global economy, putting some of your nest egg in large-company blue-chip growth stocks is essential. My two favorite funds that invest in this dynamic area remain **Harbor Capital Appreciation** (HACAX, 800/422-1050) and **Janus Fund** (JANSX, 800/525-8983). Both are among the first funds I recommended to you when I became editor of THE RETIREMENT LETTER five years ago. Since then, they've increased our wealth much more than even I imagined they would, outperforming the S&P 500 over the past one, three and five years.

Jim Craig, Janus' longtime manager, will change jobs next month, becoming research director for the Janus Capital Fund Group. Craig's successor at Janus Fund will be Blaine Rollins, who has assisted Craig there for five years and manages two other funds. I recommend that you hold on to Janus Fund. Little is likely to change, given Janus Capital's team-oriented management approach. Naturally, I'll monitor the situation closely for you.

For a more conservative approach to large-company growth stocks, I continue to prefer **Selected American Shares** (SLASX, 800/243-1575), **T. Rowe Price Blue Chip Growth** (TRBCX, 800/638-5660) and **Fidelity Fund** (FFIDX, 800/544-8888). However, I recommend that you now *sell* **Fidelity Growth & Income** (FGRIX) for a 116% return in four years. This fund is no longer generating superior results. I suggest you switch to Fidelity Fund.

Mid-Cap Funds Give You Faster Growth at Reduced Risk

Despite the increasing dominance of some large companies in their industries, many medium-size companies are growing even faster or trading at significantly lower price/earnings multiples. So you should have a stake in this area if you're a long-term investor. I also advise you to use mutual funds in order to limit your risk. Reason: Diversification and professional management are essential because these companies generally aren't as well established as the big ones.

Janus Enterprise Fund (JAENX, 800/525-8983) is my first choice if you can invest for superior growth potential and you have a long time horizon. This fund, which invests in several types of technology and other fast-growing companies, has returned an impressive 32% annually over the last five years.

Two other mid-cap recommendations that are more conservative yet also top performers are **Strong Opportunity** (SOPFX, 800/368-1030) and **Weitz Value** (WVALX, 800/232-4161). Both emphasize undervalued companies.

Stock Funds That Keep Growing at Low Risk

Regardless of whether you're a conservative investor or one who relies on retirement income in addition to long-term growth, you'll generate solid, worry-free results with my recommended "total-return" funds. These are funds that combine growth and income in varying degrees, ranging from all stocks to different combinations of equities and fixed-income securities.

I must tell you that we need to be even more selective here now than before. We can no longer count on falling interest rates to boost the value of bond holdings and high-yield stocks. And most total-return funds invest primarily in undervalued

stocks, as opposed to growth stocks. The "value" approach has lagged the market for some time now. It's time for us to make some changes.

I still like **Vanguard Wellington** (VWELX, 800/523-7731). It has consistently delivered above-average returns among income-oriented stock funds, at below-average risk. Wellington generally holds 60%-65% in dividend-paying stocks and the rest in bonds. This remains a solid conservative retirement investment that pays about 3.5% a year.

Vanguard Asset Allocation (VAAPX) has provided us with excellent long-term returns by investing in two indexes: one for blue-chip stocks (the Standard & Poor's 500) and the other in Treasury bonds. The investment allocation between the two can vary quite a bit depending on market conditions, typically running between 80% stocks-20% bonds to 50%-50%. The fund's annual yield usually exceeds 3%.

Unfortunately, I must now advise you to *sell* **Vanguard Windsor II** (VWNFX). After several excellent years, it has been hurt by weakness in financial issues and other "value" stocks, and by a refusal to invest significantly in technology issues. Sell for a 164% return in six years.

I also recommend that you *sell* **Vanguard Wellesley Income** (VWINX). This has been a good, low-risk fund for us, returning 104% in seven years. But with a 60% stake in long-term bonds and the rest primarily in rate-sensitive stocks, Wellesley Income is now swimming against the tide.

If you prefer to stay at Vanguard, I suggest you switch to Wellington or Asset Allocation. Or consider this new recommendation: **Dodge & Cox Stock** (DODGX, 800/621-3979). Run by a management team, it invests in a broad range of undervalued companies and carries low annual expenses. It has a long record of providing solid returns (15.6% annually over 10 years) at subpar risk. Current yield: 1.4%. Since the fund tends to keep its investments for many years, its low portfolio turnover reduces taxable fund distributions.

Your International Stake Will Pay Off Again

I've noticed that many equity investors tend to avoid foreign equity investments. I think that's a mistake, given the many positive changes that are occurring outside the U.S. as well as here at home. Our investments outside the U.S. paid off in a big way in 1999, with my two recommended mutual funds returning more than 50%. Both were among the top 5% of 600-plus international equity funds.

I expect the year ahead to be another good one for international companies. The main reason is the accelerating pace of the "capitalist revolution" that I've often referred to in the past. This is most evident in Europe, where we continue to see an accelerating pace of big mergers, restructuring, industry consolidations and deregulation that will boost efficiency and profitability for the strong operators. Similar trends are finally emerging in Japan too.

In Europe, Japan and elsewhere, the level of equity ownership is in the early stages of rapid growth from low levels. Managements are increasingly focusing on the importance of both profitability and of increasing shareholder values.

Another reason I'm optimistic is that the global economy is showing steady improvement after the severe problems of 1997-1998. And inflation remains low, averaging less than 2% across the world's industrialized regions.

I recommend that you start with a broadly diversified international stock fund in order to capitalize on the best opportunities around the world. The managers of my recommended funds will spot and capitalize on low-risk opportunities as they develop.

My first choice remains **Artisan International** (ARTIX, 800/344-1770). Manager Mark Yockey's approach is simple: Buy good growth companies for the long term, when they're available at reasonable prices. After investing almost entirely in Europe, Artisan now has a 20% stake in Japan. Yockey says he's more positive about Japan than he has been in 10 years. **Janus Overseas** (JAOSX, 800/525-8993), my other favorite international, is closed to new investors, but if you're already in, add to your investment.

I'm also recommending a conservative international equity fund that provides generous rewards at low risk: **UMB Scout Worldwide** (UMBWX, 800/996-2862). This

virtually unknown gem has delivered solid double-digit returns in each of the last five years. Manager Jim Moffett invests in large foreign companies that are expected to generate steady growth of earnings and cash flow. Unlike most managers, he does this primarily through American Depositary Receipts (ADRs), which trade here like U.S. stocks. Companies issuing ADRs must meet U.S. accounting standards.

Where You Can Still Get High, Safe Retirement Income

With the reversal of the long-term trend of falling interest rates, it's essential that you protect your fixed-income investments from the risk of lost principal. So my first piece of advice is to emphasize bonds and bond funds with intermediate-term maturities (10 years or less). Avoid long-term government bonds, which suffer the most when rates rise.

For maximum retirement income, I recommend that you focus on types of bonds that require professional analysis and management, and where we can benefit by using superior managers. Unlike U.S. government bonds, these other issues—corporate, mortgage and foreign-government—trade based on other factors in addition to interest-rate swings.

For example, in our solid economy, high-yield bonds offer good potential. Reason: They trade partly on the perceived prospects and financial strength of individual issuers, and they're more sensitive to economic and credit factors than are other types of bonds. Another plus: Maturities generally are under 10 years, so these bonds are less sensitive than long-term issues to rate fluctuations. High-yield bonds now are relatively cheap compared with government bonds, based on their historical yield relationship. Yields exceed 10% in many cases.

Northeast Investors Trust (NTHEX, 800/225-6704) remains my first choice for reduced-risk investment in this area. Managers Ernest and Bruce Monrad (father and son) have extensive experience in guiding investors through both good markets and tough ones like 1999's. The fund's current yield is 8%.

I'm now adding a new choice for more aggressive income investors: **Fidelity High-Income Fund** (SPHIX, 800/544-8888). Fidelity's high-yield bond team is among the best in the business, and this fund has been near the top of its class for eight years running. Current yield: 8%.

If You'll Need to Tap Your Principal Sooner

To make the most of the changing interest-rate environment for shorter-term needs, I'm adding **Vanguard GNMA** (VFIIX, 800/523-7731) to the RETIREMENT LETTER portfolio. This fund offers two advantages for those of you who want good retirement income: a generous yield (currently 6.5%) and top credit safety—the fund invests only in government-backed mortgage certificates and other issues.

Mortgage securities hold their value better than most types of bonds when rates are trending flat to higher. In effect, they're intermediate-term vehicles because some homeowners sell or refinance their properties ahead of time. And government-backed mortgage issues carry higher yields than do intermediate-term bonds with good credit-safety ratings.

Intermediate-term Treasury notes you hold to maturity are the ideal investment for no-risk retirement income. You don't need professional assistance to invest in T-notes—just buy them directly and hold on. T-notes carry maturities of two to 10 years. Interest is exempt from state and local income taxes—a meaningful benefit if you live in a high-tax state.

Now that yields have climbed sharply, you can comfortably go out to seven years on new T-notes. Yields currently run 5.9%-6.1% on T-notes maturing in two to seven years. This is only modestly lower than the 6.2% yield on 30-year T-bonds, without heavy interest-rate risk.

For extra protection and flexibility, you can build a T-note "ladder" of different maturities. For instance, you might buy notes maturing every year over the next five; or in 2002, 2004 and 2006. Whichever ladder you choose, you reinvest the proceeds from maturing T-notes in new longer-term notes at market rates. This will enable you to boost your retirement income if yields rise.

HOW TO KEEP IN TOUCH

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Lock In Rich Retirement Income With Tax-Free Bonds

I suggest that you focus on municipal bonds with new purchases if you need retirement income and (a) if your marginal federal tax bracket (the tax rate on your next dollar of income) is 28% or higher; and (b) if you pay state income tax. Yields on tax-exempt municipals are relatively high compared with those on federally taxable Treasury securities.

High-quality 10-year municipals—those with the top credit-safety ratings of AAA or AA—currently pay yields of about 5.2%. That's comparable to a 7.2% taxable yield if you're in the 28% federal tax bracket, and 8.6% in the 39.6% bracket. If your state has an income tax, your "taxable-equivalent" yield rises even higher when you buy bonds issued there because your bond interest is also generally exempt from state and local income tax.

Here's my capsule advice: Buy individual bonds only if your initial investment will be at least $10,000 per issue. Buy only bonds with high credit safety ratings of AA or better. And stick with municipal maturities of 10 years or less.

You should use a bond fund to invest in municipals if you're investing less than $30,000 overall. If you live in a state with no income tax or a low tax rate, go with a "national" municipal bond fund. This buys issues of many states, so you'll get more diversification and probably the highest net yield. If you're in a high-tax state, you'll generally come out ahead with a single-state fund, which invests in one state's bonds. Absolutely essential: Choose no-load bond funds with low annual expenses. **Vanguard** (800/523-7731) is my top fund-group choice. Its **Municipal Intermediate Term** (VWITX) is a solid national fund, and Vanguard offers reliable single-state funds for California, Florida, Massachusetts, New Jersey, New York, Ohio and Pennsylvania.

Is It Really Different This Time?

Some observers contend that the next century and millennium will bring a new, as yet undefined era. Maybe, maybe not. But, as a longtime student of history, I believe that many important factors are different today than they've ever been.

We're in the midst of a long period of low-inflation prosperity, aided by relative peace in the world and a global trend toward free markets and personal freedom. And we're in the early stages of a technology explosion that's changing the way we do so many things. As we enter a presidential election year, I'm also happy to note that politicians are becoming less relevant to our prosperity.

With all this change comes the ever faster flow of information and opinion—and sometimes volatile securities prices. That's why you need a sound, long-term plan for successful wealth accumulation and preservation. So stick around and stay in touch! Have a wonderful holiday season and a Happy New Year.

Sincerely,

Philip A. Springer

Philip A. Springer is the nation's leading authority on building and enjoying a rich retirement. He has 19 years of experience as a specialist in investments, tax reduction and other financial areas of importance to people in or approaching retirement. His investment approach focuses exclusively on high-quality stocks, bonds and no-load mutual funds. THE RETIREMENT LETTER was named Best Financial Advisory Newsletter for 1998 by the Newsletter Publishers Foundation. Mr. Springer also offers an independent wealth-management service.