SY SYMS SCHOOL OF BUSINESS

THE EXCHANGE

THE OFFICIAL BUSINESS PUBLICATION OF YESHIVA UNIVERSITY

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Rabbi Miller, seen here attending to the students' concerns.

Student Accounts Suspended Due to Improper ID# Usage

by Jeffrey Gamss

There has recently been an issue that has occupied the time of both deans and student organizations. It involves the Yeshiva University Finance department, Commercial Bank of New York. and goes as far as the Internal Revenue Service.

The inception of a student organization at Yeshiva University eventually results in the need for a bank account for depositing and checking purposes. Over previous years, the clubs have benefited from the services provided by Commercial Bank of New York, a member of the Safdie group. Current student leaders were baffled when earlier this year several of the student councils received a startling notice from Commercial Bank. The letter informed the organizations that they have been improperly using a Taxpayer Identification Number (TIN) that legally belongs to Yeshiva University. The notice further stated that Commercial Bank would close the accounts if the student leaders would not file their own proper ID numbers by a certain deadline. Some leaders, not knowing what to do, decided to close their accounts. Others decided to ignore the letter completely.

The Internal Revenue Service, for tax reporting and filing requirements, assigns the TIN that the organizations had filed to open the respective bank accounts. The TIN for businesses, more commonly called the Employers Identification Number (EIN), is generally recorded with the IRS for a tax-exempt organization, specifically, Yeshiva University. However, according to Mr. Spolansky of Yeshiva University's Finance Division, "the student organizations are not associated with the University for tax purposes. Therefore, the organizations do not have the right to use the EIN that had been assigned to the University by the Internal Revenue Service." In other words, the previous leaders of each organization were improperly using YU's EIN for deposit purposes.

When the bank informed Yeshiva University of these questionable actions, YU ordered the EIN number removed from every one of the clubs' accounts, effectively disabling all clubs that relied on Commercial Bank of New York for funding. When *The Exchange* opened its account two and a half years ago, the newspaper's Editor-in-Chief decided to follow procedure set by the other organizations, opening the account using the University's EIN number. Rabbi Adam Miller of Student Services found out about *The Exchange*'s actions and reported the alleged misuse of the number to Mr. Joseph Rasson, a customer service representative of Commercial Bank of New York After reviewing the files for the club accounts held at Commercial Bank, Mr. Rasson notified the Office of Student Services that all of the student organizations initially opened their accounts with the same EIN number. "When I told Yeshiva that all the accounts were using the EIN of the University, they had us remove the number from every account. We also sent letters around to the account holders to inform them that if they did not submit a proper ID number by a certain time, we would close the accounts. Because of our policies, we began penalizing each account $15 a month for not submitting the ID number," said Mr. Rasson.

In order to clear up any misunderstandings, a meeting was set with Mr. Spolansky to discuss the situation. Mr. Spolansky informed the student leaders that they should file an SS-4 form with the Internal Revenue Service to receive their EINs over the telephone. Since confirmation from the IRS takes approximately four to six weeks, some organizations that may not have received confirmation of their individual EIN number,

Exchange Gets Facelift and Extends Focus

By Exchange Staff

After a recent upheaval in *The Exchange's* staff, due to the graduation (recent and upcoming) of its core members, new, enthusiastic staff members have joined the newspaper, assisting in both fine-tuning the paper's quality and in expanding the paper's focus. Heading the staff are new Editors-in-Chief Yair Oppenheim and Jeffrey Gamss, both of whom have risen quickly through the ranks with the common point of boosting the quality of the paper.

Through the course of the past few years, *The Exchange* has acted as the sole student-publication of the Sy Syms School of Business of Yeshiva University. "*The Exchange* has been great in raising SSSB's profile in the New York business community," says David Anziska. "It has been instrumental in enabling students to acquaint themselves with today's changing marketplace." Beginning with a conventional focus circling student news and career paths, *The Exchange* soon branched out to handling current events and in-depth looks at areas in business. Set with that goal, *The Exchange* managed to pique the interest of Sy Syms students, providing comprehensive coverage of investment opportunities, financial news, and accounting standards. As Associated Editor Ilan Scharf puts it, "While we are proud of the past achievements of *The Exchange*, we have decided to pursue a fresh perspective in its future production."

The Exchange was given the facelift it needed as it shifted its target to being a "Barron's-type publication." Though this did improve the quality of the paper, as noted by the SSSB student body and faculty members, it seemed to alienate readers by seemingly regurgitating *New York Times* and *Wall Street Journal* articles. Editor-in-Chief Yair Oppenheim said, "*The Exchange* needed a shot in the arm because of a lack of creativity in last semester's edition."

The staff of *The Exchange* would like to inform its readers about the changes that will make the paper more user-friendly.

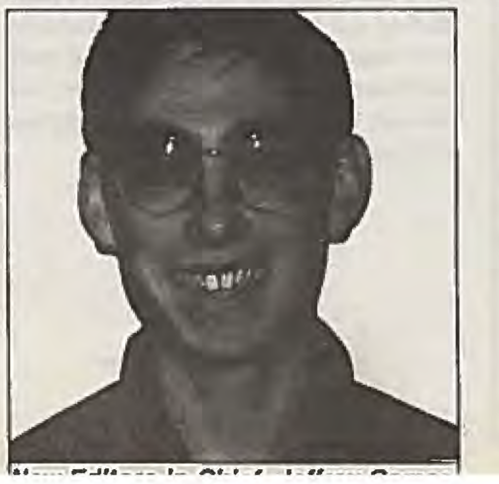
Increased inter-campus coordination: It is exceedingly difficult to coordinate the publication of a single newspaper between two distant campuses such as the Uptown and Midtown campuses of SSSB. Efforts are being made to ensure that both student bodies are being sufficiently represented within *The Exchange*. Furthermore, we are finding new ways to increase the communication and participation between the two campuses and integrate them into the new and improved *Exchange*.

Increased coverage of the consumer marketplace: *The Exchange* will increase coverage of non-financial business news. Instead of simply publishing informative articles about mutual funds, derivatives, stock analyses and regulatory measures, *The Exchange* will diversify its focus to include all aspects of the business world. New topics will include job placement, corporate politics, issues related to human resources and global economic policies.

Real business personalities: The business world is comprised of individuals, the "Movers and Shakers" who every day are faced with decisions that will effect thousands of people. One can only imagine the pressure a CEO must face at the workplace when formulating a corporate vision necessary to avoid the usual market troubles. *The Exchange* hopes to introduce an innovative series of various corporate executive profiles. This series should provide the reader with a better sense of how practical decisions are made in today's global economy.

Sy Syms School course evaluations: Courses will be showcased each issue via an interview with each offering's respective instructor. The instructors will provide descriptions of the classes along with their methods of teaching. This is to establish student interest in these electives and obtain feedback from readers.

Opinions and Editorials: As any seasoned journalist can tell you, the most important and most telling aspect of a newspaper is its opinion pieces and editorials. *The Exchange* hopes to provide piercing commentary on various issues ranging from ease of registration at the Sy Syms School of Business to general events in the business world that affects the student body. As a result, all students and alumni are encouraged to submit their own perspectives on issues relating to business.

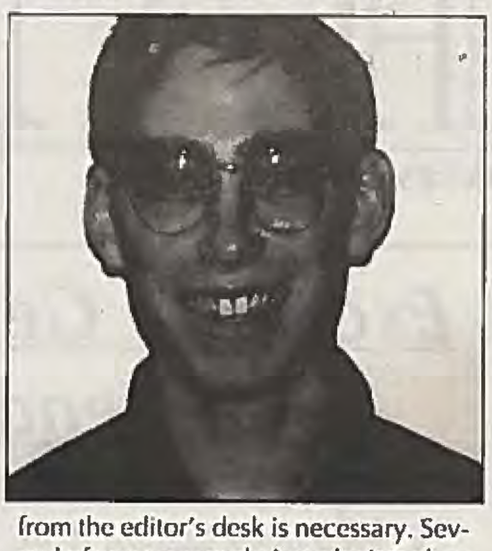


From the Editor's Desk

Dear fellow students,

Three years ago, a few students at the Sy Syms School of Business decided that the school needed its own newspaper. The idea was that if the school were to compete with The Wharton undergraduate business school, The Stern (NYU) undergraduate business school, and the like, then our own newspaper was a necessity. Students were encouraged to participate in this endeavor initiated by Jason Buskin.

We have come along way from the original format and focus of The Exchange. In fact, as this article is being written, the people who bring this newspaper to you are researching issues of international concern that will affect the business world for years to come. It will inform the students about international culture, and we hope that it fills a void in our own education.



However, I feel that a brief confession from the editor's desk is necessary. Several of you are wondering why it took so long to publish the second issue of The Exchange. Well, we have had difficulties which prevented us from operating any quicker. After receiving information early this academic year that The Exchange had ordered its own computers, the reality that we have neither the computers nor the money to purchase computers surprised the staff of the newspaper and some university faculty, as well. We appreciate the staff at The Commentator for continuing to allow us to use their office to publish The Exchange. However, we regret the fact that our schedules often run concurrently and, therefore, we are incapable of publishing on a consistent monthly basis.

The Exchange would like to thank the Sy Syms School of Business Student Councils on both campuses for covering our publishing expenses. We would not be here without you.

Sincerely,

Jeffrey Gamss

Jeffrey Gamss
Editor-in-chief

Dean's Message

Dear Students,

With the Spring 1998 semester beginning, we find much excitement in the Sy Syms School of Business. Our enrollment continues to grow and with it, a large number of new and exciting courses being offered. Dr. Charles Snow is teaching FIN 2505-Entrepreneurial Finance as part of the Rennert Entrepreneurial Institute. Dr. Mark Licht is teaching, INF 2250-Internet for Business; Dr. Moses Pava, MAN 4635-Seminar in Business Ethics based on his research and new book; Prof. Ira Teich, MAR 3331-Industrial Marketing; Dr. Fred Palumbo, MAR 3345-International Export Promotion; and Prof. Claire Zakheim, STB 1456-Quantitative Analysis for Business. All these courses are being offered to meet the changing needs of the business community. The Contemporary Problems in the Business Seminar is again being offered on Fridays with an impressive list of CEO's and corporate executives.

The Office of Placement & Career Services has already launched its Spring activities. The on-campus recruiting schedule is one of the largest in years. Workshops on recruiting for permanent, summer and internships positions have been offered. A large number of graduating seniors have already received offers. With a very strong job market existing, this looks like an excellent placement year. The Office of Placement & Career Services has also seen some new staff additions and promotions. Naomi Kapp has been promoted to Associate Director, and Jennifer Berman and Robert Bomersbach have joined us as Assistant Directors. Lana Steiner is the new administrative assistant for the The Office of Placement & Career Services.

Those seniors who are interested in applying to graduate schools should meet with Naomi Kapp to plan the application process. Last year we had a near-perfect accpetance rate, and this year looks even better.

Field trips to the New York Stock Exchange, and Coopers & Lybrand, LLP were held, with more to follow. Speaker events in Finance, International Business and Business Careers in Israel will be held this semester. We invite students to join the excitement that exists in the Sy Syms School of Business.

Sincerely yours,
Ira L. Jaskoll
Associate Dean

SSSBSA Presidents' Messages

I am quite pleased to once again address you all through the forum of The Exchange. Congratulations to the editors for their persistence and dedication in bringing this issue to fruition. With the spring semester upon us, there has been a great deal of activity at the Sy Syms School of Business. The Joint Business Society recently organized a very successful trip to the New York Stock Exchange, and the Max Investment Club has met on February 17 with the hopes of hosting alumni speakers in the near future. Please be sure to read the signs around campus, and also provide the Student Council with your feedback and recommendations. While I have your attention, I'd really like to stress to all Sy Syms students that we truly can compete with students from any other university in any arena. Our school days are longer than those of any other college in the country, while many of our classes and exams are just as challenging. Many of us have often been intimidated because our school is only ten years old, and doesn't yet receive the recognition that some of the nations more established universities do. However, while we have fewer alumni to turn to for guidance and support, our alumni have been very successful in a multitude of fields. Their success is indicative of what we can achieve through hard work and pride in our roots. To fully prepare for both the technical and time management challenges that we will encounter upon our entrance into the business world, we must begin utilizing those very skills during our time at Yeshiva University. We must take full advantage of both our morning and afternoon classes, and provide ourselves with capabilities that will last a lifetime.

Sincerely,
Simcha Gissinger
President, SSSB

During November 23-25, 1997, I and three other SSSB students, Rachelle Butler (Joint Business Society President [Midtown campus]), Jonathan Teitelbaum (SSSB Treasurer [Uptown campus]), and Michael Gewirtz (SSSB Secretary [Uptown campus) had the opportunity to attend an international conference given by the Foundation for Student Communication of Princeton University on the topic of "Corporate Public Responsibility". At this conference, we had the chance to listen to Presidents and CEOs of Fortune 500 corporations, as well as smaller companies discuss their companies' business philosophies and views of communal altruism. The conference was quite intriguing and it gave us a chance to learn in a different forum other than a typical classroom setting. What was most fascinating during these three days of seminars, lectures and public ruminations was the way we as students, yet at the same time, representatives of Modern Orthodox Jewry, interacted with other college students.

Predictably, there were times when I felt the differences between the four of us with respect to the other 300 students. During the long group discussions where we interacted with panelists and speakers, I realized that as opposed to some, Jews view the role of charity from corporations or individuals somewhat differently than the non-Jews. Many students felt that it is the company's obligation to "save the world" at any and all costs. I on the other hand, took a more modest approach. Based on my Jewish background, I disagreed because I felt that charity starts within the immediate community. Only once corporations reach out to the direct communities should they go on to more ambitious altruistic endeavors. Aside from these few trivial

Sincerely,
Cheri Ochs
President, SSSB

Published throughout the year by the Yeshiva College Student Council and the Sy Syms School of Business Student Association. The views expressed in these columns are of the writers alone and do not reflect the opinions of The Exchange, the student body, faculty, or the administration of Yeshiva University.

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Exactly What Is A "Leveraged Buyout" Anyway?

By Avi Goldin

The Leveraged Buyout craze of the late 80's created a frenzy in the financial community unparalleled in its scope and impact. Billions of dollars in commissions were earned, and huge companies changed ownership in one of the most exciting times in investment banking history. While almost everyone has heard of an LBO at sometime in their collegiate career, or has had to bluff his/her way through a conversation on their evils and merits, few actually know how one works and what it accomplishes. Although the trend has subsided it is an important one to understand.

What is an LBO?

A leveraged buyout refers to the transaction that takes place when an organization takes over the decision making process of a company by acquiring enough shares of the target company to assume control. The term leveraged refers to the fact that most of the capital used to acquire the company is financed through debt.

LBO's most commonly occur when the market undervalues a company in terms of its equity. In layman's terms that means that the market price of the company's stock is worth less than the value of all the assets of the company. The most common type of LBO is where a financing group will buy the company for the purpose of selling off all or some of its assets. Many times, the group will sell off what it feels are the weaker divisions of the company and keep the one or two parts that they feel can keep up a positive cash flow.

For example: suppose a company has 10 million shares outstanding, trading at $20 a share. This places the market value of the company at $200 million. Suppose that the corporate raider determined that he could sell off all of the parts of the company for $250 million. This could theoretically result in a profit of $50 million just by buying and then selling the company! Of course nothing is as simple as that. In order to get the shareholders to sell their shares, the raider typically is forced to offer a slight premium over the current stock price, say $22 a share. This lowers his profits to $30 million - still quite a tidy sum. In addition, speculation about the takeover will drive up the share price, forcing the raider to pay even more for the company.

Who makes an LBO?

There are three types of groups that attempt LBO's. In the first type of group, the management of the company is part of the takeover group. In effect, the managers, along with a financial institution, buy the company from its shareholders replacing equity (stock) with debt (loans and bonds). Having management on its side gives this type of team a great advantage over the others. First, only management knows exactly how much the company is truly worth in terms of undervalued assets and hidden values. This information is critical in knowing how high they can bid and still make a profit. Lack of this knowledge can lead to an overbid or an underbid. Second, management will best know how to cut costs and trim fat.

The second type of group is established when a financial institution attempts to buy the company without having management on their side. In this case an outside firm sees an opportunity to purchase an undervalued company and sends a bid to the company's board.

The third type of group forms as the employees of the company get together and attempt to purchase the company. This is called an Employee Stock Ownership Plan (ESOP). Like the first group, ESOP's have distinct advantages over outside groups. Workers who are owners are more motivated to make their company a successful enterprise and will also be willing to accept the salary and benefit reductions necessary to make a post LBO company profitable.

Once a company is targeted as a candidate for an LBO a chaotic series of events are put in to motion. If the board of the company is opposed to a takeover, one series of events follow. What we will focus on here is when the board is not opposed to being taken over. By law, any candidate with a respectable bid must be considered by the board. This often results in a bidding war between prospective buyers. The team with management on its side is generally considered to be in the best position both for the reasons which we have discussed and for the fact that the board might look more favorably on a management sponsored bid. The team that comes up with the bid that is best for the company is accepted, and they then gain control of the company.

How is a LBO financed?

Now the question arises, "Where on earth does a group get $200 million to buy a company?" They don't! LBOs are financed through a myriad of different debt and equity instruments that reduce the cash outlay to a small amount.

There are four different levels, or types, of debt used in financing a LBO. The first level is called Senior Debt. Senior debt typically accounts for 50-70% of the total financing. It is issued by banks and it is the safest of the loans in that it has first claim on the assets of the company in the event of a default. The first part of senior debt is a revolving line of credit. A revolving line of credit is a straight loan whose amount is based on the liquidation value of the company's inventory and accounts receivable - its most liquid assets. The term of the loan is generally one year with renewal positions. The interest on this loan is typically 1-1.5 points over prime.

The second instrument under senior debt is called Senior Term Debt. This is a loan, also from a bank, based on a percentage of the market value of the companies land, buildings, machinery and equipment- it's next most liquid assets. The term for this type of loan is typically 5-8 years with interest ranging 1-2 percentage points over prime. The reason for the higher interest on this loan is because there is slightly more risk, in that the assets backing up the loan are not as liquid.

Once the venues of senior debt have been exhausted the group will turn to the next level, Subordinated Debt. The status of subordinated debt is secondary to that of the senior debt. Subordinated debt generally accounts for 15-30% of the total financing. It is a loan by insurance companies and subordinated debt funds based on the predicted cash flow of the company after senior debt interest payments are paid out. Since it is more risky than the senior debt, the interest that the lender receives can be as high as 3-7 points above the prime rate.

Another type of subordinated debt is junk bonds. With junk bonds, a brokerage house will take on a large portion of subordinated debt and then break it up into bonds that they in turn issue to their clients. These bonds have high returns because of the risk involved in being subordinated debt, hence the name junk bonds.

The last piece of the financing puzzle is the part that is actually put up by the purchasing company. This takes up around 10-20% of the total debt financing. This investment is completely unsecured in terms of the assets of the company; however, these are the people who now have total control over the company's functions. They are given 1) voting rights, 2) dividend rights, 3) trading rights, 4) appreciation rights, 5) liquidation rights, 6) hypothecation rights, and 7) information rights. An equity investor usually seeks a 30 40% annual return on his investment, but there are absolutely no guarantees on his money.

The reason for the wide range in the interest rates of each level, and the wide range in percentages of each debt instrument used, is due to the relative risk present in the particular company being taken over. For a solid blue chip company, more of the upper levels of debt will be issued at the lower interest rates. For a risky company however, banks and other institutions would not be willing to invest as much and they would demand the higher interest rate. This will force the group to turn to the lower levels of debt, at high rates, in order to secure the amount of financing needed to fund the buyout.

Using this structure the purchasing group is able to secure the company by only putting up $20-$40 million of the total $200 million.

So now that they have the company, what do they do with it? In an ESOP and a management backed takeover, the company runs pretty much as it had before. There is a lot of cost cutting as the company struggles to meet the demands of the interest payments, but otherwise it is business as usual – just with new owners. If an outside group is the one to take the company, the group has a number of options. One option is to sell off all of the pieces of the company separately and earn a quick profit. Another option is for the group to sell off those parts of the company that they term as the weaker ones while maintaining the stronger parts that will keep up a positive cash flow. Often buyout firms will amass a portfolio of solid companies and use the money they earn from them to finance other LBOs.

What are the problems?

So what happened to LBOs? Why is it that so many politicians and business authors decried LBOs as destroying the country? To answer this question we turn to two big indicators - the difference between equity and debt, and the health of the company after the LBO.

One of the main reasons that LBO's are able to work is because the cost of debt is cheaper than equity. Why? Since it is tax deductible. While that might not sound like such a big deal, in reality is huge! Take the following example. A company is taken over. Prior to the takeover, the company was very well run and was generating $50 million in sales per year. While the company was financed by equity, that $50 million would then be taxed with the remainder of the money split between retained earnings and dividends paid to shareholders. After the takeover, the company now has about $200 million, from our previous example, worth of outstanding debt that it has to pay interest on. Since interest is tax deductible, the $30-$40 million worth of interest that it owes comes out of the $50million in income before the government gets its share. Basically a company that used to pay taxes on $50 million now only pays taxes on $10 million. In some extreme examples the company can be so leveraged, with so much debt, that not only does it pay no taxes, but it qualifies for a rebate on taxes previously paid because it can claim a loss. Corporate tax income makes up a large part of Federal Tax income for the government. The impact of this lost revenue for the government trickles down and ends up hurting common taxpayers. This tax trick is one of the main reasons that LBO's work.

The second main problem with LBO's is the status of the companies after the takeover. All raiders will tell you that the companies are still well run and profitable. The truth is that once they are taken over many companies are forced to cut costs so deeply that it is impossible for them to stay profitable, sending them into bankruptcy. This hurts the economy and results in loss of jobs and other functions. Similarly if the company fails and is unable to make the payments on its loans, the banks that lent it the money bear the brunt of the collapse.

The leveraged buyout craze of the late 80's is attributable to a number of factors. Interest rates were pretty low, making the cost of the debt cheaper than normal. Also with corporate profits on the rise many companies were seeking high rates of return by collecting widely disparate companies under one corporate umbrella. The most famous example of this was the buyout of RJR Nabisco by Kohlberg, Kravis, Roberts &Co. After peaking in 1988, merger activity faded with the recession that hurt a lot of post LBO companies. With the revival of the stock market, merger activity has returned with a vengeance, but more in the form of mergers using stock and capital, than LBO takeovers.

Morningstar's Rating System for Dummies

by Jonathan Teitelbaum

Morningstar is an independent mutual fund rating and analysis service based in Chicago. Morningstar has created a simple, catchy signature of its own - the star system for indicating value in a mutual fund - that's very much like the signature "thumbs up" or "thumbs down" ratings made popular by movie critics Siskel and Ebert. Both ratings offer an endorsement, but neither claims that the choice is right for you.

For example, before deciding to watch a movie, you may want to inquire as to whether it is an action/adventure film, whether it stars an actor you enjoy, and if there dazzling special effects. Correspondingly, before deciding to invest in a mutual fund you may want to inquire whether the fund's price will take you on a roller coaster price ride, whether the fund manager has a solid record, and if it relies on exotic, risky investments. Just like "two thumbs up" doesn't mean you'll like the movie, a five-star Morningstar rating doesn't mean the fund is for you.

The stars describe what's already happened over the last 3, 5, and 10 year periods. (Of course, past performance is no guarantee of future results.) They're designed to answer two specific questions: How did a fund perform based on the risks investors took, and how did that performance compare to all the other funds in the same investment category, including all sales charges and assuming reinvestment of distributions.

The star system is a ranking system. That means that even if every fund in the category showed terrific performance, the last of those terrific funds would still receive only one star. Similar to percentiles on standardized exams; you may have received a mark of a 90 on an exam, but if everyone received higher, you will still be at the 1 percentile.

Again, the stars don't predict the future. They won't tell you how the fund will perform tomorrow. The stars also don't summarize all of the information that you should analyze before selecting an investment. They don't tell you whether the fund is right for your specific goals, in what kinds of markets the fund performed well - and not so well, the strategies of the people who manage your money, the amount of price volatility over the years, and many other important details about the fund.

A fund can only earn its stars if it is at least 3 years old. Morningstar believes that a mutual fund must have a significant track record for a star rating to be worthwhile. So, like horses in the Kentucky Derby, funds must be at least 3 years old to enter the competition.

Morningstar separates mutual funds into four categories: 1) domestic equity funds (U.S. stocks), 2) international equity funds (international stocks), 3) taxable bond funds (U.S. and international bonds), and 4) municipal bond funds.

Categorizing allows Morningstar to compare funds against other funds with generally similar objectives. Funds in the hybrid category are the exception. They're compared to all mutual funds except the municipal bond funds. While there are certainly more distinctions among funds within each category (for example, large growth funds vs. small value funds), Morningstar prefers to rely on only one important characteristic: the risk inherent in each fund's investment strategy.

Mutual Funds are first scored by annual return. Each fund receives a score based on its total return for 3, 5, and 10 years (what it earned after deducting all sales charges). T-bill returns, for the same periods, are then subtracted from the fund's 3, 5, and 10 year total returns. Morningstar finds the average return for the funds in that category and assigns it a score of 1.00.

They then rank all the funds. A fund with a score below 1.00 is below average. A fund with a score above 1.00 is above average. For example, if a fund scored 2.68, it did 168% better than the average (1.00) for the category. A fund with a 5-year score of 1.97 did 97% better than the average.

Next, the fund is scored by its risk. To rank the fund's level of risk, Morningstar compares the fund's total return to the total return of a 3-month Treasury bill over the last 3 years. The T-bill is the benchmark because there is virtually no risk of loss of principal.

First, they count how many months the fund's total return was below that of the T-bill. In those months, according to Morningstar's standards, the fund's return didn't justify its risk. Then they total the amount of earnings missed during those months by investing in the fund instead of in the "risk-free" T-bill.

Morningstar conducts this process for every fund in the category and then finds the average "loss" of earnings. This average amount is assigned a score of 1.00. Now comes the scoring. A fund with a score of less than 1.00 has lower-than-average risk. A fund with a score above 1.00 has higher-than-average risk. For example, if a fund scored 0.25 for the last 3 years, it exhibited 75% less risk than the average fund in its category.

Finally, the fund is ranked by combining the risk and return scores. To come up with the star ratings, Morningstar uses a bell-curve system. First, they subtract a fund's risk score from its return score. The difference between the risk and the return is the new score that is then plotted on the bell curve along with all other funds. It's awarded its 3, 5 and 10 year stars. Next, Morningstar conducts the risk and return analyses for the previous 3-, 5-, and 10-year periods (if the fund has been in existence that long). Then it scores, ranks, and awards stars for each time period.

The top 10% of funds are awarded five stars; the next 22.5% receive four stars; the middle 35% receive three stars; the 22.5% below average funds receive two stars; and the bottom 10% receive one star. The fund is then awarded its overall stars. Morningstar combines the 3-year, 5-year, and 10-year scores for each fund. If a fund has had 10 years of performance, the 10-year score counts for 50%, the 5-year score counts for 30%, and the 3-year score counts for 20% of the overall score. If a fund only has had 5 only years of performance, the 5-year score is worth 60% and the 3-year score is worth 40%. If a fund has only a 3 year history, its 3-year score counts for 100%.

One should realize, however, that once a mutual fund receives a star rating, the fund can lose that star. Poor perfor-

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Course Spotlight: Organizational Behavior

by Dr. Stephen Reschke

Since receiving my doctorate in industrial psychology, I have spent over 30 years as an internal and external consultant for a variety of organizations in the United States, Canada, Israel, and Iran. I have held positions ranging from Director of Human Resource Development for the Israeli Military Industries to Vice President for Organizational Effectiveness in the Citibank Mastercard/Visa Division. For three years in the mid-seventies, I was on the faculty of Tel Aviv University, in addition to teaching a number of courses at the Technion and at the Shenkar College of Textile and Design.

About five years ago, I returned to the academic environment as a member of the adjunct faculty at Sy Syms. Concurrent with my position at the Sy Syms School, I am the Managing Director at Corporate Performance, Inc. a company specializing in performance management and productivity improvement. We have developed a computerized algorithm model for the objective management and evaluation of performance in organizations. The model is applicable for all jobs in all types of organizations.

These varied experiences in applied as well as academic settings have allowed me to reflect on the challenge of designing an undergraduate business school course in organizational behavior which is relevant to the needs of our students. The course must serve the dual purpose of being an overview for students who plan to enter the work force upon graduation as well as being an overview for those who intend to pursue graduate studies.

A course in Organizational Behavior has the added challenge of conveying information beyond what we consider to be common sense. If the course does not go beyond common sense, the students will rightfully claim that the material is "fluff" and should certainly not be required for Management and Marketing majors. If the course contradicts common sense, it creates a serious credibility gap between what students already "know" and what we plan to teach them.

Unfortunately, many of the so-called experts bombard us with management homilies which either contradict each other or contradict the accepted body of knowledge in organizational behavior. For example, ever since our students were able to understand concepts, it's been drilled into their brains that people are created equally or that they have equal opportunities. When these students take organizational behavior, they quickly learn that effective organizations differentiate between leaders and followers, between strategic thinkers and implementers, between promotable executives and those who have reached a plateau, between line managers and staff managers, and so on.

Another dilemma which often comes up in our class discussions is the conflict between providing superior customer service at any cost, a philosophy of Total Quality Management, and the judicious use of funds which would perhaps limit spending to whatever had been allocated in the budget. Finally, we encounter situations where students and managers alike hop on the 'teamwork' bandwagon even though individual achievement and performance is often more beneficial to overall productivity. These are but three brief examples where Sy Syms students and future practitioners must sort out fact from fiction even if the fiction sounds good.

One of the most important considerations in designing a course in organizational behavior for business school students is arriving at the proper balance between theoretical and applied content. Clearly, a course which emphasizes the theoretical will not be perceived at being practical. On the other hand, a course which emphasizes the applied aspects will not be perceived as having much conceptual framework. And, the lack of a conceptual framework severely restricts our ability to generalize from one situation to another. Furthermore, it would be almost impossible to understand, manage, or predict the behavior of individuals in an organizational setting.

Since organizational behavior is affected by a multitude of variables, some readily identifiable and others unknown to us, we need a formal structure to help us sort out perceptions, motivations, peer pressure, leadership styles, and other antecedents of behavior. While we may be tempted to qualify predictions of individual and organizational behavior with the proverbial "it depends," we really need to make specific recommendations, if at all possible, if we are to have an impact on improving organizational performance.

Therefore, relevance in an undergraduate business school course in organizational behavior must be defined in terms of content which enables the student to identify and understand those variables which will determine individual and organizational behavior.

The Crux of Computer Consulting

By Yair Oppenheim

An Interview With Dr. Allen B. Zilbert, David Zysman Chair of the Information Systems Dept., SSSB

Q: What specific tasks do Computer Consultants do on the job? What areas do they focus on?

A: Well, there are several areas where consultants can work. Some of them will design as well as write entire applications if needed be. In other words, they have a person sent to a company to carry out a project for them. It can be a one-time assignment. The consultant will do the project and once he's finished with the project, he may maintain it for the organization, or the organization may decide to run the project on its own. Consultants may also be used for training applications software because some companies may be too small to maintain their own staff for doing this, thus they might decide to upgrade to new packages and the consultant will also perform those operations. Some consultants will also set up networks for organizations. Again, we're talking about small organizations. You're not going to find consultants really getting involved in major organizations unless they work for a consulting company - where their main job is just doing consulting.

Q: What makes a consultant more needed or unique than a company's own technical help department?

A: Again, when dealing with a small company, it may not even have a technical help department. They may just have someone who learns the new software once they know how to use the software, or even someone who knows how to use it once a consultant has set up the hardware.

Q: Would there be a case where a company would have a help desk and still require a consultant?

A: You're talking about a medium sized or large-scale company. In that case, the company could have one. It would basically be an area that it would want to look at as a new area and it's not sure if it should delve into it and needs someone who is totally unbiased so that he could give his opinions for what is needed in that situation.

Q: How involved or objective do consultants have to be when they work for a company? Do they need to know the inner workings of the business or just do as they're told?

A: Well, they must have some kind of idea of how the business performs. Unless they have the background of what the business does, they won't be able to make the decisions in terms of regarding the appropriate applications as well as the hardware for that business. It's not the major detail, but they have to have a background relating to how it functions.

Q: Thus the more long term they work for the company...?

A: The more involved they'll be.

Q: How would you begin a career in consulting - are there any requirements to learn and can said information be self-taught?

A: You have to work for other companies first before you can do consulting. You have to be employed as a regular employee before you'll be able to do any consulting.

Q: Of that respective company?

A: Of any company. In other words, you have to get your feet wet. You need experience with computers. You can't just walk in and say that you want to be a consultant even though there are plenty of people today that attempt to do this. These are the fly by nights. Some people try to pretend to be a consultant when they're really not consultants.

Q: Is it easy to get started - is there some way to transport yourself from here to there?

A: You have to be experienced in the business so that people have heard of you before. In other words, you used to be with such and such company doing this, and now you've decided to go out on your own to do the work.

Q: How does one get work to begin with? Is it similar to working for an agency and then developing a private practice?

A: Well, it is developing a private practice. You get recommended from one company to another, and sometimes you'll take a work with a consulting company where they'll just farm you out.

Q: Is it a full time or part time job?

A: You can make it both. As a part time job, you'll also have to do it with other people. You can't leave the company hanging, as in the case that you're doing another kind of job as a full time job and you sudenly decide to move to consulting as a part time job. You can't come back to it in two or three days. You have to be working with other people on a part time basis to do that kind of consulting, because there always has to be someone to cover for you.

Q: How creative is the work? Do consultants get to apply solutions to situations thoughtfully, or do they partially rely on programs as a crutch? For example, when they do the work do they get to design an application from their head or do they just make a database in, say, Microsoft Access?

A: It depends on a few factors. If it's something in the area of design, the company might tell you to design it and someone else will implement it. If no one can implement it, the consultant might have to do the implementation on it; he might be doing it from start to finish.

Q: So there's a distinction between the two? Someone will be preparing the application and somebody will think it out beforehand?

A: Correct. Perhaps one person may be doing both, depending on what has to go on. For example, when I worked for a company at one time I had a person working for me and I gave her a job to do. I gave her exact specifications on what should be done. I could have done it in a few hours, but it took her a long time to do it. I gave her two weeks and she didn't finish it, so I had to take a few hours to do it before the deadline.

Q: What are the pros and cons of consulting? Why do people enter consulting?

A: It can be famine or feast...It can be constant at times, as MIS is a strong market to begin with, while at other times, it can be torture - you might not be able to find anything.

Q: Can I assume right now that more people need it?

A: Due to the year 2000 problem, people are looking for consultants to solve that left and right.

Q: Can you advertise yourself or even go further and just look for work?

A: You can advertise yourself in the local yellow pages or newspaper. I've seen people advertise in newspapers. As an example, Newsday on Tuesdays has computer advertisements for hardware, software, training, or consulting; but this is looking towards small companies - very small companies, with respect to that. You can also set yourself up with "headhunters", and those headhunters will set you up with consulting jobs.

Q: How effective is working in a private practice rather than an agency? Can you get more work because you have reputation or does an agency have more contacts?

A: An agency has a lot of contacts. Sometimes companies are looking to fill a full time slot and can't fill it yet, so they sometimes bring in a consultant just to get some of the work done. Sometimes the consultants even wind up with a full time job afterwards.

Q: Once you work for an agency and decide to develop a practice on your own, is it possible to take their clients with you?

A: Their clients are now your clients, because they'll call you directly without going through the agency. The agency was just doing their job at that time. Additionally, an agency only gets a fee for that time; it's a one service project. The agency will also ask for compensation if a company that the agency placed you at hires you. The company that picks you up afterwards owes them, not you.

Suspended Acounts...

continued from front page

were nevertheless allowed immediate use of the EIN by the IRS at any bank for deposit purposes. However, the organizations can no longer maintain their former federal tax-exempt status.

After much deliberation within the IRS, Yeshiva University will not be charged with tax fraud. When asked if there will be charges filed against Yeshiva University student organizations, a spokesperson from the IRS said, "Because they never filed in the past, there is no penalty. Had one of the organizations filed a return with YU's number there would have been more serious complications." Mrs. Marion Jablin of the IRS commented, "It's not problematic that the organizations misused the EIN. The reason why the University required the organizations to get their own EINs is because had there been any tax liability, the University would have been required to pay the tax."

One can find an exempt organization package from the Internet at http://www.irs.ustreas.gov. Mr. McLaughlin of the IRS Exempt Organization Division suggests that student leaders file Form 8718: User Fee for Exempt Organization Determination Letter Request, and Package 1023: Application for Recognition of Exemption. Package 1023 is primarily for organizations that qualify under section 501(c)(3) of the Internal Revenue Code. He suggests that they download Publication 557 off the Internet as well. A copy of the organizations' constitutions must accompany the applications. It must contain the month, day, and year of formation and valid signatures for the application to be processed. Student leaders must also submit copies of the past three years' financial statements.

If the IRS accepts the request for exempt status, the organizations will be required to file Form 990, or comparative form, on an annual basis, if their income exceeds $25,000. Form 990 is the tax return for exempt organizations. Student leaders will be required to record and report income to the IRS from now on.

There is yet another relevant issue that concerns The Exchange, The Commentator, and The Observer. Namely, what is unrelated business income? Do newspapers have to file Exempt Organization Business Income Tax Return on Form 990-T?

According to Publication 598: Tax on Unrelated Business Income of Exempt Organizations, "an exempt organization is subject to tax on unrelated business income if the income is from a trade or business which is regularly carried on by the organization and which is not substantially related to the performance by the organization of its exempt purpose or function except that the organization needs the profits derived from this activity." Any organization that expects its unrelated tax to be $500 or more is required to file Form 990-T.

One example that the IRS provides of this kind of income would be yearbook advertising. Income of a tax-exempt organization that comes from the sale of advertising in its annual yearbook is considered unrelated business taxable income if the nature of the advertising meets certain conditions. Another example would be advertising income. If, for example, a bar association publishes legal journals containing opinions of the county court, articles of professional interest to lawyers, advertisements for products and services used by the legal profession, and legal notices, the commercial advertising does not advance the exempt purposes of the association. Therefore, it is taxable as unrelated taxable income.

Analogous to the previous situation is the sale of commercial advertisements in The Exchange, The Observer, and The Commentator. Presumably, the advertisements do not fall under the auspices of exempt practices. Therefore, it is safe to assume that the revenues are taxable as unrelated business income, which happens to be the same rate as corporate tax.

Show Me (Anywhere Between 5 to 6 Percent of) the Money!!

by David Rappaport

Simple pop quiz. Let's say you're in a band with three other people. You've signed a record deal and you've just sold your 500,000th copy of your first record. Disregarding the signing bonus, each member of your band has made.....

A. Between $150,000 and $200,000
B. Between $120,000 and $150,000
C. Between $80,000 and $120,000
D. Between $20,000 and $80,000

If you answered anything but "D", then curiosity should motivate you to read the rest of this article. At some point in your life, you may have been listening to the radio or watching MTV and said to yourself, "I wish I had learned to play guitar when I was younger. I could be as rich as he is right now. I bet he pulls $1 million a year, easy." In 90% of cases, if both your parents were garbage men, then your family would easily be in a higher tax bracket than the object of your adulation. Why is this true?

A very wise man once told me that the most fundamental thing to understand about the music business is that "music business" is composed of two words which are equally important. Without the business side we wouldn't be able to purchase music. And without the music there wouldn't be product.

Where does the artist fit in?

Almost all record companies compute the artist's royalties as a percentage of the Suggested Retail List Price (SRLP). The SRLP is an approximation of the price that the *retailer* is receiving for each record sold (note: the record company is paid by the retailer at wholesale price). Believe it or not, most contracts for new artists give the artist ten "points" (points is another term for royalty percentage). Since ten points is the generally accepted practice, this number will be used in the example. It is also important to note that royalties are based on *suggested* retail list price. The retail list price that will be mentioned at a subsequent point in no way mirrors the amount of money you pay to buy a CD at the local music store.

You should now be asking, "what happens to those ten points?" For our purposes, let's use the example of a CD at SRLP. The current SRLP for CDs is $16.95. That means that for every record that the artist sells, the artist recoups $1.69. The first thing that the record company does is deduct a packaging charge, usually 25% for each CD.

MATH: $1.69 - (25% of $1.69) .42 = $1.27

The artist is now set to receive $1.27 for each record sold. This $1.27 is called the "Royalty Base." You should now be asking, *"Does the artist get paid when the records are sold to the retailer or when they are sold to the consumer?"* The artist is paid when the record is sold to the final consumer, because all records are 100% returnable to the record company if the retailer is unable to move them off the shelves.

The next deduction is for free goods. Record companies generally deduct 15% from the royalty base, to account for goods given away.

MATH: Royalty Base of $1.27 - (15% deduction) .19 = $1.08

The artist now must give away some points in order to "make it" in the business of music. *You should now be asking, "who gets these points?"*

The people who are hired to keep everything under control and ensure a maximum net worth for the artist are as follows: The *personal manager*, who is the person who helps the artist make the creative decisions such as which record company to sign with, selecting a producer for the record, assembling the rest of the artist's professional team, and generally making sure that the record company does not foul up the record's release and marketing process. The personal manager's fee can be anywhere between 15% and 20% of the artist's earnings. The *business manager* is the person who handles all of the artist's money. He keeps track of the bills, taxes, etc. The business manager generally receives 5% of the artist's earnings. The *attorney* looks over the contracts, negotiates the deals, advises the artist about the law etc. Lately, the lawyer's role has been expanding, but that is altogether another can of worms. The lawyer also takes 5% of the artists earnings. It should also be noted that all of the people mentioned in this paragraph receive their fees both from the artists royalty base and from his final income.

The *producer* is the person who helps you the music down onto tape. Because most artists have no idea how to get the sound they want onto tape, the producer plays an integral role in the artist's life. The producer generally receives 25% of the royalty base.

MATH: Royalty Base $1.27 - (less free goods) .19 - (less personal manager [17%]) .21 - (less business manager) .06 - (less attorney) .06 - (less producer) .25 - (less groupies) .00 = (Total) $0.50

The band now makes just $0.50 a record. When multiplied by the 500,000 units sold we get $250,000. We then divide this number by the 4 members of the band and we end up with $62,500, before taxes.

There are a great number of factors involved in splitting a band's royalties. For example, I am assuming that all of the albums sold are CD's. That is not usually the case, because CD's are the most expensive format available. So our final figure is a little exaggerated. A good book for further reading on this topic is Donald S. Passman's, "All You Need To Know About The Music Business."

Leasing Vs. Purchasing

by Kovi Smolack

Financial managers, without a doubt, will at some point be faced with the decision of whether to purchase a given asset or whether to lease it. When making this important decision, one must understand both the different types of leases available and the financial ramifications of those leases.

Firstly, it is important to distinguish between the different types of leases. Operating leases includes both financing and maintenance and are not fully amortized. As a result, they do not extend for the full economic life of the asset. An additional feature of this type of lease is that it often contains a cancellation clause. Another type of lease is the financial lease. This type of lease is fully amortized, does not provide maintenance service on the asset, and unlike an operating lease, is not cancelable.

One important factor that managers will have to consider when weighing their options is the effect the transaction will have on the company's balance sheet. When a company buys an asset, they will no doubt finance it, because an efficient company is assumed not to have a significant amount of cash on hand. This transaction appears on the company's balance sheet under assets and long term debt. When a company engages in an operating lease transaction, the transaction does not appear on the balance sheet. The reason for this is that it is too difficult to separate the maintenance costs from the costs of the asset. This type of transaction is known as off balance sheet financing. The same treatment does not apply to financial leases. Because they include only the financing and not the maintenance costs, they must be reflected on the balance sheet using the present values of all the lease payments and of the price of the asset. The effect on the balance sheet of acquiring the asset can be an important consideration, depending on the company's financial position, because the debt ratios of the company will clearly be affected.

The primary consideration, affecting the buy vs. lease decision is the tax factor. When a company buys an asset, it may depreciate the asset for tax savings using various types of depreciation schedules. The entire value of the asset usually will not be fully depreciable because the asset will usually have some salvage value. In the case of a lease, whether it is an operating lease or a financial lease, the full lease payment may be deducted from the company's taxes. In the case of a financial lease, the maintenance of the asset is also deductible as is the maintenance cost if the asset is purchased. Knowing these facts, the financial manager must work out the numbers and determine which option best suits the company.

As an illustration of this choice, one can analyze the decision process of Company X, which is deciding whether to lease or to purchase a given asset for $1,000,000. The company has the option of a financial lease for five years, with payments totaling $268,179 per year or the company may also choose the alternative of purchasing the asset and financing it with 10% annual interest year, for payments totaling $263,783 per year. In the case of leasing, the lease payment is multiplied by (1-Tax Rate) to obtain the tax savings, and then subtracted from the lease payment to obtain the net outflow to the company. Assuming a 40% tax rate and a discount rate equal to the cost of the debt to the firm (10%), the present value of net outflows over the five-year period is $609,839. In the case of purchasing, both the interest expense and the depreciation is multiplied by (1-Tax Rate) to obtain the tax savings and this number is then subtracted from the loan payment to obtain the net outflow. Taking the present value of the net outflows over the five-year period, we obtain a total cost of $594,372. In this example, purchasing the asset is the less costly option. Additionally, because the lease would be classified as a financial lease, it must be reflected on the balance sheet just as the loan must be. Therefore the financial manger clearly should choose to purchase the asset.

The question of whether to buy or lease does not have an empirical answer. The financial manager must analyze each asset acquisition on a case by case basis. Only after examining the numbers involved as well as the company's overall financial health will the manager be able to decide on the better option.

REIT Funds

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teristics of real estate include high transaction costs, lack of publicly available audited information, and varying state and federal laws. Although The National Association of Real Estate Investment Trusts (800-3-NAREIT or www.nareit.com) can provide data on the REIT industry, a REIT has no net asset value. You can't compare the REIT's share price to some liquidation value to see if you are getting a bargain; you have to look at other measures of value. Recent history proves a good argument to invest. In 1996, the index of 198 publicly traded real estate investment trusts tracked monthly by the National Association of Real Estate Investment Trusts (NAREIT) returned 35.8%, including dividends, compared with 20% for the Standard & Poor's 500-stock index. Not only did REITs outpace most stocks, but they also offered better yields than a lot of bonds.

The industry is still in its infancy. The REIT market is shedding its bad rep and is attracting new investors. The REIT allows someone like our little Jimmy to have ownership in a portion of that $3 trillion commercial real estate market. Starwood Lodging Trust, for example, created a hotel empire with more than $4 billion in annual revenue. Sam Zell, a REIT visionary, alone heads three REITs, accumulating over $8.5 billion. REITs can offer high yields, steady returns, and a financial safety net. "We are watching what could be the biggest asset class in the country - bigger than the Treasury or bond market - begin to go public," says Andrew Davis, manager of the top-performing Davis Real Estate Fund. "Ultimately, REITs are the way real estate should be owned." It has certainly come a far way since Monopoly.

New Capital Gains Tax Laws

by Jeffrey Gamss

The recently enacted Taxpayer Relief Act of 1997 (Public Law 105-34) carries a variety of important amendments to the Internal Revenue code of 1986. It is one of the most complex tax laws in recent memory that affects individuals, families, investors, and businesses. A proper understanding of the tax law is crucial for maximizing its benefits. This article will focus on the capital gains element of the new law.

As under the prior law, net short-term capital gains remain taxable at ordinary income rates (15% - 39.6%). Short-term capital gains continue to be defined as gains from the sale or exchange of a capital asset held for one year or less.

The complication comes with long-term capital gains. Possible capital gains rates of eight, ten, eighteen, twenty, twenty-five, and twenty-eight percents now confront middle-class taxpayers. The maximum rate of tax on the net long-term capital gains of individuals has fallen from 28% to 20%. Until recently, only those in the highest tax brackets on ordinary income, i. e. 31, 36, 39.6 percentiles, benefited from the 28% tax cap. Now, people who are in the twenty-eight percent or higher bracket have a flat tax rate of 20%. A 10% long-term capital gains rate applies to gains for taxpayers in the 15% tax bracket.

Since July 28, in order to qualify for long-term treatment, one has to hold assets for eighteen months. Between the twelve-month, or short term, and the eighteen month, or long-term, period, holdings fall into a new category dubbed "mid-term" and are subject to the old twenty-eight percent maximum tax if sold.

[Note: a proposal has been submitted to the Senate, endorsed by William Roth the Senate Finance Chairman, to repeal the newly established eighteen month holding period.]

Take the following scenario. On August 1, 1997 Roberto C. Goizueta sells 1000 shares of Coca-Cola Co. for a $20,000 gain. He bought the shares on June 25, 1996, so at the time of the sale he held the shares for just over 13 months. Roberto is in the 36% tax bracket. Since he held the shares only just over 13 months, the 28% tax-rate applies. Had he held the shares for eighteen-months the 20% rate would apply.

Starting in 2001, a fourth holding period will comes into being. Assets owned for more than five years will face an eight-percent or eighteen-percent tax rate, a reduction from the respective ten percent and twenty percent tax rates. Taxpayers in the 28% and higher brackets can benefit from the special 18% rate only for gains on assets bought after the year 2000. However, taxpayers can elect to treat assets acquired before the year 2001 as sold on January 1, 2001 at their fair market value. Any gains on the deemed sale are taxable, but any apparent loss on the sale is not recognized. Lower income investors can benefit from the five-year holding period even if they currently own the now, as long as they sell after 2000.

For instance, on June 15, 2001 James Dimon sells 1000 shares of the Travellers Co. that he has held for 6 years for a $20,000 gain. In that year, he is in the 15% bracket. He pays tax on the gain at 8%.

Let us assume that the facts are the same as above, but in the year 2001, James Dimon is in the 28% bracket. His gain falls into the 20% category, not the lower 18% rate, because he purchased the stock before January 1, 2001.

Suppose James Dimon sells the Travellers stock in the year 2008. He still cannot use the lower 18% rate because of the purchase date, which was before January 1, 2001.

Now we will assume that Gary Wilson bought 100 shares of the Northwest Airlines Corp. on June 15, 1998 for $20,000. On January 1, 2001, the stock is worth $30,000. Gary thinks the stock will increase in price rapidly so he makes a deemed sale, paying a 20% tax on the $10,000 gain. If he holds the stock for more than 5 years after January 1, 2001, he can use the 18% rate.

This decision is very risky. If the asset had fallen in value after the deemed sale, Gary will have made a big mistake. He may not come out ahead even if the price increases, but the rise is small, since he has already paid tax on a gain up front. One might want to make the election for a sure thing – real estate in an improving market, stock in a business, etc.

If you are an investor in mutual funds then your information return (Form 1099) will contain the above breakdown on gains in 1997 for tax reporting purposes.

The tax rate on long-term capital gains from the sale or exchange of collectibles (stamps, antiques, gems, and most coins) will remain taxable as ordinary income if in the 15% tax bracket or at the maximum tax rate of 28%.

Real Estate investors must deal with a special twenty-five percent recapture tax. When one sells tangible personal property, the difference between the adjusted basis of the asset and the selling price determines the taxable gain. Previously, any gain up to the amount of depreciation taken, or depreciation recapture, increased ordinary income and was taxable as such. Now, any sales or exchanges of section 1250 property (depreciable real property) that yield long-term capital gains not exceeding depreciation previously taken will be taxed at a maximum 25% rate. Gains above that amount will incur regular capital gains tax rates (10% or 20%, depending on one's tax bracket, if held more than 18 months).

For example, if you have claimed $25,000 worth of depreciation deductions on property over the years, then the first $25,000 of profit when you sell the property will be taxed at 25%. If you fall into the fifteen-percent bracket, then you would elect to record that gain as ordinary income, thus it would be taxed at the fifteen-percent tax rate.

[On September 9 House Representative Philip English introduced a bill (HR 2403) to lower the rate from 25% to 20% on the depreciation recapture tax on the sale or exchange of depreciable real estate discussed above.]

The rules above apply not only to individuals but also to pass-through entities (S corporations, partnerships, estates, and trusts). For example, a gain on an asset sold by an S – corporation is passed through to the shareholders that are entitled to the new rates. The holding period rules are applied at the entity level, that is, from when and how long the S – corporation, partnership, etc. has owned the asset. These lower rates do not apply to regular corporations.

These new rates also apply to the alternative minimum tax (AMT). The AMT is a separately computed tax that is paid to the extent that it exceeds the regular tax. The computation of AMT is based on regular taxable income, plus certain tax preferences, increased or decreased by certain adjustments, and reduced by an exemption amount. The AMT before the Taxpayer Relief Act of 1997 was a graduated tax with a base rate of 26% on alternative minimum taxable income (AMTI). AMTI above $175,000 was taxed at 28%, the same rate the maximum capital gains tax had been. The purpose of the AMT is to prevent taxpayers that enjoy certain tax benefits from avoiding a minimum tax on their income. Had the AMT been left alone, then taxpayers would not have benefited from the relief. In effect, the old AMT rates would have made the bill meaningless.

Investment Strategies:

Before selling assets that have appreciated, one may wish to optimize gains by transferring the asset to children (assuming he has children) over age 13. The assumption being that the children's other taxable income is below the 28% bracket and, therefore, qualify for the 10% rate for net long-term capital gains. Children under the age of thirteen or under the "kiddy" tax rule are subject to the parent's higher tax rate.

A business owner that encounters wide fluctuations in income should time investment sales so that he meets the eighteen-month holding period while he is in the fifteen-percent tax bracket.

Tax Deferred Annuities (TDA) are less attractive now. Besides the normal early withdrawal penalty and early distribution tax penalty, all distribution income from the TDA is subject to ordinary income taxable at a higher rate than long-term capital gains.

To minimize taxes, if you are mutual fund investor, you may want to seek out funds with a lower turnover rate. Most mutual funds have an aggressive turnover policy and therefore, any capital gains qualify as short-term investments. In other words, the gains are taxed as ordinary income.

Technical Corrections:

The House and Senate tax-writing committees wrote on September 29, 1997 that they would introduce legislation that would provide for the grouping of long-term capital gains by tax rates so that losses for each rate group would first be used to offset gains in that group. If a long-term tax-rate group has a net-loss, then the loss will be used first to offset the highest long-term tax-rate group and then for the next highest, and so on. A carryover of a net long-term capital loss from a prior year would be used in the same manner to offset the current period's long-term gains. Any net short-term capital loss would also be used to offset the highest long-term capital gains tax-rate group first. The Taxpayer Relief Act of 1997 does not allow for such a technique; left as is it would raise the taxpayers' bills.

To illustrate, Michael Eisner has a net capital loss of $30,000 in the 28% tax group. He also has unrecaptured section 1250 gains taxable at 25% of $10,000, and long-term capital gain $30,000 in the 20% group. The net capital gain here is $10,000 (-30,000 + 10,000 + 30,000). Under the proposed technical corrections, $10,000 of the loss in the 28% group would be used to offset the gain in the 25% group, and the remaining loss of $20,000 in the 28% tax group would offset $20,000 of the $30,000 gain in the 20% tax-rate group. Net capital gains tax is $10,000 taxable at 20%

Without the technical correction, the $30,000 loss would have first reduced the $30,000 gain of the 20% rate-group leaving the 25% tax-rate group untouched. The net capital gain is $10,000, taxable at 25%.

Morningstar Funds

Continued from page 4

mance doesn't necessarily cause a fund to lose a star. In fact, it's not uncommon for a fund to maintain - or even improve - performance, and still lose a star. Remember, funds are awarded stars based on how they've performed relative to all the other funds in their category. So, if other funds dramatically improve their performance while one fund stays the same, the loss of a star may simply mean the fund hasn't kept pace with the competition.

It's tempting to rely on a star system because it's a simple, quick evaluation. Morningstar analysts point out, however, that there's too much data involved in selecting a fund to put your faith only in a limited rating system. Instead, Morningstar recommends using the stars to narrow the list of funds you'll want to look at more closely, then conduct a more thorough evaluation of the funds and of your needs. Did the fund earn high returns by taking more risk than you'd like, or, conversely, did the fund use a very low risk strategy to achieve decent returns - but not high enough to suit your needs? One must therefore obtain a copy of the fund's prospectus and annual report to see if the objectives and policies match your investment needs.

If you're cautious, you may want to place more emphasis on low risk. If you're aggressive, you may want to emphasize the return. By isolating the risk and return scores, and evaluating them separately, you can adjust the analysis to create your own star rating.

A five-star rating doesn't automatically make a fund right for you. Look at the performance graph. Did the fund improve performance but drop in the rankings after being outperformed by other funds? Remember, you're not always looking for the absolute winner. Consistency is a big factor in long-term success.

With a little understanding of how mutual funds receive their rank, we can now understand where the name MorningSTAR comes from.

THE SEVEN DEADLY

by Moses L. Pava

Some half-truths, if not corrected, can unbalance your accounting education and leave you with a serious career liability.

Accounting students arrive, like tourists in a foreign country, overladen with unnecessary baggage. Worse yet, the baggage may not only prove to be useless, but in the end it may prove to be harmful. I think of these students' prejudices as "the seven deadly accounting myths."

The best way to combat the seven deadly accounting myths is to develop precise teaching goals specifically designed to counter them. Are you susceptible to any of these myths?

Myth 1: Learning accounting is like learning the rules of a game.

The most common question, "Is this material going to be on the exam?," reveals a deeply held and primitive belief prevalent among students. Students assume that the only thing that really matters is memorizing the appropriate list of rules involved in calculating, say, LIFO versus FIFO cost of goods sold or the formula to determine the number of units to be sold at the breakeven point. Students reason, "If I learn the mechanical steps involved in applying this accounting rule, I will get a good grade on my exam, and that means I have learned accounting."

This myth is often reinforced in the classroom. Textbooks are written like convoluted cookbooks with the number and difficulty of recipes growing exponentially from year to year. If academic disciplines were to be evaluated solely on the basis of the sheer weight of textbooks, accounting would have virtually no rivals. Classroom presentations and homework exercises emphasize rule-following to the neglect of discussion, analysis, and critical thinking. Worst of all, midterm and final examinations measure and reward those students who are the most zealous advocates and proponents of the myth.

Fact: Learning accounting is like learning a new language. It would be preposterous to accept the idea that students of language who simply memorize the meanings of long lists of foreign vocabulary words actually have learned a new language. Obviously, students need to be able to read, write, and talk in the new language. Meaningful communication is the only acceptable proof of mastery of a language. Accounting also is primarily about communication. The ultimate educational goal is not to force students to memorize an ever increasing list of rules but to create an environment where students learn how to communicate financial information to interested parties in an effective way.

Many of the best textbooks begin with this insight in Chapter 1 only to neglect it in the chapters that follow. Good accountants are experts at selecting, organizing, presenting, and auditing huge amounts of data in ways that will be useful to decision makers. It is an enormous task that, when done efficiently, directly improves the material well-being of society. If the final products—financial statements, managerial reports, and oral presentations—are difficult to understand and irrelevant, accountants—even if all rules have been applied correctly—have failed. Accountants are valuable as communications experts. They are society's specialists in the "language of business."

Myth 2: I'm good at math, so I'll be good at accounting.

My students are often puzzled when I tell them that the final examination will include a number of essay questions. Further, they seem to resent our school's graduation requirement of a lengthy and substantial research project to be completed during the senior year. Students' responses seem to be based on the idea that accounting exams should be merely one more opportunity for students to rehearse the mechanical steps involved in solving homework problems. If an exam question is presented in a different form than homework questions, I inevitably hear the complaint, "That's not fair. This wasn't in the homework." Many accounting students enjoy the fact that there are obvious right and wrong answers in accounting. Had they wanted ambiguity, they would have chosen English literature or philosophy as majors instead of accounting. Accounting problems often are thought of as interesting mathematical puzzles.

As with all of the accounting myths, there is a kernel of truth here. For example, preparing a statement of cash flows from balance sheet and income statement information certainly has this "brain teaser" quality. When I hear a student involuntarily yelling "Aha!" during a midterm examination, I know (even without checking her paper) she has solved the cash flow problem. Answering a highly stylized textbook question on "make or buy" requires math proficiency and confidence. Quantitative skills are important. Being able to add up numbers quickly, being sensitive to the magnitude of numbers, understanding the concept of the time value of money are bedrock requirements. But they miss the essential educational point.

Fact: Successful accounting students and accountants are experts at communicating financial information. If it is true that accounting is ultimately about communication, it stands to reason that verbal skills are often as important as quantitative skills. A student who argues, after the fact, that he knew how to do the problem but got it wrong because he didn't understand the way the question was worded probably thinks he has a strong and impregnable argument. In a world where the second deadly accounting myth holds, the student would be correct. If accounting were simply a branch of mathematics, perhaps the only thing that would matter is the student's ability to master the mechanical steps involved in "solving" the problem. The reality is, of course, successful students need to be able to read, write, and speak effectively. In this context, a student's inability to read through a test question carefully and understand what it is asking is a serious problem.

We accounting educators need to create a learning environment rich in opportunities for you students to obtain the necessary verbal skills. The use of case materials and newspaper articles enhances reading comprehension. Asking you to present answers to homework problems gives you a chance to make informal and low risk oral presentations. Group projects emphasize communications skills and better prepare you for real-world work environments. Essay questions on exams and more writing projects ensure that students' "compensation" will increase. The assumption that students are mastering these skills elsewhere in the university and can easily import them to the study of accounting is proving increasingly naive.

Myth 3: There is such a thing as the bottom line.

If it is true that accounting is like math, then accounting should always yield one right answer; we call it the "bottom line." Thus, the third deadly accounting myth is born. For the past few years, I have asked hundreds of intermediate accounting students to answer the following question as part of their final examination: "What are the benefits and limitations of 'net income' as a measure of corporate performance?" The answers I receive are strong evidence that even the very best students are deeply perplexed. Given the students' own accounting theory, the question makes little sense to them. It is almost as meaningless as asking them to evaluate the benefits and limitations of "subtraction" as a mathematical operation. Just as students take subtraction for granted, students have inherited a view where net income enjoys a granite-like status. Net income simply is. These robust results are obtained in spite of the fact that most of the two semesters in intermediate accounting have been devoted to mastering what the students themselves often describe as "arbitrary" rules.

Fact: Corporate performance has many dimensions and cannot be captured through a single number no matter what we call that number. Case studies emphasizing situations where companies with healthy reported net income suddenly went bankrupt for lack of sufficient cash flow provide strong evidence to support the contention that corporate performance has more than one dimension. But while emphasizing the supplemental use of the statement of cash flows is an important first step, it is not enough.

Students constantly need to be reminded that the quality of net income as a measure of financial performance is only as good as what finally goes into creating the number. Consider the following examples. On the expense side, depreciation is a function of the choice of depreciation methods, estimation of useful lives, and future salvage values. It is based solely on historical costs and tells us nothing about current market values. Research and development costs and advertising outlays are expensed immediately and lower reported net income regardless of the future earnings potential created as a result of these activities. The pension expense can be altered drastically by changing crucial assumptions about interest rates, expected future salaries, and numerous actuarial assumptions. Similarly, reported revenues can be altered significantly with small changes in estimates of the timing of future cash flows.

As the external demands for corporate accountability and responsibility increase, corporate stakeholders, those groups on which the corporation is dependent for survival—including investors, creditors, employees, customers, governments, and local communities—increasingly will turn to accountants for more and better measures of performance. A stakeholder view of the corporation is becoming increasingly dominant. As a result of this enlarged view, investors and other interested parties are asking for better-quality information about environmental effects of corporate actions. There is a growing demand for accountants to measure precisely the cost and benefits associated with environmental impacts. Similarly, society is beginning to demand more information about product quality and safety. Issues related to measuring employee and managerial compensation already have been in the headlines and will continue to stay there until satisfactory yardsticks have been developed to gauge them. Investors want more disaggregated data concerning segments and products. Students who conceptualize corporate performance as a single measure will be uncertain as to what is being asked of them.

Myth 4: Accounting is a "thing apart." Understanding other disciplines is a waste of precious time.

My university started a separate business school eight years ago. The business school replaced a preexisting accounting program. Even today, many of our undergraduates would still prefer to choose the accounting program and eliminate the additional requirements the business school imposes. The myth is that accounting can and should be learned as a "thing apart." Students complain about the "soft" nature of management and marketing. While they tolerate finance courses, organizational behavior "is a complete waste of time." When I recently suggested to

MYTHS OF ACCOUNTING

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an accounting major that he consider taking a psychology course as one of his electives, he actually thought I was joking. (After his reaction, I didn't have the heart to tell him that I had majored in psychology as an undergraduate and never regretted the decision.)

Fact: Accounting is embedded in an economic and political system. Accounting students have good reasons to be proud of the rigorous and highly logical nature of their discipline. Accounting is correctly thought of as no-nonsense. But just as "bottom-line" thinking is fast becoming a thing of the past, it is now more evident to accounting educators and researchers that accounting cannot stand alone. The following questions-critical to the accounting profession-cannot be answered in isolation: What is it that we are accounting for? What is the ultimate purpose of the corporation? To whom are managers ultimately responsible? How can auditors maintain independence? How will technological breakthroughs affect and ultimately alter the traditional accounting cycle? Will accounting standards need to be more (or less) flexible as business becomes increasingly international? Accounting students need to begin thinking about these and similar questions as early as possible in their careers.

Successful accounting students will begin to integrate what they learn in nonaccounting courses, including other business courses and liberal arts with their accounting lessons. There can be no such thing as accounting Robinson Crusoes. Teachers need to emphasize the economic effects of alternative accounting standards, analyze the motivational effects of alternative accounting standards on employees and others, compare U.S. standards to international standards, discuss the effects of increasing disclosure of nonfinancial information, and isolate the political assumptions underlying the accounting standards-setting process.

Myth 5: All decisions are based on the cost-benefit criterion. If not, they should be!

Indeed, many decisions are best thought of in terms of the cost-benefit calculus. A favorite example from the managerial accounting literature will help clarify.

Suppose Dan Smith, the proprietor of a small ice cream shop, has just purchased a new ice cream maker for $20,000. He expects the machine will last 10 years with no future salvage value. Maintenance and other costs to run the machine are expected to be about $1,000 per year. Smith is happy with the new machine. Its capacity is more than adequate to meet the demands of his modest clientele, and he is delighted to be rid of the old machine.

Three days after the purchase, supersalesman Buck Starr meets Smith at a local chamber of commerce meeting. Smith, still excited about his recent purchase, brags to Starr about it. Starr turns to Smith, "You should have talked to me first. We just found out about a new advanced ice cream maker which sells for substantially less and is considerably more efficient in terms of annual maintenance costs." Smith learns that Starr's machine, with the same capacity as his, sells for just $8,000, and the annual cost of running the machine is only $300. The advanced ice cream maker also has an expected life of 10 years with no future salvage value. Smith's initial exuberance over his recent purchase suddenly vanishes, but he's not about to buy a second ice cream maker in the span of just three days. (He owned his first machine for more than 15 years.) Smith reasons, "Even if I could sell my new machine for $4,000, I can't afford a $16,000 loss this year (the original $20,000 minus the $4,000). My business is simply too small to absorb a huge blow like that."

Dan Smith would do well to reconsider. This simple scenario provides a concrete example of the benefits associated with a careful application of the cost-benefit criterion. At the heart of this model is the assertion that actions should be compared only in terms of expected future consequences. As managerial accountants often remind us, "Sunk costs are irrelevant for decision making." In the case at hand, Smith has two alternative actions. If he keeps the newly purchased machine, his total cash out will be $10,000 over the course of the next 10 years. Alternatively, he can sell the newly purchased machine for $4,000 today and turn around and buy Starr's more efficient ice cream maker for $8,000. The net cost of Starr's machine is thus only $4,000. In addition, under this alternative, Smith will incur $3,000 in maintenance costs. Total cash out under the second alternative is only $7,000. If Smith prefers more cash to less cash, the rational choice is obvious. Smith's reasoning that he cannot afford the huge $16,000 loss this year is spurious. The $20,000 sunk cost is irrelevant in this context. (For simplicity, we assume a 0% interest rate.)

Fact: Many decisions are best thought of as ethical! The profound problem with the cost-benefit criterion is that it is myopic. While the cost-benefit approach fits the decision to buy a new ice cream machine, in many situations—especially those involved with human relationships—the assumptions of the model are inappropriate.

Business managers, board members, employees, shareholders, consumers, government regulators, accountants, and social critics are increasingly aware of the importance of and need for a well-developed business ethic. Even a casual reading of the daily newspapers and weekly news magazines suggests that business ethics failures are rampant. Consider for a moment just one example. A recent Business Week cover story focused on some questionable business decisions at a large American company.

During the late 1980s and early 1990s, the international division often racked up annual growth of 25% as it rocketed to about $100 million in revenues by 1993. Trouble was, in recent years, some of the reported sales were fake. The Business Week article suggests that these and other ethical lapses were pervasive, not isolated incidents. The questionable behavior, which included extremely dubious accounting practices, an attempt to fool consumers to get them to pay exorbitant prices for the company's product, and little concern for the welfare of the local communities in which the company engaged in commerce, was the result of an organizational philosophy that emphasized short-run financial goals to the exclusion of other corporate responsibilities. The cost-benefit ethos dominated thinking. According to former executives at the company, the corporate culture was driven almost exclusively by the numbers. The most important goal was "double-digit annual growth." This case suggests, above all, that business executives need a more precise and expansive language with which to conduct business. Business executives, including accountants, need to incorporate ethical language. An attempt should be made to integrate business ethics literature into accounting courses.

Myth 6: God gave GAAP.

Students have an odd view of Generally Accepted Accounting Principles. No student has ever told me that he thinks that "God gave GAAP," but so many of my students' questions and comments are consistent with such a belief that I now imagine that it is a kind of secret lore imparted by graduating students to incoming freshmen.

Students are uneasy during a class discussion when I offer a criticism of an accounting standard. I might suggest, for example, that the lack of discounting the deferred tax liability makes it difficult for users to compare the numbers to other liabilities on the balance sheet. Students are uncomfortable and unfailingly try to steer me back to a discussion of what the current standard requires. Apparently, one does not question "God's laws."

On those occasions when I can convince students that accounting principles somehow might be improved, students simply cannot fathom why the standards are not altered immediately. After all, if accounting students understand that there is a problem, standard setters also must be aware of the situation. Indeed, if God gave GAAP, I'm sure He would immediately alter the faulty standard. But, alas, God is silent on accounting matters. We must turn elsewhere.

Fact: Human beings continually create GAAP. As strange as it sounds, it is the result of a political process. Sometimes it is difficult for students to accept the reality that accounting standards are the result of a political process. There is no known infallible procedure for deriving the best accounting solutions. Different groups have different interests. What benefits one industry may harm another. What's good for shareholders may harm managers. The interests of environmentalists may conflict with consumer demands.

Ultimately, accounting, like all institutions, is constructed by human beings. The standard-setting process thus requires compromise, ingenuity, creativity, and trade-offs.

Myth 7: I'll learn what I really need to know when I get my first job.

The title of an enormously popular book suggests All I Really Need to Know I Learned in Kindergarten (Robert Fulghum, New York: Villard Books, 1988). Accounting students have the opposite view: "All I really need to know I'll learn when I get my first job...My older brother told me." The myth holds that the sole purpose of the undergraduate accounting degree is job placement. The university is a sophisticated (if not completely honest) employment agency, and faculty are glorified headhunters. This final myth is nurtured by the earlier ones. If accounting were truly only about memorizing a list of rules, if accounting were indeed a "thing apart," if all decisions were framed best in terms of a cost-benefit calculus, perhaps there would be no role for university accounting programs. Such a world does not exist.

Fact: The goals of a university education are not necessarily the same as the goals of major accounting firms. The six facts discussed above cannot be duplicated easily by for-profit organizations. Accounting educators, at best, take a long-term perspective. Accounting firms, as my former students justifiably complain to me, are notorious for choosing the short-term perspective. The turnover rate hardly encourages long-range planning. Accounting education is designed to provide students with a panoramic view. The early years at accounting firms rarely provide "the big picture" nor prepare students for careers in industry where most accountants will finish out their careers. Accounting education is designed not just with survival in mind. Each of the "truths" described above is designed to provide you with the tools to thrive and blossom. All seven emphasize language and communication, verbal skills, an enlarged view of corporate performance, the relationship of accounting with other disciplines, ethical thinking, and human creativity.

Accounting is a dynamic, exciting, important, controversial, and challenging discipline. It's time we let our students in on the secret!

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THE NEW REAL ESTATE INVESTMENT

by Isaac Galena

Young Jimmy Yeagers was a Monopoly prodigy. By the age of seven, he had mastered the intricacies of the Parker Brothers Board game. He knew all the game strategies, as well as the mortgage payments on each color-coded property. His parents recognized his God given talents; when it came time for young Jimmy to join the work force, his parents directed him into real estate. Jimmy was quite successful; however his dreams of owning a multi-million dollar property never came to fruition with his mere professional golf course caretaker's salary. He would never have that chance to own the real "Boardwalk" or "Park Place" properties. That is until he discovered REITs.

Today there is a way to own that "piece of the farm" you have always dreamed of owning. It's called a real state investment trust, alias REIT. It's like owning real estate directly, with a lot more liquidity. REIT shares trade on stock exchanges like other stocks. When you buy a share, you are essentially buying a piece of the different real estate that the trust owns. You can own hotels, apartment complexes, golf courses, shopping malls, industrial parks, and office buildings, all depending on the trust.

On the market today, there are about 195 publicly traded REITs. The market capitalization of these 195 is approximately $94 billion, which means the entire publicly traded component of the industry is a miniscule piece of the investment world. The field is relatively new and surprisingly small. The legislation that produced the REIT industry was signed in 1960; it would be 30 years before REITs could be called respectable, mainstream investment vehicles. The market capitalization of REITs has increased from approximately $10 Billion in 1986 to over $90 Billion today. "The REIT craze is far from over," writes Peter Lynch, vice-chairman of Fidelity Management and Research.

How do REITs Work? The process begins with an initial public offering, let's say the management group of a new REIT sells ten million shares for $10 each. With that $100 million it builds, or more likely buys, income-producing property. The source of the income is rent, paid by college kids in off campus apartments, families in residential complexes, companies in office towers, or stores in extravagant shopping malls. This type of REIT is called an equity RIET. Equity REITs constitute about 89 percent of the REIT industry in terms of market capitalization. Basically, if you're a shareholder in an equity REIT, you're a landlord.

The other category of real estate investment trusts is mortgage REITs, which make up half of the remaining market capitalization. These trust's do not buy property, but instead invest in mortgages taken out by builders and property owners. Mortgage REITs succeed only if borrowers don't default and interest rates don't sharply rise or decline. That can be quite risky. The remaining REITs are so-called hybrids, which both own property and loan money.

The primary reasons to invest in real estate are high returns and low correlations with other major asset classes, which can make real estate a valuable diversifier. Investors can also diversify within real estate by location, economic region and property type. REITs are even sometimes referred to as the "mutual funds of real estate.

Another major reason to invest in RIETs is due to the related tax laws. REITs pay no federal corporate income tax. However the tax regulations also require that a REIT distribute at least 95 percent of its net income to shareholders as dividends. That sharply limits the REIT's options for growth.

Within the equity sector there are ten or so subsectors. The largest, with 43 REITs and about $21 billion in market capitalization, is retail: REITs that own shopping complexes of various sorts. Next, with 36 REITs, is residential: apartment buildings and complexes. Third is industrial/office, containing industrial parks and office buildings. There's also much money invested in self-storage and health-care facilities (these REITs tend to own not hospitals and clinics but the ground beneath them).

So how does a REIT grow? One way is to sell property from its portfolio at a profit; another is to issue more stock. It can also borrow money and pay the smallest dividend allowable by law and acceptable to shareholders (thereby retaining a maximum of earnings). The best combination for a REIT is a market that is turning up with leases that are turning over. In that environment, a new lease is seen as an opportunity to raise prices.

Kenneth Heebner, portfolio manager of CGM Realty Mutual Fund, has nearly half his portfolio in hotel REITs, including FelCor Suite Hotels. FelCor, owner of the premium brand Embassy Suites, acquires undermanaged hotels, upgrades them, and raises room rates under the Embassy Suites name. It's expected to return 20% in 1997.

In order to attract institutional investors, REITs are in a race to get bigger, in a short time. Institutional investors are starting to forsake direct investment in real estate to focus on buying and swapping properties into REITs. REIT mutual funds are proliferating too. There are now 58 REIT funds, and 19 of them are sold without front-end loads. Several pension funds have announced recently that they will also shift assets from private real estate to REITs

However, investors are still hesitant to vest into this emerging venture. Charac-

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ISRAEL REPORT

How Israel Deals With Inflation

by Larry Solomon

It often seems that Israeli politics is a whirlwind of unique, unsolvable problems about the peace process, terrorism, immigration, and determining who is a Jew. Now, one of Israel's major political debates, threatening the stability of its economy and exports, is not at all unique, but in fact, one faced by every other industrial nation: how much power to assign the central bank of a country with regard to controlling inflation and unemployment.

The Bank of Israel is the Israeli counterpart to the U.S. Federal Reserve, it essentially dictates how much money will be circulated in the economy at any given time. Like the Federal Reserve and the German Bundesbank, the Bank of Israel operates independent of government control; economic conditions dictated by money circulation are decided not by the general population or their designated representatives, but by the heads of these banks. The principle behind this separation of Bank and State is that decisions about money circulation are too important to allow popular influence on the decision. Politicians might not be willing to make unpopular but necessary changes in monetary policy if it threatened their re-election, thus, the decision is put into the hands of appointed, unelected officials who do not have much threat of losing their jobs. (The same mentality is illustrated in many facets of the government, including the selection of judges and military leaders.)

What is the importance of monetary policy? The amount of money in circulation influences and is influenced by the rate of inflation and interest rates; the more money available, the less the money is worth. This will lead to higher inflation and often lower interest rates. Why this is so, is a fundamental economic question revolving around supply and demand (The more of anything available the less it is worth normally). Inflation, along with the rate of money flow, influences and is influenced by the growth rate of the economy; In general, the more money available in the economy and the higher the inflation rate, the more growth occurs and the less unemployment in the workforce. (This has to do with the ease of acquiring loans for expansion, the general incentive for business owners to continuously raise their prices, the supply curve which dictates more goods will be supplied at higher prices and other issues.)

The Bank of Israel defines its responsibilities as follows: "Maintain the internal value of the local currency (i.e., its purchasing power) and its external value (against other currencies). Keep inflation low, and achieve high levels of production, employment, national income, and capital investment in Israel."

Thus, growth of the economy and reduction in unemployment often occurs at the expense of high inflation. Inflation is detrimental to any economy because it makes money's value unpredictable and thus less useful. As a result, loans become harder to secure as lenders take on increased risk.

The Bank of Israel defines inflation problems as follows: "Past experience in Israel and abroad has shown that inflation has a distorting effect on the economy – affecting production, consumption, foreign trade, labor, and the financial markets -and also creates problems in the execution of fiscal and monetary policy. Hence the importance which the Bank of Israel (like central banks all over the world) attaches to maintaining the value of the local currency, and combating inflation."

In a small economy such as Israel's, which is open to the movement of goods and capital, over-expansion could also affect the balance of payments and lead to a fall in foreign-exchange reserves. For this reason, as well as the effects that changes in exchange rates have on domestic prices, exchange-rate policy constitutes an important aspect of the Bank of Israel's policy.

Given the importance of monetary policy in a nation's economy, it is little wonder that Alan Greenspan, who heads the U.S. Federal Reserve, has been described as the second most powerful man in the United States. Jacob Frenkel has similar power over Israel's economy as he is the head of the Bank of Israel and determines the country's discount rate, effectively controlling the rate of money flow. However, recent economic problems in Israel have prompted requests by Israeli businessmen such as Dan Propper, head of Osem, to call for a limiting of Frenkel's power due to his tight control of the money supply in the face of slow growth and high unemployment.

Israel's unemployment rate has climbed to 7.6% recently, (well above the debated natural unemployment of 5-6%), and growth has slowed to 2% (for a small country, this is a low figure) Despite these figures indicating poor growth, Frenkel wants to raise interest rates, which may slow things down even further. Frenkel is prompted to do this by Israel's current 10% inflation rate, which is the ceiling for the government's targeted healthy inflation.

Thus, Israel is faced with a classic problem in Macroeconomics: Should interest be raised and money flow cut, curbing an inflation that is bordering on high but stifling the economy, or should interest rates be lowered and money flow increased, boosting a sagging economy but threatening to increase inflation?

Frenkel favors the former, business leaders favor the latter. This division of opinion is understandable. Frenkel is a macroeconomist who understands the dangers should Israel's currency become devalued due to high inflation: hard to import goods, hard to attract investors willing to accept shekels, lack of confidence by the population in its money's worth, and so on. Business leaders however, see things in terms of a microeconomic perspective: they care about their particular business's health as well as the employment of the population more than the reputation of Israel's shekels in the International Monetary Fund.

The Knesset meets to vote on the Business leaders proposal to have a committee made up of bank employees as well as outsiders to make decisions about Interest rates, inflation, and growth. This decision would take from Frenkel sole power over monetary policy. No matter how the situation resolves, one thing about it makes it typical for Israel politics: there is no solution.

The Russian Economy: Order or Chaos

by Ilan Scharf

American investors seem to be enamored with the Russian economy. Indeed, its stock market has risen a dramatic 60% since April, and is up 156% since 1996. American investors are currently pouring money into the country like never before. Forty-one debt and equity funds now exist, controlled solely by foreign investors, accounting for 1.4 billion dollars in foreign investment. The news only gets better: wall street pundits predict foreign investment to increase even greater. This can be attributed to a stabilizing political situation. Boris Yeltzin, although still suffering from lingering health problems, appears to have appointed competent advisors well versed in modern economics. New legislation, aimed at patching up the loopholes that allowed 30 billion dollars of investment to be lost to pyramid schemes, have lent a sense of security to a perpetually embattled financial system. But beware: do not blindly throw in your American dollars to the Russian stock market just yet; for all is not quiet on the Russian front. Even the most sanguine Wall Street wizard and portfolio manager harbors grave concern about what lies ahead in the 21st century.

There are a number of problems inherent in the Russian economic-political system that make investing there a risky proposition. Flagrant fraud and violent crime are endemic in Russia. It is common place for the infamous Russian mafia to engage in brutal, if not deadly shakedowns of businessmen, aimed at exacting large "protection" payments. Indeed, serious crime is up 70% since 1990; a murder is committed in Moscow, the Russian crown jewel and capitol, every five hours. International businessmen are fearful for their lives when traveling there. Financial fraud - pyramid schemes and costly kickbacks - has risen twofold since 1996. Whether trying to take out a loan from the bank or splurging on the family in a nice restaurant, one feels the effects of these unsavory activities. Nevertheless, the corruption in the business sector pales in comparison to that of the private sector. The government is mired in corruption from head to toe. Politicians, hailed as those "servants" of democracy, accounted for nearly half of all financial crimes committed. Only Kenya, Nigeria and Pakistan third world countries and political oligarchies are considered more corrupt than Russia. Moreover, a large proportion of financial crimes go unreported. This stems from a vastly corrupt police force - one plagued by staggering nepotism and cronyism. Either out of laziness or incompetence, the police force fails to properly investigate even the reported crimes, arresting false suspects and beating the "truth" out of potential state witnesses. Nearly, six percent of the police force were disciplined last year.

But stifling crime and shameless political manipulation are only the tip of the iceberg. The tax system, the most fundamental service a country can provide, is in complete disarray. Myriad companies and corporations have used pricey American style lobbyists to cajole the government into granting them sweeping tax exemptions. These tax breaks create a financial burden that small businesses must make up. Thus, this predatory system has restricted mobility for hungry entrepreneurs and nascent small businesses trying to make it big. Indeed, small businesses estimate that they pay up to 80% of their profits to Uncle Boris. One firm estimated that even by doubling revenues it would still exist only a two percent profit after taxes and inflation. While stiff penalties are placed on those who are convicted of tax fraud, the conviction rate is minuscule at best. Tax authorities do not have the necessary capacities and resources to seriously combat tax evasion. Of greater importance, it is not uncommon for individuals and corporations, either out of confusion or a desire to raise skimpy profits, to simply not pay their taxes. Corrupt tax collectors have facilitated this practice, making themselves readily available for bribes and political favors.

Still, what frightens potential investors the most is the Russian mentality. Indeed, our Russian counterparts fail to grasp basic capitalist ideas and principles. Monolithic corporations demand deals to be done their way or no way. Attempts by foreign investors to breach this "failure to communicate", by teaching Russian businessmen how business is done in the West, are met with defiance and obstinacy. For example, when General Motors attempted to open a plant in Moscow, they stipulated for the project to produce 50,000 units a year. The Russians, on the other hand, wanted a unit that would produce 500,000 units. This desire to do things on a enormous scale has lead Western corporations to proceed with extreme caution. For a withering infrastructure and undiversivised economy, has made serious investing a risky proposition. Foreign corporations realize the obvious: it will be difficult for them, no matter how much resources they are willing to use, to compete with entrenched Russian businesses - behemoths, such as, Gazprom, the largest natural gas producer in the world, who have a virtual monopoly on basic services. The sniffling stranglehold Russian big business has on the economy is best seen when looking at simple statistics. A company like Gazprom accounts for nearly 6 % of the entire GDP of the country. The largest six Russian companies pay over half of all business taxes. Thus fundamental concepts, like competition and fairness, are not yet ingrained into the Russian ethos. The Russian plutocracy does comprehend the idea that what is good for the country as a whole, will also be good for them in the long run.

It is a shame: Russia has all of the necessary tools - an educated work force, limitless natural resources - to thrive in the next century. Yet, Russians, whether lowly peasants or wealthy fat cats, still do not comprehend that remaining entrenched in their Bolshevik ways will do little to improve an already depressing situation. A free market economy does not mean that government officials should bestow early Christmas presents to political cronies; it does not mean that a select few should get rich while the rest of the populace flounders. If Russians are really serious about becoming a prime investment center, another Asian Tiger, than they should join the capitalist boat, by realizing that there is never an easy way out: difficult problems call for equally difficult solutions.

The Fund Universe

by Shmuel Cahn

Before describing different mutual fund categories, a reason needs to be given as to why many people ignore a large part of the fund universe, "load" funds. A load fund is one that charges investors fees for either depositing or withdrawing money from the fund. Load funds deduct either a portion of the initial investment (front-end load) or a portion of the proceeds of redemptions (back-end load), as opposed to no-load funds that deduct only the annual management fee. Often these "loads" are as high as 5%; thus an investment of $1000 would only buy $950 worth of a fund that has a 5% front-end load. The obvious downside of paying a fee is compounded because as the investment grows the additional gain that could have been derived from that $50 is not realized; in this example if the fund appreciates by 10% the investor will only have $1045, a 4.5% gain. Some would argue that overlooking load funds is counterproductive because the loads buy superior management and reduce annual management fees (usually about 1-1.5% for domestic stock funds), though it is to be argued that the historical yields data does not prove that. It should be pointed out, though, that many back-end load funds charge loads based on a sliding scale, declining as the account ages; at times that can result in the load being lowered from 5% to 1% for money that has been invested for five years.

Generally, diversified US stock funds are categorized by both the market capitalizations (total value of all the shares outstanding) of their holdings and by whether they are growth or value oriented. Some common categories include blue chip, mid-cap, small-cap, and micro-cap.

The exact size of a micro cap stock is difficult to define, but small-cap stocks are usually those whose total market capitalization is less than $1 billion, with micro-caps being a lot smaller. Aside from the usual risks associated with investing in the stock market, micro-caps are often thinly traded, making selling a position difficult, something that is unheard of on the NYSE. In addition, many of these smaller firms do not yet have an established product, which makes for shaky earnings. Another risk is that, traditionally, this category of stocks is the one that attracts the most fraud, partly due to lack of general interest on the part of investors, and partly because with so few shares outstanding, serious price manipulation is accomplished with less difficulty than with bigger stocks. Although the diversification provided by a mutual fund does protect against these risks, the large amounts of money invested by these funds makes it difficult to invest completely in stocks whose total capitalization can be less than that of the fund (given that funds often want to keep their individual holdings to less than 5% of the total shares outstanding). This problem is compounded as the price of a fund's holdings rise, raising their successful stocks out of the micro-cap classification.

One respectable fund in this category, the Robertson Stephens Micro-Cap Growth Fund, happily focuses on "the least efficient market sector" (efficiency being defined by the availability of information and its immediate effect on price).

International funds come in many specialized flavors aside from the general diversified international fund, and it is these specialized funds that have the greatest volatility (both on the upside and on the downside). Last year, the Asian funds (and the broad emerging market funds which include Asian holdings) were dragged down by the collapse of the Thai Baht, which precipitated a fall in other local currencies and markets. Similar to the Mexican Peso's collapse a few years ago, Thailand's troubles serve either as a reminder that what shoots up can just as easily drop down, or as just providing a good opportunity to buy low. For the short term, the former has certainly proven true, as the phenomenon of declining markets and collapsing currencies spread through the region, even affecting stronger markets like Hong Kong. Originally, this caused the spotlight to shift to Latin America and Europe; however, Latin America was hit almost as badly as Southeast Asia during the ensuing panic. The advantage of diversifying a portfolio with foreign investments is simply that many of these markets have low correlation to the American stock markets. If the American markets have a bad year, the European and Asian markets will not necessarily be terribly affected. The exception is when panic sets in, as we recently saw. Once panic overtakes the market, institutional investors are prone to start liquidating all of their worldwide holdings, causing the panic to spread. That is caused by irrational self-fulfilling prophesies of collapse, and because the decline of foreign economies can adversely affect domestic companies which are heavily involved in foreign trade. The other key attraction of Latin American and Asian stocks is that the lesser developed emerging markets (such as Mexico, Brazil, Thailand, and Malaysia) often have much sharper market movements (both gains and losses) than the fully developed countries such as the United States and Japan. Since the emerging market economies (and hence their corporate earnings) are growing at a much faster pace than in the developed countries, their stocks often appreciate at a much faster pace. Although Russia and Africa are also emerging markets, they are usually ignored because of their extreme political and economic instability, leaving the focus on Latin America and Southeast Asia.

Generally, diversified international funds attempt to attain a good mix of all of these stocks from developed and developing regions, with the emphasis frequently shifting along with the prevailing market conditions. When comparing international funds, it is important to remember that their management fees are always higher than those of similar domestic funds. A domestic fund that deducts 2% annually would be ridiculously expensive, while an international fund charging 2% would be considered reasonable. When managing an international fund, travel expenses are much higher and local assistance must often be enlisted, which is not true of domestic funds.

Another group of domestic funds that are worth noting are sector funds. Each of these funds concentrates on a specific industry, such as regional banks, gold, biotechnology, or software, to name just a few. The advantage (or disadvantage) of these funds is that by concentrating on a specific industry they can take advantage of that industry's growth or profitability, and they often experience large fluctuations as their industry passes in and out of the market's favor. The gold funds, for instance, have generally been down for the past ten years because the price of gold bullion keeps on dropping. Additionally, many central banks are coming to the realization that they do not really need to stockpile gold reserves, causing a glut in supply that has been depressing prices. The more speculative gold funds which invest in speculative mining companies that have not yet established productive mines took a big hit months ago when a stock that many of them had invested in, Bre-X (NASDAQ: BXMNF), turned out to be totally worthless. Starting in late 1995, Bre-X had publicized tests showing that their property in Busang, Indonesia contained a large quantity of unmined gold, causing their share price to skyrocket. When an independent geological survey was finally released a year and a half later, it found that the gold was imaginary, causing the stock's price to tumble from nearly $20 to the current low of about $0. The story is still ongoing as the chief geologist is being sued in the Cayman Islands. The point of this story is that some sector funds can be risky, especially in those sectors of the market that seem especially prone to fraud.

The other important segment of the fund universe that must be mentioned is bond funds. Most bond funds pay a steady dividend based on the interest rates of the bonds in their portfolios, making their returns much more predictable than those of stock funds. Aside from collecting interest on their bonds, they also profit when declining interest rates raise the prices of their holdings. Treasury funds are usually considered to be the safest funds because there is no risk of a default by the U. S. Treasury. However, when Treasury funds engage in derivative trading (which if successful can greatly boost a fund's yield), they assume all of the risks that are typically associated with that type of security. U. S. Government funds are categorized by their average date of maturity, while corporate and municipal bond funds are also differentiated by the credit ratings of their bonds' issuers. Bonds with decent credit ratings are known as investment grade, while those with low credit ratings are referred to euphemistically as high-yield securities and colloquially as junk bonds. Lower credit ratings and longer terms increase bond yields, and of course the risks of both declining prices and default.

Of late, bond funds funds have seen a comeback in their popularity. At the same time, a number of factors caused them to appreciate noticeably. Specifically, rates have declined while the dollar has risen in value. The continuing rise of the dollar has attracted many foreign investors to American bonds at the same time as a decreasing federal budget deficit has decreased the growth in the supply of Treasury bonds. The latter trend is likely to continue as both Congress and the President support a balanced budget, and decreasing supply, when coupled with steady or increasing demand, always causes prices to rise. On a related note, the fact that inflation has been dormant for the last few years has kept interest rates downm although the future of interest rates and inflation is unknown.

Also worth noting is the appearance of many emerging market bond funds. The risks of these funds are similar to those of emerging market stock funds; if a developing country's government feels disinclined to pay its debts (or if its currency collapses making such payments worthless), investors will get stuck with worthless paper. It would be unfair, however, to mention the risks without mentioning the rewards, which have been phenomenal.

When appraising a mutual fund for potential investment, it is important to keep in mind that the past performance of a fund is no guarantee of its future gain. This is especially true if the fund has had its management changed, in which case its past performance is irrelevent. Nevertheless, the best way that one can evaluate funds is to compare yields (especially going back up to five years, if possible, to get the most complete picture). One other factor that is often overlooked is the total assets of the fund. Ten years ago, a growth stock fund with over a billion dollars invested was considered very large. Now that figure has risen considerably. Bigger funds are often unwieldy, and their top performing investments are often overshadowed by the multitude of lower quality stocks that they are forced to buy in order to be fully invested. With bond funds the opposite is true because the selection of individual securities is less important, especially with treasury funds, where there is no difference between the credit worthiness of the individual bonds. In addition, as for new funds, they often start out with an unsustainably high return. It is very important to realize that a variety of factors can unnaturally boost a new fund's return. Specifically, one highly successful investment can swing a new fund's return more than it would later on after that fund has grown and diversified. In addition, fund managers who are eager to prove the success of their new funds will go to great lengths to secure shares in IPO's at discounted prices specifically to raise the fund's short-term return, something which will often not be done after the fund has gained recognition.

Personal Investment Strategy

Continued from Back Page

written history. The earthly cause of the Egyptian Bondage was ups and downs in the price of grain; something that caused friction between every agricultural society and its nomadic neighbors. Athens experienced the Great Land Crash of 333 (333 BCE that is), Tulipomania ruined Holland in 1636 and the 18th Century witnessed the twin calamities of the Mississippi Scheme in France and the South Sea Bubble in England. But the first fully-modern crash was the Great Cotton Crash of 1837.

In 1835 a fire had destroyed much of Wall Street. Out of the ashes a new breed of speculator arose, betting on the agricultural products of the South and the settlement of the West. The most aggressive of these newcomers were the Josephs Brothers. They invested their new-found wealth in construction of a magnificent new bank building near Hanover Street.

On March 14, 1837, cracks appeared in the almost-completed building. The cracks grew until the entire building suddenly collapsed, shaking the foundations of every Wall Street building. Three days later, on Friday, March 17, a packet ship arrived from New Orleans. The cotton market had collapsed leaving $200 million in worthless debts, and the Cotton Panic of 1837 had begun. Within two months, Bowling Green would be filled with troops and the mayor of New York would be storing ammunition in his office against a starving, violent mob. This is a classic crash contradiction: people starve while food prices are so low that banks fail.

Not only agricultural markets but the stock market and real estate would fall, and keep falling for three years. The historian Reginald McGrane, writing in 1924, called it "one of the most disastrous episodes this country has ever experienced."

International Aspects

The crash was not limited to Wall Street, or even to the United States. The origin can be traced either to the United States in 1835 or England in 1836. It spread (or returned) to the United States in 1837 and from there to continental Europe (this makes sense financially, if not geographically). From Europe it reinfected England in 1839, provoking one last calamity in the United States in 1840. This is another classic crash pattern, a decline in one place ripples out to cause declines in other places, which spread back to abort recovery in the original place.

A third element of a modern crash is the series of ups and downs over a period of years. Like all crashes, this one began with a rally. Expansion of the British Empire and improvements in textile technology led to a cotton boom from 1826 to 1835. The cotton boom drew investment into cotton, of course, but also into spinning mills, land to grow the cotton and railroads to transport it. At the same time, American states were borrowing money to build canals and other public works.

This created a tremendous demand for capital. In England it was met by laws authorizing joint stock banks in 1826 and 1833. The United States used soft-money banks and began switching from silver to gold. The increase in capital fueled the expansion that created the need for more capital. Also all this capital was making people rich so demand for luxury goods soared.

In the summer of 1836, the Bank of England cut off credit to the "W banks," Wiggins, Wilde and Wilson. These were three of only seven United States banks operating in England. This action, and the resulting failure of these banks, caused capital to evaporate. At approximately the same time, hard-money Democrats in the United States pushed the Specie Circular that required payment for public lands to be backed by gold. This further reduced available capital and weakened banks. By early 1837, the price of cotton had plummeted and dragged down all associated investments with it.

Bank Failures

In New York, dozens of banks failed (including J. L. & S. Josephs & Company, collapsed building and all) on Friday, March 17, 1837. New York turned to the great Nicholas Biddle. Biddle ran the United States National Bank until 1833 when President Andrew Jackson refused to renew its charter. He was still the most powerful and respected banker in the United States.

Biddle agreed to ship $1,000,000 of gold and silver to London and New York banks did the same. This failed to restore American credit so the bank run continued. As Charles Collman told it in 1931, "These bank runs of '37 were different from the ones with which our day is familiar. They consisted of a frantic onrush of the poorer people, who demanded cash for the paper money which had been issued by the bank." The result, familiar to Mr. Collman in 1931 but rare today, was that troops were called out to quell the mob and silver and gold disappeared from circulation.

The next blow came when the solid and respected Mechanics' Bank failed and its president, John Fleming, committed suicide. Next the august Dry Dock bank failed. By the middle of April, 352 banks had failed. All of the South and most of the West was bankrupt. The losses caused a recession throughout Europe and North America.

Blood in the Streets

Great investors know that the time to buy is when there is blood in the streets. The streets were literally bloody this time. Millions of dollars of assets could be had for thousands of dollars of cash. Slowly the gold and silver that had been hoarded throughout the crisis came out to snap up land, companies and factories. Moreover the cheap cotton (and tobacco as well) made the factories profitable, factories opened and expanded throughout the American South and in Europe as well.

Nicholas Biddle had a bolder plan. He decided to corner cotton. With cotton so cheap, he could buy the entire available supply. Then he could name his price. He arranged credit through several European banks, most prominently Maison Hottenguir of Paris, and bought cotton throughout the growing season.

By the summer of 1838, the price of cotton had soared. The people who had bought land and built mills after the 1837 crash were ruined. European spinning mills refused to buy American cotton and the entire world textile industry ground to a halt for six months. But the boycott succeeded and Biddle's corner failed. Cotton prices fell to new lows and caused another round of bankruptcies and bank failures.

This cycle, rally, crash, new investment, new rally and new crash was repeated at least two other times before the United States emerged from depression in 1841. And more crashes were to come. As listed by Charles Collman: "the currency embroilments of [18]37; the wild October 13, twenty years after, with its mobs ariot; the hysterias or September, '73 the wrack of the great adventurers of '84; the terrors of '93, when all the fat of the monopolies was in the fire; the railroad exasperations of 1901; the black year of 1907, when the very devil was to pay with coppers and the banks."

October 1997

I started writing this in the early morning hours of October 24, 1997. Yesterday, the stock market fell the limit and I have to make a lot of trading decisions for tomorrow. I have been up all night, watching the Asian markets, overnight futures trading and analyses from various parties. Europe will open soon and give more clues.

At the moment, it seems as if the market will open lower, drop under 7,000 briefly, then rally. Why do I say that? Because the overnight futures are trading at levels that will force the initial drop, but orders to buy stock are high. So I am putting together orders to pick up certain stocks that I thought were good values two weeks ago and should be great values tomorrow. But "value" is relative, I hope they will do better than the average stock, and the companies are solid economic propositions. But if the market heads further south, my stocks will not look like bargains.

Even if I am right in the short-term, what will the rally mean? Will it be a brief hiatus in a major crash? Or will it be the first step on the road to new stock market records? Personally, I am confident about the medium-term based on the behavior of interest rates and commodities. Long-term is no problem, in the long run the stock market has always outperformed alternative investments.

Late nights and dramatic events conjure up the ghosts of history. I imagine a distant ancestor herding livestock in the Sinai. A drought has made it difficult to find forage, the same drought has driven up the price of food in Egyptian cities. Does it make sense to bring the animals to the city for slaughter? The price is good, and the alternative difficult.

If the rains return in the next few years, the price of livestock will fall. My great100-grandfather can purchase a larger herd with the profits from the sale; he will have sold high and bought low. But if the drought persists, all the profits will be spent on expensive food and he will be impoverished, forced to labor in cities to survive.

Perhaps another distant cousin owned land in Athens or tulips in Holland. No doubt various relatives were caught up in the financial panics of the 18th and 19th centuries. I know my grandparents were touched by the Great Depression.

I doubt that October 1997 will go down in history like these events. It may well be forgotten in November 1997. But on the eve of a crash, you never know.

EDITORIAL OPINION

Service With a Smile

As any person in today's predatory business climate can tell you, the most important ingredient to success is good personal service. In this post-modern society where computers seem to be displacing humans in all areas, a nice, friendly face can go a long way in improving one's day. Indeed, sometimes a nice, friendly face behind the counter can be the sole reason why someone buys a product. Located on 186'th Street and Amsterdam Avenue, there are two businesses – Grandma's Cookie Jar, a first rate bakery whose delicious muffins have achieved folk-lore status, and The Collegiate Book Store, a third rate establishment whose claims to fame are exorbitant prices and a paltry selection of books - where one can see how pivotal of a role service can play in making a pleasant business environment. When first entering The Collegiate Book Store, one is struck by the clerks' apathy and unreadiness in helping. They respond to simple to simple questions, like a book's location or cost, with snide facial expressions and abrupt shouts of disbelief. When a professor requests more books, one becomes common witness to fiery diatribes about how a book's shortage is not their fault and how they should not order more books in order to teach the professor a lesson. Crude behavior is the local dialect.

Grandma's Cookie Jar, on the other hand, is a business establishment that realizes the importance of efficient service. Taking a cue from the Yeshiva University's Cafeteria, "Grandpa", Grandma's cuddly owner, hired two cute Hispanic women to serve consumers. With their sweet smiles and friendly demeanor, "Lorraine" and "Wanda" have made buying pastries a whole new experience. When they are around, muffins taste more scrumptious than usual, and bagels are miraculously softer, while the decadent aroma of hot cookies and chocolate brownies smells better than ever.

However, what intrigues us most are the reactions many a Yeshiva student has to these women. Instead of acting like normal consumers buying products (i.e., paying their bills and leaving), many students deem it necessary to forgo the traditional pleasantries of "Have a nice day!" and "How is your life going?" for more meaningful conversations. Indeed, it is not an uncommon sight to see a Yeshiva student swapping family stories or a newly heard joke with these two women. Often after finishing his conversation with one of them, a student will punctuate the moment with an awkward smile or laugh. Although we are sure that "Grandpa" did not hire "Lorraine" and "Wanda" with the intent of boosting business by having them flirt with the student body, we are equally sure that "Grandpa" is not dismayed with the results - added sales and fatter profit margins. Unfortunately, in rare occasions these long conversations can hinder business as well, when annoyed consumers not interested in seeing students make fools of themselves in awkward conversation, walk out of the store upset at the slow service.

Managing a successful business is a tricky game. On a daily basis, businessmen, whether wealthy or rich, strive to get an upper hand on their competition. The Collegiate Book Store and Grandma's are two stores that show how service can alter a business environment. While students do everything in their power not go through the hellish experience of buying a book in The Collegiate Book Store, people go out of their way to buy muffins and shamelessly hit on the "Grandma Girls". But we feel the need inform The Collegiate Book Store that all hope is not lost: if they wants to see what good service means then they should take out their wallet, and prepare to hire people of the opposite sex.

THE EXCHANGE

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Personal Investment Strategy DISASTER

by Professor Aaron Brown

The deadliest volcanic eruption in history was the 1815 explosion of Tambora, just west of Sumatra. The resulting tsunami flooded the low-lying areas of hundreds of nearby islands and killed 10,000 people. Most of the victims were islanders living in low-lying areas who supported themselves by fishing or trading.

The disaster caused a profound cultural shift among the surviving islanders. It seemed apparent that beach dwelling was sinful and dangerous, that fishing and trading were suspect occupations. The ancient ocean gods who united society among thousands of islands were neglected in favor of religion tied to ancestral sites on land. The loosely-knit society of Micronesia gave way to economies firmly rooted to one island.

As the years passed some people began to question these changes. Not the people who had actually witnessed the Tamboran tsunami, of course, but by the 1840's most residents had only heard about this event from their parents. There was attractive land available near the ocean and it seemed silly for sailors and fishers to climb to highlands every night. People longed for the old free-roaming beach ways. Mountain life seemed stilted and over-regulated, the beach promised adventure and freedom. But 10,000 dead are hard to forget, even if you have only heard about it second-hand.

By the 1880's, second-hand had changed to third-hand. The only living witnesses to Tambora had been children in 1815; even most of the people whose parents had witnessed the event were dead. The grandchildren began to move back down to the underexploited shore. The old beach subculture was resurrected in a manner not unlike the contemporaneous settling of the American West.

In May 1883, rumblings began on an uninhabited island a few hundred miles northwest of Tambora. Its central volcano had been dormant for over 200 years. A series of small explosions were heard on neighboring islands. Then, in August 1883, Krakatua blew.

This was the second-deadliest volcano in history. Although Krakatua killed fewer people than Tambora, its cultural consequence in the western Sumatran islands was many times greater. The first disaster molded the island societies, the second, confirming disaster, was the kiln that fired those changes into glass-hard permanence.

The Great Crash of 1929

What is this story doing in a personal finance column? If you can forgive the impiety of comparing losses of money to mass deaths, consider the analogy to the market crash of 1929. This was not an event of October 29, 1929, when the stock market fell 13% in one day. It was not the three months of sharp negative returns from September to November 1929. It was a three-year disaster from 1929 to 1932 with seven distinct crashes separated by record-breaking rallies.

From September to November 1929, the stock market declined 37%. Stock prices were near the level of the beginning of 1928. Now the smart money started flowing in, the people who had been waiting on the sidelines because they knew the market had been overvalued. "The Great Bear," Jesse Livermore, who had been short (i.e. had bet that stock prices would go down) since May 1929, began to snap up bargains left and right. Over the next six month the market rewarded these brave souls with a 20% return, undoing more than half of the Crash. Then, in June 1930, the entire 20% was taken away in three days of frantic trading and the market was back to the lows of November 1929. By the end of 1930 the market was 25% below those levels.

Now the really smart money appeared. "The Great Bear" was now "The Bankrupt Bear," having lost all his and his investors' money by getting in too soon. But there were others who had realized that 1929 had not squeezed all the excess out of the stock market. To these careful investors, after further reductions of 25% by December 1930, the market looked cheap.

These investors received 20% returns in January and February 1931. Then they gave back 30% in the next three months. These cycles continued until by December the market was down 43% from the 25% below the post-crash values in November 1929.

Now the worst had to be over. First there was a 37% crash in 1929, then a further 25% reduction in 1930, then a further 43% decline in 1932. Now even the most cautious investors had to admit the market was cheap. February 1932 seemed to be the turning point with a solid 6% return for the month. But the next three months were springtime only for the calendar. The stock market fell another 44%. 1932 ended up just as bad a year as 1929.

Crash Theory

A one-time decline in prices, no matter how severe, does not test the financial markets. There is always money on the sidelines, waiting to repair the damage. But a constant cycle of rally followed by deeper decline leaves a lasting imprint. Four of the six years after 1932 saw stock market returns better than +30%, including +54% and +48% years. By the end of 1936, every stock market investor who had stayed in the market was showing a profit, whenever they had bought. But by this time, there were very few investors who had not had their faith shaken by the crash/rally/bigger crash cycle.

This is why the 13% stock market crash in 1929 changed the financial system in fundamental ways while the 23% 1987 crash caused only minor technical adjustments. 1929 is still the "Great Crash"; 1987 is already forgotten.

A simple decline in stock prices that stabilizes at a new, lower level, should not have a lasting economic impact. It does not destroy any real assets, it does not withdraw any capital from productive use. The defining characteristic of a true crash is an extended period of negative returns, it takes time for the economic damage to occur.

A Brief History of Crashes - Cotton Crash of 1837

Financial crashes are as old as

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