

# The Blue Sheets

A quarterly review of the markets and the economy  
April 2004

## *A Completely New Approach to Capital Conservation*

### A Unique Time

Most of the money we manage for our clients is earmarked for retirement, either present or future. For this reason, we are especially concerned about capital preservation; about minimizing losses; about doing everything in our power to earn positive returns even during times when stock prices are falling, as they were in 2000, 2001 and 2002. During those gloomy years of the “bear market”, we were able to identify several asset classes that represented good value... small cap stocks, mutual funds that adhere to a deep-value discipline and, of course, long-term bonds that rose in price as interest rates declined. Emphasizing these asset classes allowed us to preserve capital and earn a fair return for our clients despite a nearly 40% drop in large cap stock indexes over those three years.

In 2003 the stock market rebounded sharply, bonds held their own and we enjoyed double-digit returns on conservatively-diversified portfolios.

In this spring of 2004, we find ourselves in a unique situation where none of the traditional asset classes appears attractive. Neither growth, nor value nor small caps nor any class of bonds appears to offer much in the way of appreciation potential. Said another way, stocks, overall, seem richly-priced relative to current and prospective corporate earnings and dividends. Bond yields are so low that any meaningful upturn in the rate of inflation could depress bond prices, wiping out their return from interest income. And cash reserves pay virtually nothing. All three traditional asset classes, in the aggregate, are unappealing as investment alternatives. That is a unique set of circumstances.

Not only that, but we perceive a *risk* of another round of serious declines in stock prices, especially if corporate earnings should disappoint the current bullish consensus expectation (+15% or so for this year). Stock valuations, while not nearly as absurd as they were in early 2000, are quite high by historic standards, especially if one factors in a possible increase in interest rates. Over on the fixed-income side, long-term bonds and lower credit quality bonds are very vulnerable to serious price erosion if inflationary expectations should rise and/or if the Federal Reserve or world debt markets should start to put upward pressure on rates.

Because capital conservation is vital to most of our clients, they want us to “invest conservatively”. To invest “conservatively” when stocks, bonds and cash are expensive, and still

to earn a decent return, is going to require some non-traditional approaches to portfolio management. As you may have guessed, we have some ideas.

### **Coping with High Valuations and Economic Uncertainties**

One approach we have taken in an effort to reduce our exposure to general stock market risk is to focus our equity investments in individual stocks that we believe represent better value than the broad cap-weighted indexes like the S&P 500 or NASDAQ.

Our stock selections are diversified across a number of business sectors... financial services, industrial services, technology, utilities and energy producers. Our financial stocks will do best if short-term rates remain low; while this is our very near term expectation, the steepness of today's yield curve is unlikely to endure if economic growth remains in the 4% range. Yet, even if a consumer pull-back should head the economy into a slow stretch, we believe our financial companies will gain market share in their industries. Furthermore, their valuations appear reasonable.

Our energy stocks should benefit from the strong commodity prices which we anticipate due to rapid demand growth from Asia, and central bank liberality in the industrialized nations (which seems to be turning into a sort of mild currency war).

If US economic growth continues in the 3%-4% area, our energy, industrial service and utility companies' businesses would benefit. But that same environment could also cause short-term interest rates to rise, which would put pressure on the prices of our bonds and interest-sensitive stocks (like preferred stocks and utilities) and dampen profit margins for our financial stocks. Our technology investments are also influenced by the general prosperity of the nation, but the continuing drive for increased business productivity should strengthen demand for these companies' products and services in just about any environment.

We are increasingly concerned about a possible rise in the general rate of inflation, driven by soaring commodity prices and a surge in housing costs. Our approach to reflecting these realities in our portfolios is to raise our holdings in energy stocks and to add several mutual funds whose portfolios would benefit from broad commodity inflation. We continue to shorten our average bond maturities and add TIPS to lessen the degree of interest-rate risk. We will still have some longer-dated bond exposure in our portfolios, but nothing like we had a few years back.

Our mutual fund preference in this environment runs to "focus funds", primarily research-based funds with a successful history of operating within a strict value methodology. Focus funds own relatively few stocks (typically 30 or so, rather than hundreds) and tend to concentrate money in their "best ideas". Investment returns for these deep-value funds tend to be independent of returns for the major indexes, as they demonstrated by posting strong positive returns during the last bear market.

Overall, in this unique environment where all major asset classes seem over-valued, we believe we have a better chance of differentiating our results as minority owners of good businesses at favorable prices than by trying to find a favorable place on the yield curve. Hence, we actually

find ourselves owning *more* equities as a percentage of our portfolios, despite the fact that stocks in general are expensive. Because we think the market is vulnerable to a valuation correction, and because most stocks' prices tend to be influenced by the overall market direction, *we need a strategy to limit our stock market risk even as we build up our equity holdings.*

### **“Shorts Positions”**

*We have been studying another investment approach that is not correlated with the S&P 500, one we would like to introduce to readers in these Blue Sheets; it is “hedging” our equity investments with “short positions”.*

Traditionally, to “sell short” means to borrow a security (say, 100 shares of Cisco at 24 a share) and to sell those borrowed shares on the open market. This would leave you with \$2,400 in your pocket but 100 shares “short” of your obligation to eventually replace the borrowed shares. An investor (or, you may prefer to say “speculator”) would enter into this situation hoping to buy back the 100 shares of Cisco for less than \$2,400 and keep the difference as profit. Hence, a short seller hopes a “shorted” security will decline in price.

Selling short is not a new invention. For decades it has been the staple of traders and hedge funds. It has generally been considered a speculative investment; especially because the very long-term direction of stock prices has been up, not down. It has also been speculative because the risk in a short sale is theoretically unlimited (the price of the stock you sold short could keep going up, and eventually you must buy it back to return it). In contrast, the potential gain (in the case where a stock price falls to zero) is limited to 100%.

Consider for example that one has borrowed 100 shares of Cisco at a share price of 24 (\$2,400), sold them at that price, and eventually had to buy them back at \$100 a share (\$10,000). That person would have realized a *loss* of \$7,600 on an original investment of \$2,400, a loss of 316%! If, instead, this person were correct in their assessment that Cisco would decline, and was able to buy the shares back at 10 a share (\$1,000), he would have earned a profit of \$1,400 or 58%.

*Selling short individual stocks is not something we expect to ever be a part of our investment strategy. (I can almost hear readers saying, “Whew!”)*

That having been said, we have been thinking for some time that in an environment when all major asset classes can reasonably be called expensive or over-priced, and when we nevertheless have a responsibility to do our best to provide positive returns, to limit ourselves to traditional “long” positions seems an unnecessary constraint on our ability to deliver what our clients (and we) expect.

What we need, it seems, is a way to *short* the market rather than shorting individual stocks, so that our short position would be *diversified* (there are 500 stocks in the S&P 500 Index, for example). Then, besides owning stocks and mutual funds that are not closely correlated with the overall market's behavior, we could also own a kind of security that would actually rise in value when the overall market declined; i.e., it would have “negative correlation”. Such a security

would give us control over our market risk and provide an opportunity to take advantage of stock market volatility in both up and down markets via a rebalancing discipline.

There are in existence a handful of mutual funds precisely designed to meet this description.

### **A Bear Fund**

Rydex is a mutual fund company headquartered in Rockville, Maryland. Besides offering a stable of typical index-related funds, Rydex has also created several mutual funds that produce results the exact *opposite* of certain stock and bond indexes (like the S&P500 and NASDAQ.) One such fund is called Rydex Ursa (from the Latin for Bear); this fund is so designed that if the S&P 500 index *falls*, let's say, 2% in a day, the value of the Ursa fund will *rise* 2% that day (and vice versa, of course). Over longer periods of time, the contrary relationship is not precisely 1 for 1, but nearly so for planning purposes. The fund achieves the opposite of the market's performance by establishing "short positions" in stocks and by using "put options" and other derivatives to achieve the overall objective.

We sometimes refer to this type of mutual fund as a "Bear Fund" because it is designed to rise in value during a "bear market" in stocks (a period of generally declining stock prices). It is also called an "Inverse Index" fund

Last spring, at our annual client reception, I mentioned that we would be doing research on the subject of bear funds and experimenting (with our *own* money!) with owning such securities because to find some pleasure in a declining stock market will plainly be a different emotional experience, and will take some getting used to! We have been doing that research and have (painfully, because the market has been rising) owned shares of Rydex Ursa in our own accounts to get a feel for it and to think about how best to use such an unusual security in our investment strategy.

We have learned that there are actively managed bear funds and index bear funds. Until we become more familiar with the strategies of some of the better-known active bear fund managers, we will stick to the index kind where we are more clear about what we actually own.

Rydex has designed a small stable of negatively correlated or "inverse" funds to enable portfolio managers to hedge the S&P 500, NASDAQ 100, Dow Jones 30, Russell 2000 (small caps) and even long Treasury Bonds. Some of their funds are leveraged so that they will exhibit 150% or even 200% of the inverse of an index's return! There could be a place in our future for a leveraged inverse fund, but we expect to begin our hedging strategy using the un-leveraged version.

### **Harnessing the Valuation Cycle**

Rydex Ursa would have been a wonderful security to own during the 2000-2002 bear market. Alas, we did not own it. But neither did we own it in client accounts in 2003 when it would have

*lost* over 25% because the S&P 500 was soaring. The point is that we profess no particular skill in forecasting market movements; that is not the reason we are going to include inverse funds in our investment tool kit.

Though we cannot forecast whether the market will rise or fall in the next year, we *can* identify periods when the market's valuation is well up in the historical valuation range and seems likely to revert to the mean valuation either by a drop in stock prices or by the passing of time during which corporate earnings grow and stock prices stagnate. History is replete with examples of both forms of reversion to the valuation mean.

The *higher* the market's valuation, the greater the risk that an equity portfolio will lose ground due to the market's reversion toward its valuation mean. Conversely, the *lower* the market's valuation is in the historic range, the greater the recovery potential. It seems to us that the upper 20% and the lower 20% of the market's historic valuation range, insofar as these generally prove to be temporary conditions, present opportunities to enhance our portfolio returns. This seems far preferable to letting our portfolios be hostage to the vicissitudes of market valuation. The ability to profit from a shift in market valuation seems especially worth pursuing when all the traditional asset classes look pricey, because that condition sets up a probability of low or even negative returns for traditional portfolios.

An investor considering what to do with respect to a highly-valued stock market actually has three choices. First, she may ignore the valuation and maintain a "normal" allocation to this asset class (for example, a 60%/40% equity/bond portfolio). Or, choosing to take some action based on the valuation, she may reduce the allocation to the expensive asset class or even avoid it altogether until such time as it is reasonably priced again; or (the third choice) she may hedge her long positions with a market *short* position in an effort to profit from a potential valuation correction.

Factoring market valuation into our investment strategy is not, we believe, a version of market timing. Rather, what we propose to do is to add a new device to our investment toolbox; one that we can use strategically to harness the valuation cycle. We think it makes good sense to own an inverse index fund when the market is in, say, the top ten or twenty percent of its historical valuation range ESPECIALLY when we are not turning up other traditional securities (stocks, bonds, mutual funds, bank deposits, limited partnerships) that we can confidently use to overcome poor overall market returns the way we did with long treasury bonds and small caps in the last bear market. After all, isn't our assignment to make every effort to earn positive returns, not to excuse losses by blaming them on an over-valued stock market?

### **Advantages and Disadvantages**

Inverse funds are not magic; they have advantages and drawbacks. For example, Ursa will *diminish* a portfolio's returns in a bull market (i.e. when stock prices are generally rising). Let's say, by way of example, that a \$1,000,000 portfolio holds 50% in an S&P 500 index fund that rises 20% in a given year. Assume further that the other 50% of the portfolio earns 3% in high credit-quality, short-term bonds. For the year, that whole portfolio's return will have been 11.5%.

Now, wind back the clock and assume instead that this portfolio had 10% in Ursa (which would *fall* 20%), 40% in S&P 500 (which would *rise* 20%) and 50% in the same bonds as before. This hedged or “Ursanized” portfolio’s total return would be only +7.5% or \$75,000, significantly less than the +11.5% (\$115,000) return for the un-hedged version.

But let’s assume that the year was one in which stock returns were -20% instead of +20%. The Non-Ursa portfolio would have lost -8.5% of its value, or -\$85,000. The one with a 10% Ursa position would only have lost -4.5% or -\$45,000, a much more tolerable result for a nasty year in the market; not good, but less bad!

So, an advantage of owning an inverse fund is that it can smooth out the ride for investors by reducing the overall volatility of returns from year to year. This feature alone provides a much-desired benefit for retired investors. Interestingly, if we compare the hedged and un-hedged versions of this portfolio after one year of +20% for the stock market and a second year of -20% for stocks, the two-year compound return for the hedged portfolio is actually better (+2.7% versus +2.0% for the un-hedged one). So, not only did the hedging with Ursa make the results smoother in our example, the return was actually *better* as well! More taste, less filling, or something like that.

Another way of looking at the usefulness of an inverse index fund is that shorting the market, when valuations suggest greater-than-usual downside market risk, would allow us to make *higher allocations* to our individual stock selections and our focused value mutual funds than we otherwise would. This is a great advantage when we cannot find compelling values in the fixed-income sector, the traditional vehicle for dampening portfolio volatility. Here’s why.

It is very hard to make money in stocks when the overall market is in serious decline, because most stocks are influenced to some degree by the ebb and flow of investor enthusiasm. (A stock’s “Beta” suggests how much it is influenced by market behavior.) In times when there is more ebb than flow, such as when equity mutual funds are experiencing cash outflows, the selling pressure tends to feed on itself by discouraging investors. Even stocks of good companies that are conservatively valued tend to be influenced by this diminution of “animal spirits” in the market.

However, there have been times when groups of stocks were able to buck the general downtrend. For example, during the 1970s market doldrums, energy-related shares were in a long bull market. And, in the 2000-2002 bear market, value funds showed very strong positive returns. By owning a meaningful position in an inverse fund during such market downturns, we will be more comfortable increasing our positions in stocks or sectors that we believe might buck the trend, because we will have neutralized some of the “market risk” that comes with greater equity exposure.

### **Stock Prices Are High.**

Based on the latest trailing 12 months earnings per share, the S&P 500 index is selling at over 23 times earnings. It is important to note that this is based on historically *high* earnings, not some

temporarily depressed figure. Our reading of the history of P/E ratios places the current valuation in the top 10% of valuations over modern financial history. In other words, about 90% of the time stocks' P/E ratios are lower than they are now. Over many decades the P/E has *averaged* about 14x or 15x.

Commentators who believe the market is not over-priced at 23 times earnings seem to believe that: (a) The high P/E is justified by the present environment of low interest rates on bonds and/or that

(b) Future earnings growth will be robust (double digits) and that this growth of the denominator (price/*earnings*) will soon bring the P/E into normal range. Since the market is a discounting mechanism, they say, it looks reasonably priced on “forward” earnings.

We would offer a few observations with respect to both (a) and (b) above.

(a) Concerning the idea that low interest rates justify a high P/E because bonds offer less competition to stocks, we now believe that present low interest rate structure is likely to be pushed higher by market forces in the next year or so. (See “Interest Rates Are Low” below.) Higher interest rates would erode this justification for high P/Es.

(b) Concerning the expectation of a strong future growth rate for corporate earnings:

1) Consumers still account for more than 2/3 of our economic activity and we don't think they will have the wherewithal or the emotional fortitude to keep spending more than they earn ad infinitum, especially if the cost of servicing their prodigious debts begins to rise. Further, the consumer is aging, and becoming more aware that the Social Security system is undependable. A (desperately needed) rise in the savings rate would naturally put a dent in consumption, hence in the growth rate of our economy.

2) Corporate profits as a percentage of GDP have never been higher. This is a cyclical phenomenon and most of the cycle is below current levels. Hence, the direction of profit margins is more likely to be a drag on the earnings growth rate than a stimulant.

3) Inflation in raw materials and intermediate goods affects the cost of most goods and services. If not passed through for competitive reasons, inflation will erode companies' profit margins. If passed through, higher prices will dampen consumer demand.

4) Recent profits have been boosted by a reduction in corporate income taxes. In the current political environment, we would be surprised if corporate taxes do not *rise* going forward, providing some downward pressure on margins.

5) Long-term, total profits can only grow as fast as GDP from point to point on the cycle. We think (real) GDP growth the next ten years is likely to be slower than in the post WWII decades for a number of reasons, not the least of which is that credit cannot keep growing faster than incomes endlessly. Also, foreign vendors, with a huge cost advantage, will continue to account for a growing share of our total consumption of goods and services.

We think there is a good chance that inflation-adjusted earnings growth of less than 4% a year will not long support a 23x P/E ratio for the general market.

## **Some Signs of Speculation**

The high end of the normal valuation range typically occurs in an environment of investor optimism. Optimism about stock prices tends to reinforce itself, leading to a speculative environment and eventually a bubble in prices that will finally burst. There are some signs in the current environment that speculation may be in its advanced stages.

We think that corporate insiders understand the risks of an over-priced market, since they are selling their own stocks at an unprecedented pace. Meanwhile, main street investors are pumping over \$20 billion of new money into stock mutual funds each month, encouraged by the strong gains in 2003 and also motivated by very low interest income on money markets and bonds. Trading volume on the OTC Bulletin Board (where shares of tiny, untested and primarily unprofitable businesses are exchanged) has increased so much that it actually exceeds trading volume on the New York Stock Exchange! Initial Public Offerings are brisk again, having all but disappeared in 2002, and surveys of investor sentiment are as bullish as they ever get. Speculation is “in”, and it certainly looks like it may be late in a cyclical bull market.

Back at the top of the 1999-2000 bubble we wrote adamantly about the danger of absurd valuations, and we hunkered down our typical portfolio to about a 30% equity exposure, and virtually eliminated so-called growth funds from our holdings. But we had bonds working in our favor, and so-called “value” stocks and small caps were actually ridiculously cheap, so life was still good.

After a very strong stock market recovery over the past year, stocks are dear again; not as frothy as the last time, but still in the top 10% or so of valuations in the past 80 years (based on P/Es and dividend yields). And this time, the value stocks and small caps have already closed the valuation gap, so, unlike the last time, they don’t offer much opportunity. And this time we do not have the luxury of substituting long bonds for stocks, as explained below.

## **Interest Rates Are Low.**

We believe that interest rates are probably bottoming after a two-decade decline; this is a new position for us. Since Financial Advantage was founded in 1987, our fixed income policy has favored long-term maturities, especially treasuries, as a way of profiting from the long downtrend in interest rates (when rates fall long-term bonds appreciate in value). We have very profitably maintained this posture in the face of consensus opposition to the idea for nearly 17 years. Now we believe that the prospects of an interest rate uptrend are increasing, and the interest yield for long bonds is too low to compensate us adequately for the price risk. It’s time to change our strategy. (Please note that we expect to still have some long bonds in our portfolios as a hedge against the continuing possibility that a bad-debt driven *deflation* could get under way at some point.) Overall, the average maturity of our bond holdings is going to be noticeably shorter than clients have been used to in recent years.

Supporting our more bearish view of future bond prices (besides the fact that rates are extraordinarily, even artificially low) are several macro developments. First is the risk that

inflation may be at the start of a long uptrend; rising inflation typically causes bond investors to demand a higher interest return to compensate for the loss of future buying power of their principal. For the last 7 years, consumer prices in the US have been held down by excess productive capacity in most industries (which prevented vendors from raising their prices for fear of losing market share to competitors), by the strong dollar and by an increasing volume of very competitive imports, especially from Asia. Recently we have seen a dramatic surge in the cost of oil and gas and other raw materials, and there is evidence that commodity inflation is finding its way into consumer prices such as gasoline, utility bills, paper products, food and building materials.

A second macro aspect of expanding interest rate risk is the recent weakness of the US dollar (not surprising, in light of low US interest rates and our swelling trade and federal deficits). A significant part of the reason that the US has enjoyed historically low interest rates is that China and Japan have been gobbling up our vast offerings of Treasury bonds, each for its own political/economic reasons. If, as many experts consider likely, Japan and China should reduce their treasury purchases in the future, that alone could cause treasury rates to rise, perhaps substantially, in order to attract enough demand among non-politicized investors to absorb the treasuries offerings.

Actually, although they all deny it, there seems to be an unspoken motivation on the part of the central banks of major trading centers (Europe, Japan, U.S.) to weaken their own currencies in order to help their export industries be competitive. Unless some event transpires to disrupt this “beggar-thy-neighbor” currency behavior, we could end up in an accelerating spiral of de-facto currency devaluation. One sure winner in such a spiral would be commodity prices; since oil, steel, grain and other essential materials are traded in currency terms (most often US dollar terms) the price of essential materials (most of which are in very tight supply due to rapid Asian demand growth) would quickly rise in currency terms.

Another factor supporting our belief that the next major trend in interest rates will be up is ballooning global debt. Let’s first look just at governments. Because they owe so much money, and continue to pile up new debt via large annual operating deficits, the governments and central banks of Japan, Europe and the US have a strong incentive a) to stimulate their economies with liberal monetary and fiscal policies in order to keep their tax revenue coming and b) to rekindle inflation. Higher inflation, of course, means debts can be repaid with less valuable units of currency. Higher inflation is also the least painful way to sidestep *deflation*, the *bête noir* of every large debtor.

Including corporations and consumers in our calculations of soaring debt leverage, total debt in the United States recently tallied to 305% of annual GDP. To put that in some perspective, as recently as 1990 debt was about 125% of GDP. Here’s another, more recent look at how much we have been relying on new debt to keep the economy growing: total outstanding debt in the United States has grown by \$6.50 trillion since the year 2000. In that same period our annual GDP grew by just \$1.24 trillion. For each dollar added to annual GDP we added about \$6 dollars to our outstanding debt! Some are calling it the greatest credit bubble in history. How long can a civilization keep up this pace of credit expansion? There is a saying on Wall Street that “Anything that can’t go on forever won’t!”

There is another saying that “The markets always do what they are supposed to do. But they don’t always do it *when* they are supposed to!” The credit markets are supposed to translate rising credit risk into higher interest rates. They will, but we don’t know when. We think we should get prepared.

### **Other Risks**

Besides high valuations, the probability of rising interest rates and inflation, and a fair chance that economic developments will disappoint current bullish expectations sometime in the next year or so, we would be remiss if we ignored the reality that exogenous, wild-card events could always ambush an optimistic market. We have in mind particularly terrorist activity, global political tensions and the potential for a major financial accident stemming from the enormous pool of little understood derivative securities. Against a background of securities that are priced for perfection, we can’t help but be concerned when the markets ignore the Madrid bombing and its impact on elections; the Al Qaeda’s offer of amnesty to cooperating governments; and the US State Department’s warning that all non-essential personnel should leave Saudi Arabia for security reasons. How surprising will it be when something blows?

Warren Buffett is sitting on a \$32 billion cash hoard and worrying out loud about derivatives. Many trillions of dollars of risk-spreading securities exist and no one knows much about the way it may all work or not work in a crisis. (Does anyone remember when Long-term Capital crashed and burned around the group of Nobel prize winning geniuses in 1998 and the central banks of the world had to bail them out?)

The insurance industry measures risks in two ways: how likely an event is to occur and how devastating the loss would be if it did occur. It seems to us, just as an observant citizen, that the risk of a major untoward development is greater than usual. Further, if a major attack, a significant breakdown in governmental relationships or a huge financial accident should occur, it would do far more investment damage at 23 times earnings and 4% interest (10-year treasury) than it would if prices already reflected the risks.

### **Our New Investment Strategy**

So this is where we are. Stocks and bonds are expensive. There is a reasonable possibility that consensus economic expectations will be disappointed, perhaps later this year. There is a higher than usual risk that a scary exogenous event will occur and that unusual financial leverage throughout the global economy could turn an everyday brush fire into a stem winder of a conflagration.

As investment managers focused on earning positive returns with tolerable risk, we need a new and creative investment strategy appropriate to the current environment.

Because every client's portfolio is tailored to his or her personal issues of liquidity, tolerance for market ups and downs, and long-term return needs, this report can only provide an overview of the changes we will be implementing with our new strategy. Here goes!

- We will reduce our overall allocation to fixed income securities and we will shorten the average duration (a calculation of interest rate sensitivity) because income returns are low and we perceive less opportunity for price appreciation in bonds than we have enjoyed in past years.
- We will increase our overall allocations to equity investments even as we sidestep large-cap index funds, traditional growth funds and "closet indexers".
- Our increased equity allocation will be implemented with a highly focused menu of securities. Among our selections will be:
  - Stocks of industry leaders with proven management and strong finances that are poised to gain market share in their industries.
  - Focused value funds with a long history of successful securities selection.
  - Stocks or mutual funds that provide exposure to sectors that we believe will benefit from the expected environment.
  - Special situations, including up-and-coming companies with great potential, promising corporate turnarounds, and securities providing high cash returns.
- We will hedge our long equity positions using inverse index (or similar) funds to provide the following advantages:
  - Reduce our exposure to loss due to exogenous events.
  - Reduce our risk due to a potential decline in overall market valuation, freeing us to capture more "Alpha" through our securities selection process.
  - An opportunity to profit from market volatility by a disciplined process of rebalancing our long and short positions in both up and down markets.

### **When the Wind's No Longer at Our Back**

Since 1980, stocks have risen considerably faster than company earnings. Said another way, the average Price/Earnings ratio has been steadily increasing for two decades. For example, the earnings for the 30 companies in the Dow Jones Industrials grew 7.3% a year for 20 years while the DJIA stock price index grew about 13.1% a year. Stocks that began the twenty year period at 8.2 times earnings finished the run at 23.4 times earnings. The willingness of investors to keep paying more for each dollar of corporate earnings (that is, the rising P/E ratio) accounted for almost half the total return from stocks over that 20 year stretch!

Bonds enjoyed a similar beneficial environment during the '80s and '90s. AAA corporate interest rates peaked at more than 14% in 1981; today they're about 6%. A \$1,000 non-callable 30-year bond issued in 1981 with a 14% coupon would today be priced at around \$1,500. Its average annual total return for the last 23 years (i.e. interest income plus appreciation) would have been 16.5%!

So for the last two decades investors in both stocks and bonds have had the wind at their backs. What concerns us looking forward is the greater potential for the P/E to *decline* and for interest

rates to *rise*... the opposite of the favorable climate of the 1980s and 1990s. We may not only forego the benefit of a favorable tail wind, but may actually have to fight a headwind to make any progress at all (falling P/Es would reduce returns just as rising P/Es boosted them.)

With interest rates at 46-year lows and P/Es near the top of their historic range, it seems prudent to expect considerably lower returns from broad indexes of both stocks and bonds in the next decade or so. In fact, many highly regarded investment managers and academics are on record with their expectation that investment grade bonds as a class will be fortunate to earn their coupons, and stocks would do well to produce 5% average annual returns, perhaps with a great deal of price volatility, over the next five to ten years as the new realities work their way into securities prices.

In this report we have described significant adjustments to our investment strategy that we believe will increase our chances of producing good investment returns for our clients in the coming years with a manageable level of volatility.

<b>DJIA</b>	<b>10,315</b>	<b>Nasdaq</b>	<b>1,978</b>
<b>S&amp;P 500</b>	<b>1,118</b>	<b>10-yr Treasury</b>	<b>4.42%</b>

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**April 20, 2004**