

The *Blue Sheets*[®]

Our quarterly commentary on the economy and securities markets

March 2005

The Long and Short of It

Our Process for Building Productive Portfolios

For the better part of two decades, these *Blue Sheets* have been our forum for commenting on developments in the global economy and in the securities markets which supply essential capital to businesses and governments. In the course of all that observing and commenting, we have learned a thing or two about the roguish independence of markets and the often tenuous relationship between economic realities and securities prices.

Over the years, experience has humbled us with her repeated instruction in the futility of *short-term* forecasting. At the same time, though, she has taught us the power of understanding *long-term* forces in both the economy and the stock & bond markets. While we do occasionally venture an opinion, say, that interest rates may be bottoming or that a business cycle seems long in the tooth, our serious decisions about the makeup of client portfolios emerge from our studied convictions about a few powerful long-term forces.

Needed: An opportunistic investment style rooted in economic realities

As regular readers know, in December 2004 we introduced what we believe is a much-needed, revolutionary way of designing investment portfolios. We call our process Scenario-Based Allocation (SBA) because it allows us to *focus* our search for investment opportunities on sectors and companies that will benefit from the long-term forces our research has identified. It also allows us to *diversify* our portfolios across a variety of possible future economic scenarios rather than determining “diversification” by something as superficial as market capitalization; or by dividing the universe of stocks in half, labeling one group “value” and the other “growth”. (These are two of the widely-accepted approaches to diversification supported by the style-box version of modern portfolio theory.

Our SBA process sidesteps the confining style-box approach to diversification, and opens up a whole new world of opportunity. The style-box approach goes something like this: allocate, say, 60% to stocks and 40% to bonds; spread bonds across maturities no greater than 10 years; divide equities among small-cap, mid-cap and large-cap, value and growth, foreign and domestic. Over the last 25 years this has become the consensus philosophy of diversifying risk in a portfolio, even though it describes mostly superficial or simplistic differences among groups of securities.

Why has MPT become so popular? Why is a change needed?

The consensus of the investment community, especially the academic contingent, seems to be that style-box diversification *has been* successful and therefore it is a valid model for *future* investment success as well. This conclusion is consistent with the Modern Portfolio Theory (MPT) view of the world that goes something like this:

Markets efficiently process all available information so that securities prices reflect all relevant knowledge. Hence, it is vain and foolhardy, the theory goes, to attempt to outsmart this efficient market, especially since there are costs associated with the effort. Better to content oneself with the average returns on capital provided by a growing economy over time. By investing in a wide swath of available securities, “diversified” by style boxes, one should experience satisfying long-term investment returns (defined as the historic average) with bearable volatility. Inevitable downturns are, MPT posits, unpredictable and temporary, hence best ignored.

The widespread popularity of the MPT thesis among investment practitioners is easily explained by two characteristics:

- (A) It worked very well from 1980 to 2000 and
- (B) It can be implemented with little work and even less knowledge.

And a fee may be charged for this simple discipline. What’s not to love?

Well, here’s the problem. Projecting *continuing* success for MPT/style-box diversification based on its *past* success is a fatally flawed proposition because it ignores the fact that the superior investment returns of the 1980s and 1990s were a result of performance-enhancing financial steroids that are not available going forward. During that marvelous period, the P/E ratio for the S&P 500 tripled from less than 10 to almost 30; this rising P/E provided the excess return on stocks. At the same time, interest rates on bonds gradually declined from about 15% on 10-year governments to a recent 4%, driving up bond prices and producing equity-like returns for fixed income investments. It almost didn’t matter what you owned; broadly diversified portfolios of the kind espoused by MPT adherents provided double-digit returns with only a few (bearable) interruptions... mainly attributable to rising P/Es and falling interest rates. A whole generation of investment professionals “grew up” in this felicitous environment when all one had to know was, “Buy the dips.” MPT made all the sense in the world.

Today, however, most investment managers and finance academics agree that P/Es are in the upper reaches of what we can reasonably expect and that interest rates are likely bottoming. If anything, interest rates are probably in the early phases of a prolonged *upturn*, and P/Es are expected to *recede* as interest rates rise. In other words, what had been for an entire generation a benevolent tailwind for both stocks and bonds is likely to become a troublesome *headwind* that *depresses* returns, possibly for an extended period of time, even if the economy continues to grow in a normal fashion. (For a thorough explanation of a secular bear market characterized by rising interest rates and falling P/E ratios see John Mauldin's "Bull's Eye Investing" 2004.)

With respect to (B) above, we would observe the following... during the ascendancy of MPT's passive investment philosophy from an academic curiosity to the dominant creed of portfolio managers, *active* portfolio management and *security selection* were widely disparaged. Many experienced active managers have retired or otherwise left the stage. And graduate business schools, the original seedbed of the MPT philosophy, have trained the majority of the 35-45-year olds who now oversee trillions of passively-invested dollars. It is our conviction that an investment culture that celebrates passivity, aims for mediocrity and proclaims that knowledge is of little advantage, eventually creates an environment of enormous opportunity for active managers with imagination, discipline and a sense of financial history.

We believe that such a time of opportunity for active portfolio management commenced with the cyclical bear market of 2000-2002 and will be with us until P/Es and interest rates have normalized, perhaps for another decade or so, unless an exogenous crisis or financial "accident" should force a sudden correction.

A more promising approach

Because we understand the vulnerability of a passively diversified portfolio when the tailwinds of rising P/Es and falling interest rates become troublesome headwinds, we have developed an *active* diversification discipline that helps us be *responsive* to the emergence of the sort of opportunities that attract capital as it flows restlessly around the world in search of superior risk-adjusted returns. We are especially interested in identifying and understanding potentially long-lasting developments such as demographic trends and competitive business advantages that we can harness to our clients' advantage.

In our search for investment opportunities, we eventually decided to jettison the accepted style-box language of so-called "asset classes" because we became convinced that labels such as "mid-cap" and "foreign" and "growth" do not identify meaningful or useful investment characteristics. We have developed, instead, a matrix of twelve categories, some traditional labels and others of our own choosing (See December 2004 Blue Sheets on our website at www.FinancialAdvantageInc.com). Some of our new categories concern macroeconomic forces such as the tightening supply-demand situation for oil, or the shape of the yield curve. Others relate to opportunities driven by demographic trends (eg healthcare) or securities market imbalances (distressed securities). Because the

driving forces behind these twelve categories are so varied, this matrix actually enhances our ability to diversify risks by owning fundamentally non-correlated investments.

We are dedicated to identifying new and potentially enduring changes in the global economy and the securities markets that will influence the success and failure of businesses and the valuation of securities. Identifying trends helps to focus our research on specific economic sectors and individual companies that eventually show up in our portfolios.

We have already mentioned the headwinds of P/E compression that we expect for the overall US stock market and how important that development would depress returns from passively managed portfolios. We believe that understanding the P/E cycle can dramatically improve investment decision making, and that ignoring it can sabotage an otherwise thoughtful investment strategy. A topping of the P/E cycle is representative of the sort of trend change we seek to identify. In this example, the practical impact on our portfolios is easy to see... besides nudging us to avoid large cap indexes and to develop of a whole new style of opportunistic investment, identifying this long-term trend has also inclined us to include an inverse index fund (Rydex Ursa) in our portfolios for use as a rebalancing tool during market downdrafts.

Following are four more examples of financial, economic and social forces that we believe have staying power and a gravitas of the sort that will create investment opportunities greater than the market currently acknowledges, since the market is so heavily influenced by efficient market philosophies that profess indifference with respect to such realities.

Four long-term forces

Demographics... In many respects, demographic data *are* the future, writ large. The population phenomenon most familiar to Americans is the post-WWII explosion of fecundity long known as the Baby Boom. The impact of the growth and development of this unusually large group of humans on housing, educational institutions, war policy and employment, among many others, is well documented. How government policy and the private economy will respond to the needs of 70 million people approaching retirement and old age is yet to be seen. But there *will be* changes, some predictable, others probably surprising. Whatever eventually develops, we believe that studying the possible impact of demographic realities on future capital flows cannot help but make us more successful as investors than if we chose to be agnostic (passive!) as to how or whether the boomers' needs will be met.

One area in which we have focused our research because of the boomer phenomenon is the huge healthcare industry. Already accounting for 14% of GDP, we are convinced that our collective demand for healthcare will be running up against resource constraints... which leads us to examine companies which may be able to enhance the efficiency of healthcare delivery. Most of our portfolios have a position in Cerner, the leading provider

of healthcare information technology solutions. Other companies with complementary emphases are on our radar screen.

Europe and Japan are aging rapidly, and China, because of its one-child policy, is in a similar demographic situation, yet the implications are probably different because it has not developed the expensive social safety nets that Western Europe and Japan have in place. The Middle East, in contrast, has an extraordinarily young demographic which, some would say, adds urgency to their development of a free market economy that can provide useful employment and a hope of participating in the global prosperity. If economic opportunity should drain energy from today's violent cultural clashes, it won't be the first time in history.

The US, partly because of continuing immigration to the States, actually has one of the healthiest demographic outlooks in the world, which complements other systemic strengths that auger well for this nation's ability to cope with future shifts in global commerce and with the unprecedented debt leverage of the world economy.

These differences among the nations and regions of the globe need to be considered as we seek investment opportunity and endeavor to avoid investment disasters.

Debt leverage... We have often mentioned the fact that in the past 25 years total debt in the US has ballooned from 125% of GDP to more than 300%. We are not alone among industrialized countries in our increasing reliance on debt to bolster economic activity. In Japan, government debt alone is something like 1.4 times their GDP, about twice the US government debt ratio. It is widely believed that around half the bank debt in China should be written off. Borrowing, even responsible borrowing, has consequences insofar as it reduces future opportunities to spend or invest. When debt rises to levels never seen before, at least not in healthy economies, it looks to us like one of those significant long-term developments that should have some influence on our economic expectations and investment thinking.

In our choice of specific businesses in which to invest, we favor companies with strong balance sheets, because in a leveraged world liquidity and borrowing power constitute a competitive advantage. Sometimes a strong balance sheet means little or no debt (such as Exxon), while other times it means a credible use of leverage (Thornburg Mortgage tries to match maturities of its assets and liabilities).

Heavy debt and potentially unmanageable social commitments make western Europe look like a huge General Motors, minimizing any interest we might have in investing there, or even in taking on Euro exposure. (Actually, because healthy demographics and a high degree of economic freedom in the US suggest a long-term ability to adapt to change, we are reluctant to make a long-term bet against the US dollar in favor of the euro, pound sterling, yen or renmimbi .)

How large debt loads may impact the policies of government, and the price of government obligations, is a concern that must pervade our deliberations about our interest-sensitive holdings. We need to be mindful that heavy debts bias a central bank toward inflationary policies, which is one of the reasons that in the past 18 months we have dramatically shortened the duration (average maturity) of our bond portfolios.

Concern that rising interest rates might put downward pressure on consumer spending, weakening the profit outlook for many business, is one reason we are not currently invested in “junk” bonds. The other reason for having a high quality emphasis in our fixed income portfolios is that the markets so far have been little concerned about credit risk, as seen in the historically narrow spreads between the yields on junk bonds and government paper. We see no advantage in adding credit risk to our portfolios without appropriate compensation. Eventually quality spreads will normalize and there may once more be opportunity in the junkyard.

Finally, there is an unknown amount of leverage involved in the investment activity of so-called hedge funds, loosely regulated private investment pools that have mushroomed in terms of managed assets in the last several years. Investors remember the near tragic explosion of leveraged investments in the case of Long Term Capital Management a few years ago, and any hint of new trouble of this sort is one of the possible “accidents” that could trigger a serious market correction. Besides shortening our fixed-income duration and avoiding low credit-quality bond funds, we have sold some of our interest-sensitive equity positions and made an effort to diversify the list of businesses from which we derive interest income. One of the short-term costs of this defensive posture is low cash income, a cost we are happy to endure in the short run as we await greater opportunities in the long run.

Drive for Freedom... In an important way, it began in 1776 when the number of democratically elected governments in the world was exactly *one*. Today, well over half the sovereign nations of the world are governed by laws and administrations that are at least nominally the result of free elections. The emergence of political and economic freedom, it can be argued, was the necessary and sufficient force that unleashed the creative power of the human mind that brought us more than two centuries of heretofore unimaginable improvements in the quality of life (and we might add, not a few fantastic investment opportunities).

But in a more modern sense, and in a sense that is potentially investable, the drive for freedom got a second wind in 1989 in East Berlin. You may recall that the prospect of a “peace dividend” from the apparent end of the cold war provided a powerful emotional stimulus to the 1990s boom in stock prices.

Because the democratization theme is considered politically charged today (think January 2005 inaugural speech), we believe that the drive for freedom is under-noticed by the investment community. We also think it offers enormous upside surprise potential with

respect to global economic activity and the prospects for an improved standard of living for vast populations left behind in the first two hundred years of miracle growth.

Kings and despots do not typically lead the charge for democratic reforms; so the revolutions which have gotten underway in the recent past promise some stressful headlines, perhaps for an extended period of time. Nevertheless, we have been surprised and encouraged at the growing list of transitions that are either underway or strongly hinted at ...Afghanistan, Iraq, Libya, Egypt, Lebanon, and former soviet states Georgia, Ukraine, and Kyrgyzstan. In Russia, where government has been getting more and more heavy-handed, it has been interesting to see Mr. Putin more or less endorse the recent uprising in Kyrgyzstan, perhaps learning from the Ukraine experience that the tide is moving against his philosophies of central authority.

A romantic view of the world? Perhaps. But the potential is so enormous that the natural drive for human freedom is well worth our continuing close observation. We are not likely to soon make investments in China (a centrally planned economy with increasing financial clout and not exactly chummy with the US). And Russia leaves a lot to be desired when we review our list of investment criteria (a rule of law and financial transparency, for example). But Eastern and Central Europe are on our watch list. And there are myriad positive implications for savvy US-based enterprises when freedom expands her influence around the world.

The growth of economic opportunity, whether wrapped in a familiar democratic package or not, surely causes ripples across the world economy. We are researching potential investments in businesses that will benefit from steadily rising traffic in goods, changes in the sourcing of goods and services, and establishment of US brands in new overseas markets. Perhaps the consequences of increasing global prosperity are most easily seen in the commodity that still undergirds every economy... fossil fuels. Which brings us to our fourth significant long-term economic force.

Decline of Oil Production... Whether the situation is permanent, temporary pending new discoveries, or politically contrived, there is little serious argument with the notion that oil demand has risen faster than the available supply in recent years, driving up the market price to levels not anticipated since the OPEC crisis of the 1970s.

The strong growth of petroleum demand reflects, as much as anything, GDP acceleration in India and China. Their growth happens to be concentrated in the early phase of the industrialization process, manufacturing and infrastructure... which happens to be especially energy intensive. We believe, despite probable setbacks, that the Chinese and Indian growth is virtually unstoppable in the long run, and our investment strategy should assume this until proven wrong. This makes the future of oil and gas *supply* the critical variable in the equation. We are intrigued, if not yet persuaded, by the case some are making that world oil production is or soon will be peaking permanently; hence we follow closely any news of major discoveries and announcements of plans to launch big exploration and production programs.

If oil *demand* will grow at above historic rates for the foreseeable future, and if the volume that can be *produced* at anything near traditional costs per barrel is actually peaking, this would indeed constitute an enormous, highly investable long-term force.

The energy theme already occupies a prominent place in our portfolios via our holdings of Exxon Mobil, Apache, T. Rowe Price New Era Fund and PIMCo Commodity Real Return Fund. We have an outsized position in energy because both the near- and long-term indications are compelling. Wall Street still expects oil to correct to about \$35-\$40 a barrel from the current \$54, so the current price of oil is not “in the stocks”. If, in the next few years, the evidence should increase that the era of cheap oil is over, we would expect even greater price increases with profound consequences for global politics, overall economic activity, traditional oil and gas and oil service businesses and a long list of alternative energy sources. The investment possibilities for supplementing traditional oil and gas sources include LNG, gas-to-liquid, shale oil and tar sands, as well as nuclear power.

Long-term forces guide investment selection

The energy example is a good one for understanding how we use our Scenario-Based Allocation approach to portfolio design to actually select investments.

We begin by identifying and working to understand long-term forces, like the five discussed above (the four “D”s plus the expected P/E compression for stocks). Then we consider how these forces are likely to influence securities prices and/or patterns of economic growth (the scenarios). Finally we identify specific investment vehicles likely to produce attractive total returns in the expected circumstances and we diversify them in a way that various scenarios would benefit different components of our portfolio.

The world today world is characterized by economic, political and social forces with enormous financial implications for the future. At the same time, perhaps influenced by the passive investing philosophies, most investment markets are characterized by full valuations that seem to assume financial tranquility. We think in such an environment our thoughtful and disciplined SBA approach to designing portfolios and selecting investments is far more likely to result in investment success than is the consensus MPT/style-box philosophy which eschews knowledge, invests in some of everything and hopes for the best.

For the Investment Committee:
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DJIA 10,540 S&P 500 1181 NASDAQ 2005 30-yr Treasury 4.81%