Monthly Investment Commentary | *April 2004*

The powerful stock market rebound that started just over a year ago continued in the first quarter, though most of the gains occurred during the first few weeks of the year. Small-caps and foreign stocks were especially strong, and both outperformed the S&P 500. High-yield bonds managed to deliver good returns on the quarter, while investment-grade bonds did quite well as interest rates declined in January, February, and March. Foreign bonds also delivered positive returns in the first quarter though they were generally lower than U.S. bond returns. Far and away the biggest winner during the quarter was the **REIT** market, which moved higher in every month and even managed to make money in March when equities were generally negative.

Our investment approach is patient and long-term-oriented. In most months and quarters our many man-hours of research efforts result in no portfolio turnover. However this quarter was an exception.

The changes we made fell into three categories:

- Reducing long-held asset-class plays that no longer qualify as "fat pitches" (High Yield and REIT'S
- Incorporating more bond fund diversification and using alternatives for our bond allocation.

Reducing Fat Pitches: For several years we've had exposure to REITs and high-yield bonds in our client portfolios. Both asset-class plays added value during that time. However, after moving sharply higher, neither qualifies as a bargain and this led us to reduce our dedicated exposure to these long-held asset classes.

Incorporating More Bond Fund Diversification: In January we added a position in the Payden Short Term Global Fund in order to diversify our bond allocation globally. We have also added to our positions in the Merger Fund and Arbitrage fund as alternatives to our bond allocations. We have also been researching and will recommend in some client accounts an allocation to a commodity fund because of their negative correlation to the equity markets.

The Investment Climate: Should We Be Cautiously Optimistic or Just Cautious?

For some time now our forward-looking view of the investment climate has been driven by several factors:

Valuations for equity-type asset classes are in a fair-value range. This means that over an extended time period it is unlikely (though not impossible) that these asset classes will return much more than their dividend yields plus their earnings growth. If true, this puts intermediate and long-term expected returns in a 5-7% range. Also important is the level of interest rates because this can have an impact on stock prices. As we all know, interest rates are exceptionally low. Using the 10-year Treasury as a reference point, if rates rise much above 5%, stock prices could be adversely affected, resulting in lower returns. The 5% level may seem like a long way away from today's 4.0% yield, but from a historical frame of reference 5% is still a very low rate, and rates have the potential to spike up to that level in a matter of months. (In 2003, rates were as low as 3.1% in June and as high as 4.6% less than three months later.)

In understanding the potential for stocks today, the table below is telling. In the last three cyclical bull markets, interest rates declined significantly (facilitating higher P/Es and stock prices), dividend yields were higher, and P/Es were lower (possibly allowing more potential for an upside move). The takeaway is that falling interest rates/rising multiples made a big contribution to returns. This is less likely this time. Moreover, dividends will contribute less to returns than in the past since yields are lower.

Bull Market Drivers: Past Versus Present

	At The Start Of The Bull Market:				During The Bull Market This Happened:					
Bull Market: Starting/ Ending Month	**Dividend Yield Was:**	**10-Yr. Tr. Yield Was:**	**S&P 500 P/E* Was:**	**Normal-ized S&P 500 P/E** Was:**	**Tr. Yield (Change)**	**S&P P/E* (Change)**	**Annual-ized Earnings Growth**	**Price Change**	**Annual-ized Dividend ROR**	**Total Return**
1/75 thru 11/80	5.3%	7.4%	4.8	9.2	+71%	+84%	8.9%	12.9%	5.5%	18.4%
8/82 thru 8/87	6.4%	13.2%	7.8%	11.8	-33%	+187%	2.2%	24.7%	5.4%	30.1%
12/87 thru 5/90	3.4%	8.9%	9.7%	13.3	-28%	+80%	9.6%	19.5%	4.2%	23.7%
11/90 thru 3/00	3.9%	8.7%	15.5	14.9	-28%	+83%	9.7%	18.6%	2.8%	21.4%
4/03 thru ?	1.9%	3.8%	15.4	20.9						
Now	1.5%	4.0%	17.3	28.0%						

* Forward P/E based on operating earnings (actual earnings used except for current P/E)
**Normalized P/E was based on average reported earnings over five years (four years historical earnings and one year of forward earnings estimates)

It is worth noting, that if earnings growth is to average 9% during this "bull" market, as it has in three of the previous four bull markets, it will only have to average 6% or less over the rest of the bull market (subject to certain assumptions). That is because growth has already exceeded 20% since this bull market started, meaning that subsequent earnings growth can be significantly below 9% for it to average out to 9% over the entire period. The underlying assumption is that the bull market lasts five years. We make this assumption to illustrate the point, not to make a prediction. The point is that earnings growth may be high during the entirety of this bull market and still be consistent with unspectacular growth from this point forward. And, it is growth from this point forward that is most relevant to future returns. (Note: there is no reason to necessarily expect that earnings growth must average 9% during a bull market—we use this level because it is what occurred in recent bull markets and to make a point that growth is often front-loaded.)

Structural risks continue to be an intermediate- to long-term risk factor. These risks include:

- The current account deficit, which is mostly driven by the trade deficit. We import about 50% more than we export and as a result we need to "import" foreign capital to help us pay for it. The required foreign capital flows are huge and have most recently been provided by Asian central banks—mostly Japan's and China's. The risk is that a reduction in the flows of foreign capital to the U.S. could result in a larger, destabilizing decline in the dollar that could negatively impact the global economy.
- Public and private debt levels. The question is whether the collective "we" that make up the net worth of the United States hold too much debt. Absolute debt levels are very high historically but low interest rates make the servicing of this manageable. A concern is, what happens when rates rise? Will the rate of borrowing decline? If it does, the rate of spending growth is likely to decline since debt growth has been fuel for spending growth. This would dampen economic growth. If there is a broad based effort to pay down debt then spending could be expected to decline even more.

Inflation/deflation is another risk "down the road." The substantial monetary stimulus provided by the Fed for some time now raises the risk of inflation. And China's booming economy is another factor that adds to that risk. However, outside of commodity price inflation (which over the years has become a relatively small component of overall inflation), inflation remains muted at present. But, if the economy continues to improve it's possible that inflation could move significantly higher (though we don't expect 1970's style out-of-control inflation) in coming years. How can we be concerned about both deflation and inflation? Deflation could occur if, as discussed above, borrowing is reduced, leading to a reduction in consumption (demand). This could happen on its own or it could happen after an initial increase in inflation and interest rates that could then serve as a catalyst to reduce borrowing (because of higher interest rates). We don't think this scenario is too likely but it is possible, and if it did happen it could be economically dangerous. For this reason we are not willing to ignore it out of hand. Though both these concerns are not imminent in our view—getting the timing right is difficult.

Geopolitical risks have not gone away. Terrorism risk impacts costs for governments and some companies, and terrorism-related economic shocks remain very much a wildcard.

The economic cycle is relatively early, which suggests that economic growth is likely to continue for several years before another recession. Though the early-cycle gains for stocks have already been strong, normally at this stage of the cycle equity-type investments would still have several more years of outperformance compared to defensive investments (on average—not necessarily every quarter or year). Stimulus remains strong, supporting this expectation. However, the labor market has not yet caught fire and this is the one worrisome aspect so far in this expansion. But, economic indicators suggest that the labor market is likely to strengthen in coming months.

The message we take away from our analysis is that, though stocks are not overpriced, there is not much margin of safety and the nominal returns we expect don't motivate us to take above-average risk. This, coupled with structural risks and the unknown risk of terrorism, pulls us to the side of caution. However, cyclical factors and healthy productivity growth provide some offsetting positives to help balance out the picture and make us somewhat more neutral in our view. **So, we are not at a point where we believe it makes sense to get defensive. This conclusion is also influenced by the skimpy return expectations we have for bonds.**

The environment we describe is the same one we described three months ago. This potentially low-return period we've forecasted for some months now has led us to research many different asset-class options and funds as we've sought ways to add incremental value. In recent months we've looked at segments of the municipal bond market, municipal alternatives (Blueriver) Treasury Inflation Protection Securities (TIPS), short-term bond funds, commodities, and various alternative investment funds (COAST).

After their strong run last year and into the first few weeks of 2004, stocks were approaching overvalued territory. But, after cooling off in February and March (stocks declined then bounced back in late March) and amidst strong corporate earnings, stocks are comfortably in the middle of our fair-value range. And though there are no guarantees, we expect the equity funds we own to do better than the market averages over the long run (though over shorter periods of time, such as one year, we are less confident in their outperformance). However, looking forward from here our long-term return expectations are not high for the underlying markets, and our ability to add value at present is somewhat limited by the lack of any hugely compelling asset class opportunities. So it is also very possible that the coming months will require patience as we wait for more exciting investment opportunities. Investing isn't easy and the need for patience is one reason why. But we know that sooner or later there will be a catalyst that will cause investors to overreact and push one or more asset classes into bargain territory—to our potential advantage.

March Benchmark Returns (Preliminary)		
	March	**YTD**
Large-Cap Benchmarks		
Vanguard 500 Index	-1.5%	1.7%
Russell 1000 Growth iShares	-1.9%	0.7%
Russell 1000 Value iShares	-0.9%	3.0%
Mid-Cap Benchmarks		
Russell Midcap iShares	0.0%	5.1%
Russell Midcap Growth iShares	-0.2%	4.8%
Russell Midcap Value iShares	0.1%	5.3%
Small-Cap Benchmarks		
Russell 2000 iShares	0.9%	6.2%
Russell 2000 Growth iShares	0.5%	5.5%
Russell 2000 Value iShares	1.4%	6.8%
Other Benchmarks		
Vanguard Total Intl Stock Index	0.5%	4.6%
Vanguard REIT Index	5.4%	11.8%
Vanguard Total Bond Mkt Index	0.8%	2.7%
Merrill Lynch High-Yield Master	0.7%	2.2%

—Lido Advisors Investment Team (4/12/04)