

Quarterly Investment Commentary | April 2005

The first quarter saw mostly red ink in the financial markets. Somewhat unusual was that both stocks and bonds experienced losses. The S&P 500 was down 2.2% the first three months, while investment-grade bonds, as measured by Vanguard Total Bond Market Index Fund, dropped 0.5%. Also unusual, mid-caps outperformed both larger- and smaller-cap stocks. Small-caps fared worst, with the Russell 2000 iShares dropping 5.4% for the year through March, while the Russell Midcap iShares were down only 0.2%. Among other asset classes, foreign bonds (the Salomon World Government Bond Index) dropped 2.6% in the first quarter, due to the dollar retracing some of its losses.

Volatility But No Fat Pitches

It has been about six months since we unwound our fat-pitch position in high-yield bonds. In the time since, there has been no shortage of uncertainty. Concerns about sharply rising oil prices and overall inflation, rising interest rates, and risk to the dollar from our massive current-account deficit have all weighed on the markets. While markets have reacted, and sometimes overreacted, to short-term news, we have not seen any misvaluations reach our threshold for taking a tactical position. Still, ongoing volatility makes us confident that it is only a matter of time before the inevitable forces of **fear and greed** create valuation excesses in one direction or another, creating opportunities for us to add value. We can never know when or how the next opportunity will show up. Often it results from a surprise event, which by definition is impossible to predict, and sometimes it's just a slow grind: an asset class moves in one direction for an extended period of time, and finally gets to the point where it is either cheap or expensive. While there are no great tactical return opportunities now, we're focusing our efforts, as always, on making sure our research is current on a wide range of asset classes. This will enable us to quickly identify and act on the next good opportunity. We are also continuing our ongoing efforts to identify exceptional fund managers who can add value even if the markets don't give them a lot to work with and we added to these positions during the first quarter.

While we don't have any traditional, return-based fat pitches right now, it doesn't mean we aren't doing anything tactical. We own small cash positions (in lieu of bonds) in some portfolios, because we expect interest rates to continue to drift higher. We also own small positions of foreign bonds as a dollar hedge, and commodity futures for their return potential independent of equities in some accounts. These aren't "fat pitches" in the traditional sense, but rather something we've informally referred to in our office as "diversification fat pitches." What does this mean? It means that they represent a way for us to directly hedge a specific risk (or reduce risk in a more general sense) without compromising the portfolios' return potential in a base-case scenario. And we'd generally expect the defensive fat pitch to have at least a decent chance of even adding a little bit of extra return. Furthermore, in most cases we would expect the defensive fat pitch to benefit the portfolios even under other scenarios, some of which are negative. We consider them to be a fat pitch

March Benchmark Returns (Preliminary)		
	Mar	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	-1.8%	-2.2%
Russell 1000 Growth iShares	-1.8%	-4.1%
Russell 1000 Value iShares	-1.3%	0.1%
Mid-Cap Benchmarks		
Russell Midcap iShares	-0.7%	-0.2%
Russell Midcap Growth iShares	-1.5%	-1.7%
Russell Midcap Value iShares	-0.2%	0.8%
Small-Cap Benchmarks		
Russell 2000 iShares	-2.9%	-5.4%
Russell 2000 Growth iShares	-3.7%	-6.8%
Russell 2000 Value iShares	-2.1%	-4.0%
Other Benchmarks		
Vanguard Total Intl Stock Index	-2.9%	-0.1%
Vanguard REIT Index	-1.6%	-7.3%
Vanguard Total Bond Mkt Index	-0.5%	-0.5%
Merrill Lynch High-Yield Master	-2.7%	-1.4%
Salomon Brothers World Govt Bond	-1.3%	-2.6%
DJ-AIGCI (Commodity Futures)	3.6%	12.0%

because of our conviction level in the payoffs: we believe that we're getting what amounts to free insurance, or better yet, that we're getting paid for that insurance (usually you have to pay for insurance, so if someone not only offers you insurance but on top of that tells you that they'll give you a little bit of free money too, it's a pretty good offer). The depth of analysis and strength of conviction are the same as they would be for traditional return-based fat pitches, but the defensive fat pitches have differing criteria and play a different, but very important role, in our portfolio construction.

Asset-Class Update

Commodity Futures: In April of 2004 we added a position in commodity futures to some of our client portfolios. We wrote about this last year, but here are some of the key points:

- Commodities have done very well in recent years and some of the arguments that fueled their rise were indeed compelling, but we suspected that much of the interest was driven by investors chasing recent returns rather than by fundamental analysis. We require a clear framework in which to evaluate the asset class and determine appropriate entry and exit points, and our research efforts were focused on trying to get over this hump.
- Commodity futures generate return in several main ways. First, the futures contracts guarantee a set price at a future date, and commodity producers pay what can be thought of as an insurance premium for that certainty. Second, the collateral that backs futures contracts is invested and earns a return. Third, individual commodities are uncorrelated to one another, and as a commodity futures index is rebalanced a return is generated over time from reversion to the mean, as strong-performing, overweighted commodities are reduced and weak-performing, underweighted commodities are added. All of this is in addition to any returns that would come from price changes in commodities that are different than what the market was expecting—i.e., if actual commodity prices ended up being much higher than what investors were expecting, those future contracts would appreciate in price. That's what makes commodity futures a good hedge against inflation.
- Commodity futures have some very attractive diversification characteristics that we think are beneficial.
 - Commodities often do well when stocks and bonds are doing poorly.
 - Many major macro-level crises (e.g., oil shortages due to war or other causes, natural disasters, etc.) are positive for prices of certain commodities.
 - **Their lack of correlation adds a nice level of risk control without having to sacrifice return potential.**
- On a long-term basis, we expect the returns from the commodity futures index to be somewhat better than the returns from a 60/40 mix of stocks and bonds (and that's where we took the money from), but the margin of outperformance is not what we'd call a traditional fat pitch. Our base-case returns, in fact, show commodity futures returning slightly less than equities on a pre-tax basis (and worse after taxes), which is why we haven't added them to all our portfolios, where we view our mandate as maximizing returns without as much focus on short- or intermediate-term risk management.

Commodity futures have been on a roll lately, raising the possibility of a near-term pullback. But since initiating the position, performance has been strong (highlighting the dangers of trying to be too precise in timing your purchases) and at current levels we think the move still makes sense from a long-term standpoint.

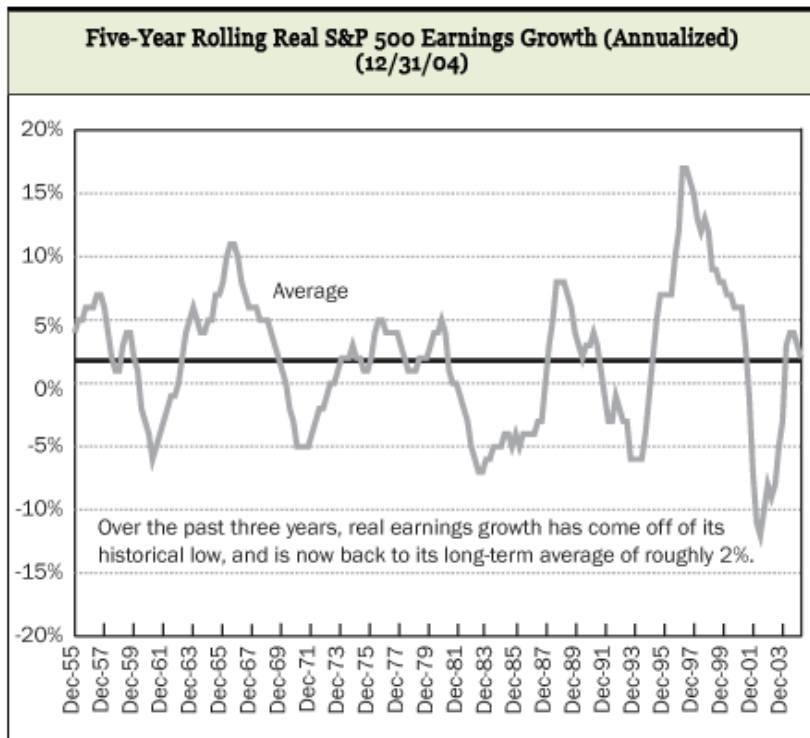
Foreign Bonds: Absolute yields on foreign bonds as a whole are now lower than in the U.S., which effectively raises the cost of our "insurance." However, real yields are lower in the U.S. than overseas, which implies that their bonds might still be a better bargain on a valuation basis.

Given the huge decline in the dollar over the last few years (30% in trade-weighted terms), one would normally expect our trade balance to improve at least somewhat. However, our current account deficit as a percentage of GDP has continued to worsen, and the most recent reading came in at a staggering 6.3%, an all-time high. It is possible that the currency has declined enough that things will start to improve, but the extent of the current account deficit could demand further declines.

There is a geographic issue to contend with as well, since some data suggests that the dollar may have run its course against the euro, but hasn't necessarily done so against several other currencies, particularly in Asia. Japan, for example, is a highly export-dependent country. And because their economy has been virtually on the edge of deflation for years, they have made a concerted effort to depress the yen (thereby making their exports less expensive to foreign buyers) by buying huge amounts of dollars. China is also an issue. They represent perhaps the largest source of our trade deficit, but because the Chinese authorities have pegged the value of their currency to the dollar, our currency has not been able to depreciate to correct this imbalance. China has indicated that they are not going to change the peg in 2005, but they have made some comments that they may loosen the band in the future.

We don't think a dollar crash is likely. The central banks of the world understand that a sudden, severe decline in the dollar would be terribly destabilizing to financial markets around the world, and so it is likely that they would present a unified defense of the currency in the event of a crisis. However, a dollar crash to us represents a scenario that would be sufficiently bad for our portfolios that we think it's worth hedging, especially given that we think we can do so at little or no cost relative to domestic investment-grade bonds. **And the continued ballooning of our current-account deficit suggests to us that further declines in the dollar are still likely, and therefore our foreign bond positions may continue to outperform domestic investment-grade bonds, while still providing some insurance against a dollar crash.**

Equities (U.S. and Foreign): In our base-case scenario, we expect both U.S and foreign equities to return high single digits on average over the next five years (returns could vary widely in individual years). On the positive side, earnings are still likely to be in the mid single digits. And while interest rates are moving higher it is quite possible that they will remain low enough to be fairly accommodative. Our valuation model assumes that rates are about 50 basis points higher than the current level and at that point the S&P 500 is still comfortably in a fair-value range. Other positives include relatively cash-rich corporate balance sheets and a pick up in capital spending.



But it is also important to recognize that the fundamentals that go into our valuation model can change, which would alter our return expectations. Some of the risks out there that could impact fundamentals include:

- Higher oil prices, changes in accounting rules, increased pricing pressure from overseas competitors, rising health-care costs, etc., leading to lower-than-expected profit margins and earnings growth.
- Macro level risks—a dollar crash, a debt crisis, unexpected inflation, a large-scale terrorist attack, etc.—could result not only in big short-term moves in the equity markets, but could also materially impact the average return we see over a multi-year horizon. Longer term there is also the risk that interest rates will move to levels that are high enough to negatively impact multiples. If this happens then five-year returns could be somewhat lower than our base-case forecast.

We suspect the market isn't fully discounting some of these bigger risks. At this moment in time, we think the overall level of risk is probably a little bit higher than average, so we think it's prudent to manage our expectations a little lower than what the numbers are telling us.

Investment-Grade Bonds: Inflation has been on the rise, and it isn't just oil prices. Core inflation, which excludes the volatile food and energy sectors, has risen from a low of just over 1% in late 2003, to 2.4% as of February 28. This number is still reasonable by historical standards, but the rate of change has been more severe than what we've seen in many years. Our guess is that this number will continue to increase, and the Fed will continue raising interest rates, albeit at a measured rate. This backdrop is not terribly favorable for bonds, especially given the very low level of real yields. On the positive side, bond yields have indeed been climbing recently, and higher yields contribute to better nominal returns going forward. This has been less noticeable at the long end of the yield curve, but intermediate-term bond yields have increased by roughly 50 basis points in just the last few months, and some taxable money-market accounts are yielding upwards of 2%. Given the Fed's current trend, those cash yields are likely to increase going forward.

We continue to see taxable investment-grade bonds as being overvalued (our return expectations are in the 4% range over the next several years). Munis are much more attractive, and taxable investors in all but the lowest tax brackets should be using a municipal bond fund rather than a conventional taxable bond fund. We have also added the Municipal Bond Arbitrage Strategy we initially invested in back in 2003 to a number of client portfolios. This fund pays a steady 10% tax free yield, but does have a high level of NAV volatility, but with the steady dividend it is proven to be a great way to generate a high level of tax free income.

In Closing

Given the recent lack of compelling opportunities, we continue to look to our active managers as a source of added value. We can't be certain this will be the case over shorter time periods, but our managers have added value over longer time periods and we are confident they will continue to do so. On the asset-allocation side, our current tactical allocations are geared toward containing risk in ways that don't impact our return expectations. While there are no return-based fat-pitch opportunities, we continue to monitor asset classes closely, and stick to our discipline of waiting for only those opportunities that are highly compelling. By doing so, we believe that over the long term we increase the odds that the tactical moves we make will add value and help us continue to outperform our benchmarks.

Lido Advisors Research Team (4/8/2005)

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