

## Quarterly Investment Commentary | April 2006

Stocks had a good first quarter in 2006, with the S&P 500 gaining 4.2%, but the real standouts were smaller-cap and foreign stocks. The Russell 2000 shot the lights out, gaining almost 14%. Foreign stocks rose 9.5%, with just over one percentage point coming from currency appreciation. REITs also had a huge quarter, gaining roughly 15%. In the face of steadily rising interest rates, the Lehman Aggregate Bond Index struggled to stay in the black, and a tough month in March resulted in a quarterly loss of 0.7%. Commodity futures struggled as well, losing more than 2%. Emerging-market short-term bonds, however, fared better with a 2.6% gain. Most of our balanced portfolios outperformed the S&P 500 with substantially less risk because our overweight to International equities and our continued allocation to small cap stocks added value in the first quarter.

March Benchmark Returns (Preliminary)		
	Mar	YTD
<b>Large-Cap Benchmarks</b>		
Vanguard 500 Index	1.2%	4.2%
Russell 1000 Growth iShares	1.5%	3.0%
Russell 1000 Value iShares	1.3%	5.9%
<b>Mid-Cap Benchmarks</b>		
Russell Midcap iShares	2.5%	7.6%
Russell Midcap Growth iShares	2.8%	7.6%
Russell Midcap Value iShares	2.2%	7.6%
<b>Small-Cap Benchmarks</b>		
Russell 2000 iShares	4.8%	13.9%
Russell 2000 Growth iShares	4.8%	14.3%
Russell 2000 Value iShares	4.8%	13.4%
<b>Other Benchmarks</b>		
Vanguard Total Int'l Stock Index	3.2%	9.5%
Vanguard REIT Index	4.8%	14.8%
Vanguard Total Bond Mkt Index	-1.0%	-0.7%
Merrill Lynch High-Yield Bonds	0.6%	2.9%
Salomon Brothers World Govt Bond	-1.2%	-0.4%
DJ-AIGCI (Commodity Futures)	2.2%	-2.4%
JPMorgan ELMI +	-0.4%	2.6%

Rising interest rates, fear that the housing market may be starting to roll over, a growing current-account deficit, volatile commodity prices, ongoing turmoil in the Middle East—all of these concerns have been on investors' minds lately.

**Looking past short-term noise is important in making good investment decisions, but many of these issues are more than noise, and require that we evaluate and try to put them into an investment context.** As always, we think in terms of scenarios and probabilities as we try to weigh both the likelihood that any given event(s) might occur, and what the magnitude of its impact on our investment portfolios might be. An important piece of this puzzle is valuations, since valuations impact how well we might do in a more positive scenario and how much of a cushion we have against a more negative scenario.

### Equity Market Outlook

Our view continues to be that risk levels are above average, but that valuations appear to be reflecting at least some of that risk. An almost endless list of positives and negatives can come into consideration, and our goal is to make a realistic assessment that weighs optimism and pessimism fairly. We give more weight to factors that are material and knowable, and then try to evaluate how they might relate to a clear, high-conviction argument for making a move in our portfolios. This approach

#### Factors Supporting Optimism

- » Attractive valuations by several measures
- » General health of corporate balance sheets
- » Low core inflation
- » Below average trailing returns

#### Factors Suggesting Caution

- » Macro imbalances such as current-account deficit and low savings
- » Impact of a housing slowdown
- » Likely deceleration in rate of earnings growth
- » Length of economic expansion

can be applied to all asset classes, but in the tables here (previous page) are some of the specific issues we believe are worth thinking about in the context of the U.S. stock market.

Valuations are at the heart of any market analysis, but valuation work involves a lot of judgment calls. Should reported earnings or operating earnings be used? Current numbers or forward-looking estimates? Where are we in the earnings cycle? Should we rely on absolute valuations or use numbers relative to interest rates? The list of considerations is extensive, and the results can be wildly different depending on the choices made. The valuation model we follow—which has shown the S&P 500 as being on the cusp of undervalued for quite some time now—provides a good example of how these complications can come into play. By way of background, this model is based on normalized earnings, which includes four years of trailing reported earnings and one year of forecasted earnings; the idea being that we want to smooth out the impact of earnings volatility. But there's a problem with this approach: Right now, normalized earnings still include a few quarters of the earnings depression of 2001 and 2002. By including earnings that are exceedingly (and abnormally) low, the model we are using is using a number that probably understates current economic reality. In other words, earnings are not as bad as what's being used by our model, and if they should actually be higher, that means the market is even more attractive than what our model currently reflects. This quirk could lead to an interesting conundrum: As time marches forward and the last few quarters of depressed earnings disappear from the calculations, our model could actually show the stock market as looking increasingly undervalued, even if the stock market (and current earnings, for that matter) rises more than earnings. Intuitively, it just doesn't make sense that valuations would steadily improve when stocks outperform earnings.

The point of the above discussion is to emphasize the importance of using multiple sources for our analysis, rather than relying blindly on just one measure. Without going into the gory details of every single valuation method in the model we use, we'll give a brief overview. Right now, the P/E ratio of the S&P 500 is around 18 based on GAAP (generally accepted accounting principles) earnings. Over the last 50 years, the average was 17.4, and over the last 25 years (which we believe is an environment that more closely reflects the modern market) the average was 20. Based on these absolute numbers, P/E multiples look about average (maybe even a little better than average), which by itself is neither strongly bullish nor bearish. However, we believe that today's lower interest rates probably justify above-average multiples, and on this basis valuations are actually attractive. **The Fed model—which explicitly incorporates interest rates shows the market as being significantly undervalued.** On balance, even when factoring in some negative earnings and macro-economic scenarios, we think valuations are somewhere between reasonable and attractive.

There are other non-valuation-specific reasons to be optimistic: Trailing long-term stock market returns have been below average (2.3% for the S&P 500 over the last five years and 8.8% over the last 10), and over the long term we think the odds favor sub-par performance to be followed by average or better-than-average performance, and vice versa. Turning to economic fundamentals, the overall health of corporate America appears to be quite good, earnings have been on a tear, profit margins are high, and core inflation is restrained (oil prices have pushed up reported inflation, but not to outrageous levels). **All these variables—as well as others—contribute to our belief that we should be at our neutral allocation to equities.**

Of course, this begs the question of why we aren't overweighting equities if valuations look so good and the fundamental backdrop is generally positive. **The biggest reason is that we believe risk levels are higher than normal.** The current-account deficit, the impact of a slowdown in housing prices, and other macro-level risks could all create scenarios where earnings could decline significantly (e.g., a weakening dollar could depress demand for

Treasuries by overseas investors, leading to recession-inducing interest-rate increases; flat or declining housing prices could cause a negative wealth effect, hurting consumer spending, etc.). Earnings growth is still quite good at the moment, but profit margins are near all-time highs, which leaves little room for improvement, and earnings are way above trend, which in the past has been followed by big earnings corrections.

Turning to the length of the current economic expansion, our economy has been growing for a little over four and a half years, which equates to an average post-World War II expansion. The last expansion (defined as the period between recessions) lasted almost 10 years, so it's possible that things could continue to be good for a while, but the odds are that we'll have another recession sometime in the next several years; the team at PIMCO has suggested the possibility that this could happen as early as 2007, as the full impact of the Federal Reserve's interest rate hikes are felt throughout the economic system. We are not market timers—as tempting as it can be at times, in the end it increases the odds of being wrong—but given the probability that a recession is statistically likely to occur somewhere within our three to five year horizon, we want to have an especially large margin of safety, and the valuation outlook isn't compelling enough right now to give us that confidence.

Another factor we consider is the opinion of smart investors we know and respect, and here, there is no clear consensus. Most of the fund managers we trust to be objective tell us they are seeing average to above-average stock-picking opportunities, but few of them are pounding the table (similarly, few of them are outright bearish). All of these views become part of a larger mosaic, and right now the diversity of opinions out there does not clearly point one way or the other.

The absence of pessimism is another consideration in our thinking. Typically, when we see undervaluation, it's associated with a market decline, negative sentiment (e.g., bearish stories in the media, big outflows from mutual funds), and underperformance of riskier assets (e.g., widening yield spreads on corporate and high-yield bonds relative to Treasuries, underperformance of riskier assets like small-caps and emerging markets). Right now, we're not seeing many of these things, at least not to the extent we typically see during good buying opportunities. (However, this doesn't suggest that stocks are in risky territory—in our view the level of optimism associated with overvaluation isn't present.) Again, this is not something to which we assign a lot of value, but at the margin it's a qualitative factor that makes us question whether right now is a great buying opportunity.

As is often the case, we face a balancing act of pros and cons, and there is plenty of uncertainty as to what lies down the road. When we weigh good valuations based on current fundamentals against the probabilities and magnitude of future risks and fundamentals, we need a larger margin of safety—in other words, larger undervaluation—as compensation for taking the portfolio level risk that would come from overweighting equities.

Among the sub-sectors of the U.S. market, large-cap and growth stock valuations are favorable versus small-caps and value stocks, respectively, and we overweighted large cap growth at the beginning of the year. Although we haven't added to our small cap allocation our positions continue to grow and add value. In looking at foreign stocks, there are some similarities and some differences in our analysis of the fundamentals relative to domestic stocks, but a big part of our thinking with this asset class is influenced by valuations relative to the U.S. market. Right now, we see more opportunities overseas and have taken our foreign allocation to the high end of our range.

## **Investment-Grade Bonds**

Intermediate-term bond prices have finally started reflecting the Fed's tighter interest rate policy, and the yield-to-maturity of the Lehman Aggregate Bond Index stood at 5.3% as of this writing. With yields at this level, it's likely that bond returns going forward will both beat inflation and equal their historical long-term average performance. Returns can and will be higher and lower over shorter time periods (anything less than three to five years), but on balance the prospects for bonds are better than they were a year ago, and we're comfortable saying they're within a fair-value range. In addition to an improved outlook in a steady-state scenario, bonds could generate fairly attractive returns should a recession (or worse) come about—conceivably even double-digit gains over a 12-month timeframe—and this would provide an important counter-balance to what would be an ugly environment for stocks.

## **Non-Strategic Asset Classes**

Right now, we own commodity futures, emerging-market bonds, fund of funds, long – short and opportunistic managers in our portfolios. Not unexpectedly, commodity futures have been on a wild ride over the past couple of years; historical data shows that this is a volatile asset class, and we knew this from the start. We own commodity futures mainly as a portfolio diversifier (they add defensive characteristics to the portfolios without compromising long-term potential returns), and we increase or reduce our exposure based on their attractiveness relative to other asset classes. As equities and bonds become more attractive, it increases the possibility that we will move out of commodity futures. We are not at that point yet, but it's something we'll be looking at more closely as the Fed nears the end of its tightening cycle (this is one of the key metrics in assessing when to be "in" or "out" of commodity futures). We have also increased our exposure to a couple opportunistic managers who have the ability to invest in all areas of the market, both long and short. Our hedge fund warrant had a great quarter increasing about 7% and our municipal bond arbitrage strategy continues to deliver returns in excess of 10%. We are also in the early due diligence stage of an equipment leasing deal which has a current coupon of 9%. We will continue to research this asset class and the firm and let you know if it is an investment that makes sense in our client portfolios.

The current-account deficit recently hit an all-time record of 7% of GDP. The U.S. continues to import far more than we export, and while there is some debate about the calculations used in measuring this statistic, the trend is clearly getting worse rather than better, and is unlikely to last indefinitely. One way—and probably the most likely way—this will be rectified is through a decline in the value of the dollar relative to the currencies of our biggest trading partners, and if such a decline occurred quickly and in a "disorderly" manner, it could cause foreign investors to lose confidence in U.S.-based stocks and bonds, and our markets could decline precipitously. We do not know how this imbalance will eventually be corrected, but emerging-market bonds provide a valuable currency hedge, as well as the potential for better-than-average returns compared to domestic bonds.

## **Final Thoughts**

With no exciting investment opportunities, it can be a frustrating time for some. However, a few great investors that we respect have commented that sometimes the big money is made in the waiting. We believe this. There will be times when investor fear will present us with some clearly great opportunities. The key is having the discipline to wait, and having that discipline is something that we take pride. The good news is that right now, equity valuations are somewhere between average and good, which gives us confidence that even if we do not get a great buying opportunity, returns on average over the next several years are likely to be at least decent. Rising interest rates have brought investment-grade bonds back into fair-

value territory, so their future contribution to our portfolios should be better than it has been over the last few years. We have our money invested with great fund managers who we believe can add significant value over their benchmarks over the long-term. These are all good things to focus on while we patiently wait for the next compelling opportunity to come along.

**—The Lido Advisors Research Team 4/10/2006**

***“This Newsletter is intended to be a general discussion regarding various capital markets for 2005. Nothing in the Newsletter constitutes a solicitation nor offers the purchase or sale or recommendation of any security. Nor should anything in this Newsletter be considered as a trend or expectation of future performance of any capital market. Investment Advisors recommendations can be made only based upon each individual’s investment objectives, risk tolerance levels, time horizon, and other personal and financial considerations”.***