

Monthly Investment Commentary | January 2004

For investors, the years from 1999 to 2003 amounted to a severe test and for many it was an excruciatingly painful experience. The truth is that in our investment lives, just as in the rest of our lives, we are always being tested. We are tested on the clarity of our investment philosophy and process. We are tested on our intellectual honesty with respect to our belief in that process, for if we don't believe then we will not stay true to it when times are tough. And, we are continuously tested on our ability to stay disciplined and resist the many temptations that can pull us away from our philosophy and circle of competency. These temptations include pursuing hot investment trends simply because they are hot, investing based on gut feel, or cutting corners on our research while hoping those corners won't really matter.

The year 2003 may have been the final chapter to the bubble run- up and collapse that started in the late 1990s. Just as the most fervent bull-market revelers tend to experience the greatest suffering when the music stops, those that latch on to doomsday scenarios fail to recognize that bad times end too. **In the worst case, former bubble investors morphed into gloom-and-doomers and missed the 2003 market rebound after participating in the worst bear market since the 1930s.**

2003 Returns	
Large-Cap U.S. Stocks	28.5%
Small-Cap U.S. Stocks	46.9%
Foreign Stocks	40.3%
REITs	35.7%
High-Yield Bonds	27.2%
Investment-Grade Bonds	4.0%

For those investors who didn't let pessimism get the best of them, 2003 was a hugely rewarding year, with all equity-type assets delivering very high returns. We entered the year cognizant of the risks and were therefore unwilling to take an extremely aggressive posture. However, we also believed stocks, REITs, and high-yield bonds were undervalued and we maintained exposure to these asset classes. Our overweight to small cap stocks and high yield bonds had a major impact on our returns. After a rough first quarter, characterized by war fears and economic uncertainty, the markets rebounded and continued to perform well through the end of the year. More conservative investments, namely, investment-grade bonds, delivered only slightly positive returns as investors were not rewarded in 2003 for avoiding risk.

It Was a Nice Year, But What About The Future?

In looking forward, a useful place to start is by assessing what has and hasn't changed from a year ago. Here are some key factors and how they compare to a year earlier:

- Cyclical, macroeconomic risks have substantially declined. The economy is in recovery and gaining strength. Deflation risk is much reduced.
 - Capital spending is bouncing back
 - Consumer spending has been very strong
 - The labor market is beginning to improve
 - Manufacturing activity is surging
 - Loan delinquency rates are declining
- The economic recovery is global with most parts of the world showing signs of increasing economic activity.
- The uncertainty of an impending war is gone.
- Terrorism and geopolitical risks continue to be impossible to predict.
- The U.S. budget deficit is higher.
- Investors are willing to take risks again.

- The potential for earnings growth is more limited. Earnings experienced a powerful rebound from depressed levels and are back near their long-run trend line. This rebound has supported capital spending and bodes well for the labor market. Consensus earnings growth forecasts for the U.S. stock market for 2004 are 12%.
- The dollar moved sharply lower against a number of currencies and is sharply lower against the euro.
- The current account deficit (mostly driven by the merchandise trade deficit) remains a significant long-term issue and is a major factor in putting downward pressure on the dollar.
- Household debt-service levels remain near historic highs compared to disposable income.
- Interest rates are higher but still very low on an absolute basis. **Rates are very likely to move somewhat higher over the next few years.**
- Equity markets are sharply higher compared to a year ago. But because stocks started the year undervalued and earnings have surged, they have not moved into overvalued territory. **Based on our analysis, all equity-type asset classes are in a fair-value range.**
- There are not any clearly undervalued asset classes. **REITs, high-yield bonds, and small-cap stocks all had big years in 2003, eliminating their undervaluation.**

Collectively these factors (and others) impact the investment climate. The influence of these many variables makes this period complex, but not necessarily more so than any other historical period. Our approach to complexity is to simplify the analytical challenge presented by so many hard-to-evaluate moving parts.

Step one is to assess whether there are clearly undervalued asset classes that provide a margin of safety that is excessive relative to history. This not only provides the potential for better-than-average returns, but also can improve a portfolio's risk characteristics. Valuation extremes are usually a function of temporary factors and therefore offer opportunity to longer-term investors. Part of our analysis includes assessing fundamentals so that we can understand the factors that are driving investors away from the asset class to make sure any clouds are likely to be just a passing storm. If we can gain confidence that this is the case, then we have a potentially exciting asset-class return opportunity, as well as a margin of safety that is helpful in our risk management at multiple levels.

Regarding the margin of safety, excessive undervaluation is helpful because it gives allowance for the fact that valuation analysis is not an exact science (e.g., we can't pinpoint fair value exactly). And, importantly, it also allows a margin of safety to account for big-picture risks that are always present but often can't be confidently assessed. Having that margin of safety makes it easier for us to be confident in taking on big-picture risk because the undervaluation means, in essence, that some or all of that risk is already "priced in" to the asset class. If the risk doesn't come to pass it skews the odds in our favor of strong returns if we are willing to be patient and wait for valuations to move back near historical norms. If the risk does come to pass we won't do as well but will still probably do okay. So, the vast majority of the time our bets are on asset-classes that are significantly undervalued relative to other asset classes. Unfortunately, at present there are no asset classes which offer exceptional value. This was not the case a year ago when almost all equity-type assets were undervalued, with REITs, high-yield bonds, and small-cap stocks even more undervalued.

Step two is to assess the risks at a portfolio level. This is done in several ways. We attempt to identify big-picture risks, though we acknowledge that there are some big-picture risks we may not be aware of before the fact. For risks that we believe have a meaningful probability of occurring, we assess the impact that they would have on each portfolio type we run. This is done by making a qualitative determination of the probable impact on each asset class and fund we hold. There is more subjectivity involved in this process than we would like, but in our opinion this is the best way to get a sense for the risk exposure to each of the portfolios and it forces us to think carefully about the reaction of each asset class to various types of economic, geopolitical, and market events. If portfolio-level risk is too high, we make adjustments to rein it in. At present, cyclical economic risks seem to us to be below average. However, longer-term risks are more troubling (the current account deficit and debt levels), though a very bearish scenario is not the most likely long-term scenario. Our awareness of these longer-term risks, coupled with our view that there are no longer

any undervalued asset classes (providing a margin of safety), played a role in the introduction of a global bond fund into some of our portfolios.

This process allows us to play off of our strengths in valuation work and asset class knowledge (including risk assessment), and to avoid being dependent on our ability to analyze big-picture factors that we are cognizant of but that we, and others, can't confidently and consistently forecast correctly. Trying to rely on analysis of those big-picture factors would result in a lower success rate for our decisions.

At this time of year it's common for people in our business to make a return forecast for the year. It seems to us, though, that the next calendar year is no more or less important than any other 12-month time period. And, as we've often written in the past, one-year return forecasts are speculative and not our cup of tea. This is because over periods as short as one year, long-term fundamentals may not be the driver of returns. Instead, returns are at least as likely to be driven by investor psychology, which can be impacted by things like geopolitics, scandals, short-term economic surprises, and other unpredictable factors.

For these reasons we are more comfortable talking about a range of possibilities. From an equity market standpoint, an improving economy, decent-to-good earnings-growth possibilities, an increased propensity for investors to take risk, and rising, but still relatively low, interest rates together suggest that stock returns could make it into the low double-digit range, and with luck maybe even reach 20%. However, plenty of uncertainty remains, including geopolitics, the declining dollar, and reasons to question the strength of consumer spending (given a sharp decline in mortgage refinancing and less growth in fiscal stimulus). And by the second half of the year, investors will be thinking about 2005, with the possibility that fear of further interest-rate increases may lead to greater caution. Terrorism uncertainty and the small chance of a dollar crash are the biggest wildcards we can see that could result in negative returns.

We are much more comfortable assessing the potential for returns over longer time periods. Our expectations are heavily impacted by our valuation assessments. With most equity asset classes around fair value, returns over five years and longer are likely to fall in the 7-9% range. If interest rates rise somewhat as we expect in the face of a strengthening economy, bonds are likely to deliver less than their yield, which is to say they will probably deliver returns below 4%.

These long-term return expectations are not particularly exciting. For this reason we look forward to the next market calamity because it will be the catalyst that will mark down the prices of one or more asset classes. If we can take advantage of an opportunity to load up on an asset class or two when they are available at "sale" prices, we will put ourselves in a position to outperform again.

Until then we will have to be patient while staying close to our neutral asset-class targets. In the meantime we will bet on horses ridden by great jockeys. Our conviction in the managers we are betting on ranges from high to very high, and evaluating specific fund management teams remains a primary focus for us. **This has been and continues to be an area where we can add a lot of value from a performance standpoint, even if there are no fat-pitch asset classes to overweight.**

Specific Asset Class Commentaries

Over the past quarter our thinking has evolved with respect to several asset classes:

December Benchmark Returns (Preliminary)		
	Dec	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	5.2%	28.5%
Russell 1000 Growth iShares	3.4%	29.5%
Russell 1000 Value iShares	6.1%	29.7%
Mid-Cap Benchmarks		
Russell Midcap iShares	3.0%	39.7%
Russell Midcap Growth iShares	1.1%	42.4%
Russell Midcap Value iShares	4.3%	37.7%
Small-Cap Benchmarks		
Russell 2000 iShares	2.0%	46.9%
Russell 2000 Growth iShares	0.4%	48.2%
Russell 2000 Value iShares	3.6%	45.6%
Other Benchmarks		
Vanguard Total Intl Stock Index	7.8%	40.3%
Vanguard REIT Index	3.1%	35.7%
Vanguard Total Bond Mkt Index	0.9%	4.0%
Merrill Lynch High-Yield Master	2.3%	27.2%

REITs: As discussed last month, REITs are no longer clearly undervalued after returning 35.7% in 2003. Our long-term return expectations for REITs continue to be competitive with our return expectations for equities, and the range of potential returns is somewhat narrower than for stocks because more of their return comes in the form of a current dividend return, and because cash flows tend to be more stable than the average publicly traded company (REITs currently yield about 5.5%, down from over 7% a year ago). Given that all equity asset classes are fully valued and that big-picture risks remain, we like the idea of more diversification, especially in assets that are somewhat less risky and which offer (in our opinion) comparable long-term return expectations. Having said that, REITs have performed very well and are now selling at near an 18% premium to their underlying net assets, new issuance has picked up substantially in 2003, and earnings forecasts are quite a bit lower than for stocks. For now we view REITs as an asset class to continue holding, but the valuation picture is clearly not what it once was and there are some risks from an opportunity-cost standpoint, so even a modest amount of outperformance relative to stocks could lead us to sell.

High-Yield Bonds: As we've also discussed in recent months, high-yield bonds are no longer fat pitch investments. With yields around 7.4% and rates likely to rise from current levels (resulting in some capital erosion that will offset some of the yield), long-term expected returns are now inferior to stocks, especially on an after-tax basis. We have reduced our high-yield bond exposure in most portfolios. However, fundamentals are improving with the economy and this suggests that bond prices will probably not deteriorate in the near term. Therefore we see no urgency to fully eliminate the positions from our portfolios. The timing of our decision to sell remaining high-yield bond positions is now pending based on research we are doing on several funds that could be the destination for the proceeds from these sales. However, we are more comfortable with the risk (credit risk) in high yields than investment grade (interest rate risk), so our allocation will most likely stay in the 10-15% range, reduced from 20-25%.

Global Bonds: Our growing concern about the current account deficit and the declining dollar led us to focus sizable attention on researching the foreign bond asset class as a possible hedge against a dollar collapse. This risk is something we've had our eyes on for a while and our concern grew as 2003 progressed, but not because we viewed the risk as higher. Rather, as stocks, REITs and high-yield bonds rallied, these asset classes were no longer undervalued. Though not overvalued, the lack of bargain pricing removed the margin of safety in our portfolios and made us more sensitive to big-picture risks. As we explained last month, the appeal of having some non-dollar exposure is that it provides us with some "insurance" against the losses that could be incurred in a dollar collapse, and we gain that insurance with the possibility of not having to pay for it. This is because we believe it is likely (though not a certainty) that the dollar will continue to gradually weaken in value for some time and therefore an investment-grade global (mostly foreign) bond portfolio is likely to outperform a domestic bond portfolio. The investment offers the type of diversification that we are looking for to reduce overall portfolio risk, while also giving us more protection if the dollar decline becomes more rapid and destabilizes the global economy. After researching a handful of funds we have decided to invest in Payden's Short Term Global Fixed Income Fund. We visited with Payden at their offices in early January, met their investment team and are comfortable with their approach. We are confident this decision will add value.

Final Comments (We Hope) On the Fund Scandal

In recent months we've commented a number of times regarding the fund scandal so we're going to limit further ethics-related comments. However, we do want to emphasize that during the last five years, the period during which most of the ethics violations are known to have occurred, our mutual fund portfolios have materially beaten their index benchmarks, with the takeaway being that investing in funds has clearly not been a disadvantage for our clients. In fact, fund investing continues to give us the ability to easily hire and fire managers, choose from a large universe of managers and, within that universe, find a handful of exceptionally skilled investors, and to opportunistically access many asset classes. Moreover, the cost for doing this has been quite reasonable in our opinion and more than made up in performance. As mentioned above, this success is a function of our investment philosophy, process, and discipline, part of which focuses on the shareholder orientation of the funds we own and recommend. Going forward, ethical lapses are far less likely to be an issue than in the past given the fallout of the fund scandal of 2003. But shareholder-oriented business practices will still be a big issue and one that we will continue to focus on. **Our bottom line is that while we have always recognized the shortcomings of**

mutual funds, we continue to view the fund universe as one that gives us a handful of excellent choices and the flexibility to apply our fundamentally based approach to tactical asset allocation in a very effective way—one which, in our opinion, could not be as efficiently implemented using any other investment vehicles.

— *Lido Advisors Investment Team (1/15/2004)*