Monthly Investment Commentary: Sorting Through Uncertainty Is a Constant Challenge | *July 2004*

The second quarter was a volatile one. Interest rates rose and bonds suffered, with the Lehman Aggregate Bond Index down well over 2%. Small-cap stocks struggled and were barely positive on the quarter and foreign stocks, REITs, and high-yield bonds all posted slight declines. Larger-cap U.S. stocks did better, returning almost 2%.

June Benchmark Returns (Preliminary)	June	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	1.9%	3.4%
Russell 1000 Growth iShares	1.2%	2.6%
Russell 1000 Value iShares	2.3%	3.8%
Mid-Cap Benchmarks		
Russell Midcap iShares	2.7%	6.5%
Russell Midcap Growth iShares	1.6%	5.8%
Russell Midcap Value iShares	3.5%	5.0%
Small-Cap Benchmarks		
Russell 2000 iShares	4.2%	6.7%
Russell 2000 Growth iShares	3.3%	5.6%
Russell 2000 Value iShares	5.1%	7.8%
Other Benchmarks		
Vanguard Total Intl Stock Index	2.4%	4.2%
Vanguard REIT Index	2.8%	5.1%
Vanguard Total Bond Mkt Index	0.6%	0.2%
Merrill Lynch High-Yield Master	1.5%	1.3%
Salomon Brothers World Govt. Bond	0.2%	-1.5%

As investors we are faced with a daunting task. Dealing with uncertainty is a given. We can never be sure what the future will look like. But even identifying the potential outcomes and sorting through all the big-picture variables and interrelationships is an enormous challenge. Being able to accurately predict the future on a consistent basis is not imperative to investment success. But understanding the possible outcomes and their odds is an important basis for determining a successful investment policy.

While no one, ourselves included, is able to accurately and consistently predict the future, this doesn't stop many amateur and professional investors from articulating scenarios with the clarity and conviction that could only come from a crystal ball. They wrap up all of the world's complexity into a few neatly packaged investment themes. Often these strategists are highly knowledgeable and articulate, which makes their outlook persuasive. But persuasive or not, their predictions are often bunk. They carefully articulate a well-reasoned set of arguments that supports their position, while not mentioning the numerous and also compelling counter-arguments. So it is not surprising that they are often wrong.

There is value in hearing arguments that bear on an issue, since they stimulate thinking, but it is important to hear and consider all of the arguments. Trying to base an investment strategy solely on the ability to predict the "winning" outcome is not smart because it is unlikely that anyone will consistently get all of the macro calls right. We are fortunate in having had the opportunity over many years to interact and learn from many great investors, and one thing we have learned is that investing is a matter of assessing the odds and attempting to invest in ways that put the odds on your side. A valuation discipline is also a critically important part of success. We've learned not to force ourselves into a high-conviction analysis of an issue whose outcome can easily be swayed by one or more factors that are simply not possible for anyone to predict with confidence. And we've learned that it's not necessary to know everything. Most of the time we can identify enough puzzle pieces to allow us to make good decisions. **When we can't, we must recognize this and play defense.**

In the past we've written about how our investment process helps us to deal with a complex and uncertain world. Our search for bargains and focus on asset-class valuations is the key component because we believe in our ability to make reasonable assessments of value much of the time. This allows us to base decisions on what is "knowable," which really means what can be confidently evaluated. **This analysis is most valuable when financial asset prices are out of whack, as**

they were a few years ago when value stocks, REITs, and high-yield bonds were cheap, and technology and large-cap growth stocks were massively overpriced. These are the fat-pitch opportunities we look for because the odds for a significant, long-term payoff are so compelling. Unfortunately, great bargain opportunities are not an every-year occurrence and we have to be patient and fall back to a neutral allocation when they are not present.

We've also written about scenario analysis, the other critical part of our process. This allows us to consider possible big-picture factors and assess the impact of different risks on each portfolio and adjust as needed. We know we won't foresee every risk. But our scenario analysis and focus on finding bargains are enormously helpful in our management of risk.

So, more than anything else, we rely on our investment process to make decisions in a highly complex and uncertain world. We thought it might be helpful to share with clients some of the additional ways we frame and assess the information that we sort through as we seek to identify and deal with various risks.

- As part of our risk and scenario analysis we differentiate between factors that are likely to be of passing significance and those that are likely to be with us for quite some time. An example of a temporary factor is the corporate governance scandals that rocked the market at various times over the last few years. Instances of failed corporate governance were one of many faces of a long cycle of greed that peaked around the millennium. Corporate behavior is unlikely to degenerate to the levels we saw in the late 1990s until many years from now, when a new cycle of greed nears its peak. So this wasn't something that factored into our risk analysis**. Many of the issues investors tend to worry about on a day-to-day basis fall into the category of passing headlines, and therefore should be ignored by long-term investors.** At the other extreme our often-stated concern about high household debt levels does factor into our long-term thinking, because the debt problem is unlikely to be resolved quickly.
- We think about variables and whether they are driven by the economic cycle (cyclical), whether they are secular factors (longer-term trends), or whether they are one-off developments. This helps us to sort out the short-term/long-term significance discussed above.
- We ask ourselves the question "What are the markets discounting?" This ties back to our valuation work and forces us to think about how much risk or optimism is built into market prices and therefore how much we may be paid to take on risk.
- If there are risks we can't analyze (in terms of probability and/or the magnitude of the risk) we think about whether we can hedge some of the potential damage without hurting the long-term return potential of our portfolios.

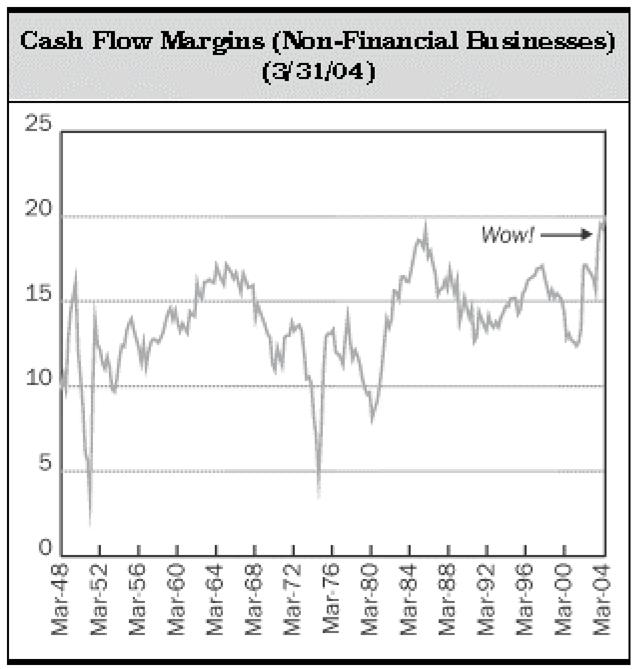
Today's Environment

Valuations: Each of the asset classes we follow is in a fair-value range except for investment-grade bonds which are slightly overvalued. It is worth mentioning that, in order to avoid mistakes due to "false precision," we define fair-value as having a wide range. Within this range, valuations are somewhat better than they were earlier in the year when they approached overvalued levels for many equity-type asset classes. The improvement is due to the decline in prices from peak levels and improving fundamentals.

The improvement is perhaps most noticeable with respect to U.S. stocks. The surge in earnings has led us to increase our base-case return expectations for the U.S. stock market. We now believe it's possible that stocks could deliver a high single-digit to low double-digit return over the next five years **(with volatility along the way)** under our base-case assumptions.

Economic activity: With each passing month the economy gets stronger and it is becoming clear that the U.S. is in a full-blown recovery. Over the last year, real (inflation-adjusted) GDP grew at the fastest rate in 20 years. Though the level of economic stimulus will be declining going forward and the economy will not maintain its recent pace, the general economic picture looks solid. The business sector is in excellent shape with exceptionally strong cash flow and improved balance sheets. This bodes well for jobs, capital investment, and the rebuilding of lean inventory levels because businesses have cash to spend and there is some pent-up demand. There has been more good news on productivity, which has rebounded to a very high level. Though productivity has a cyclical element to it, it held up remarkably well during the recession and has now moved higher, to a level not seen since the 1960s. The current level of productivity is not sustainable, but the evidence supporting a continuation of an above-average level compared to most of the last 30 years continues to build. This is important because it is one key factor supporting economic growth with moderate inflation. The big area of concern has been the labor market but that too is showing clear signs of improvement. Job creation has been very strong in recent months and is broad-based. Wage growth is also improving, but off of a very sub-par level. Consumer spending, which is of huge importance, has been healthy and if wages grow (as is likely) spending should be okay for the intermediate term.

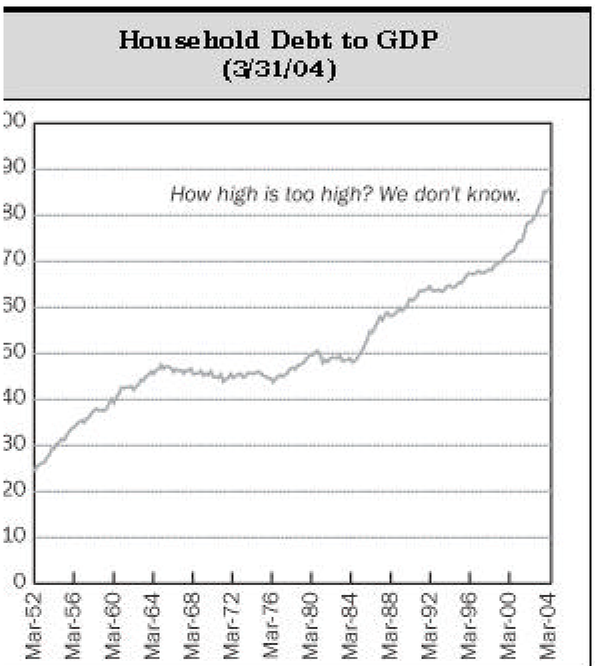
Profits: At cyclical peaks, businesses, on average, have too many employees and have over-invested in their operating capacity. As the realization hits them, they focus on cost cutting, including reducing labor costs and slowing new investment. These actions typically trigger a recession that results in a decline in economic activity and reduced revenues and profits. But when the economy bottoms and begins to grow again, revenue increases while costs continue to remain low, resulting in improving profits, cash flow, and balance sheets. In the current cycle, because profits suffered an unusually severe crash, the rebound has been almost as amazing. Profits have boomed. Cash profit margins are at levels not seen in decades, and the level of profits as a percentage of GDP, at over 10%, is extremely high. Obviously this won't last forever—profit growth will definitely slow, but for the time being profits continue to surprise on the upside even while they slow. Unusually positive pre-announcements of earnings and a very high level of upward earnings revisions from analysts suggest that better-than-expected growth could last a bit longer. Earnings are strong outside the U.S. as well. Consensus expectations are for earnings increases around the world in line with the U.S. in 2004, with slower, but still healthy, low double-digit earnings growth forecast for 2005. If the 2005 numbers are realized, stock prices could do well over the next year. However, this is a big "if." Profit margins are not sustainable at current levels, and such high levels typically lead to strong price competition (and lower margins). The likelihood that productivity will slow is another reason for profit growth to decline. A year from now investors will be anticipating earnings levels out into late 2005 and into 2006. So while profit forecasts look good for 2005, at this point it is dangerous to be too bullish about the latter half of the year and 2006.



Interest rates and inflation: Inflation is picking up and rates have backed up in the bond market. Inflation has risen at a rate of over 3% over the past 12 months. Taking out food and energy, "core" inflation is 1.7%, but this also represents a clear increase. The bond market has anticipated this pick up and the 10-year Treasury yield has moved about one percentage point above its incredibly low level of last summer. The virtual certainty of the Fed's raising short-term rates (which has now begun) has contributed to nervousness in the stock market. **But it is important to understand that rates are rising because the economy is getting stronger, and this is reflected in rising profits.** And rates are rising from such a depressed level that it is unlikely that the initial rise will hurt the stock market in a lasting way—especially since bond markets have already moved higher in anticipation of a short-term rate increase. Even the pessimists don't expect a huge spike in inflation, but there is risk. If inflation is sustained too long at a level much higher than 3%, the corresponding higher interest rates could trigger a cutback in spending and profits, and adversely impact stock prices. The arguments against this are high productivity, and excess labor and production capacity. The primary arguments for it are that monetary policy has been extremely expansionary and is not easily fine-tuned, and spare capacity may be overstated and can be rapidly absorbed.

Near-term risks: We think of risks in terms of cyclical risks, structural risks, geopolitical risks, and sometimes, secular factors. These days the risks most often mentioned are oil prices and their impact on the economy, China's overheating economy, terrorism, and interest rates (which we've already discussed). Some of these are harder to assess than others. But in general, outside of terrorism, we don't consider these risks to be any scarier to investors than the risks faced at any other point in time (there are always risks).

We must assume terrorism risk will be with us for years. Any terrorist events may or may not have a long-lasting impact on the economy and the financial markets. A growing concern has been economic terrorism, which could have a more long-lasting effect. In general it's hard to assess the chance that at some point the global economy will take a serious terrorist-related hit. Aside from the risk of an actual terrorist act, there are security and related military costs associated with the war on terrorism. The budget impact of U.S. involvement in Iraq is an obvious example.

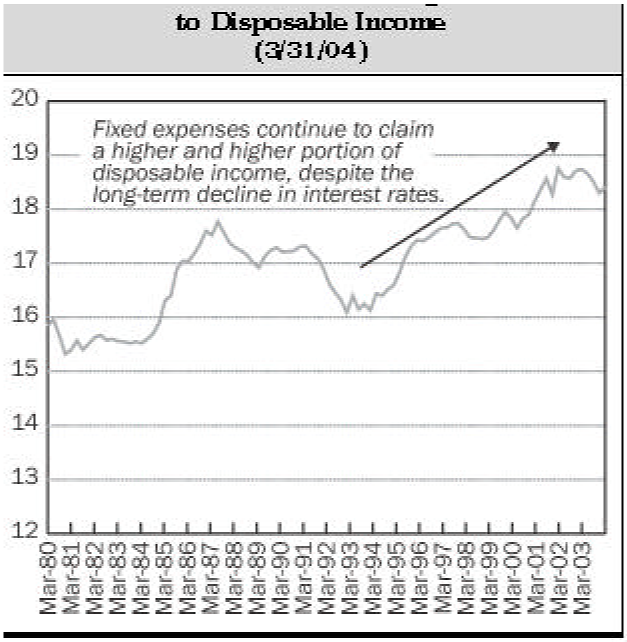


Balancing out valuations, current economic fundamentals, and near-term risks we get to an okay, but not spectacular, investment backdrop. It is easy to allow risk to paralyze you, but the risks we can identify today, with the exception of the terrorism wild card, don't seem worse than we've typically observed over the years. Financial asset valuations seem consistent with this observation. Valuations are fair, reflecting investors' willingness to take some risk, and perhaps their recognition that this could be a benign cycle with satisfactory returns supported by only moderate increases in inflation and interest rates. At the same time there is not a high level of optimism priced into financial assets, as investors understand that there are risks, including the hard-to-assess terrorism factor. **So things seem to be in equilibrium for now. Equilibrium may sound like a healthy thing but the real opportunity for investors is when things are not in equilibrium.** While the current environment isn't a bad one, volatility and excesses are what cause market prices to be out of whack and that's precisely what allows smart investors to capture high future returns. Any of the longer-term problems (areas where things are not in equilibrium) we think about could be the catalyst that sets up the next high-return opportunity. Or it could be something that is not on our radar. **One thing we can say for certain is that eventually there will be an opportunity.**

Fire and Ice: The Interrelationship of Inflation and Deflation

In dealing with complexity and uncertainty, as we wrote above, part of our process involves differentiating between issues with temporary significance and those that will be with us for some time. Certainly terrorism is one issue that is likely to be with us for years. It may result in caution over time on the part of investors that could keep financial asset prices lower than they would otherwise be. The other worry we have concerns the interrelationship between debt levels and consumption. These in turn are linked to the possibilities of both inflation and deflation.

The U.S. is a consumption-based society. Consumer spending is 70% of the economy. America's love of spending helps explain our huge trade deficit—we Americans love to buy foreign goods. There will be a limit to how big this deficit can get but we don't know where that limit is. (In the meantime the funding of the deficit is worrisome. For now, funding the current account deficit is not a problem as long as Asian central banks sell their currencies to buy dollars so they can keep their currencies from strengthening relative to the dollar.) Our consumption has been increasing, with spending taking up a higher and higher portion of disposable income over the past 20 years. This



consumption has been partly funded by debt, which was tempting not only because it was more available, but mostly because it became more affordable as interest rates gradually declined from the mid teens in the early 1980s, to the low single-digit level of today. Like the trade deficit, it is hard to know how much debt is too much, but we do know that debt relative to GDP has skyrocketed, almost doubling over the last 20 years. And even though net worth has also increased, debt compared to household net worth is higher than it's been in the 60 years that we have data for, and has moved sharply higher in the last five years. Debt service compared to disposable income is also higher than it's been in the 25 years of our data series.

So we wonder how long debt can continue to grow. There are some compelling arguments suggesting debt levels can continue rising. But, at some point debt growth must hit a wall, and the likelihood that we have already reached a bottom with respect to the long-term decline in interest rates could be a key turning point. Why do we care about debt growth? We care because if debt growth slows, consumer spending will also probably slow. And consumer spending is such a large portion of the economy that this could significantly slow economic growth and profit growth. This is not a great scenario for stocks.

While it may seem odd to be worrying about this now, while the economy is doing well, as long-term investors this is exactly the type of issue that we consider when we assess risk. Concern about debt levels and consumer spending, particularly now, is linked to another big question: inflation vs. deflation. With the very stimulative monetary and fiscal policy that has been in place, can we finally forget about deflation risk ("ice")? Is the real risk that inflation gets out of control ("fire")? These two seemingly opposite risks are connected. If inflation and interest rates (which are closely linked) rise too much, debt growth and spending are likely to contract. And if that happens, we could again be flirting with deflation. This suggests that fire can lead to ice. And if ice risk grows, policies will become inflationary again to defend against that risk.

Of some comfort is our belief that the risk of a major accident seems fairly low. We continue to believe that, excluding terrorism, the most likely case is a fairly benign cycle. A major accident could be triggered by a much higher-than-expected rise in inflation that could trigger a sharp rise in interest rates and a sharp decline in spending. But a dangerously high spike in inflation doesn't seem likely for the reasons mentioned earlier and because we believe in central banks' willingness to gently squeeze inflation before it gets too high. There is, of course, the possibility that we may be underestimating the risk of a dangerously high inflation spike perhaps by underestimating the risk that central banks will be afraid to squeeze hard enough because of debt levels.

What is fairly clear to us is that while fire is the near-term risk, ice remains in the background. And while neither is likely to get out of control, we could be in for an economic balancing act. In the economic cycles of the past 20 years there was a strong commitment to bringing inflation lower and the resulting disinflationary trend made for a fabulously supportive investment backdrop. Before that, inflation was temporarily out of control, and while painful during the 1970s, this set up once-in-a-generation bargains. It seems increasingly possible that there will be an ongoing battle between fire and ice that may define this economic cycle and perhaps others that follow. This would be quite a different environment from the disinflationary cycles we experienced since the early 1980s, or the inflationary cycles that preceded it.

In a battle between fire and ice, investors will have to be prepared for either possibility. That means having exposure to assets that can hold their own in each environment. Thus, the defensive portion of our conservative portfolios consists of some cash even though yields are low. And one of the bond funds we hold, FPA New Income, is postured for an interest-rate rise. We also own traditional bond funds despite fairly low interest-rate yields. And, we own global bonds in order to provide some additional diversification. We also believe non-dollar bond holdings are likely to provide slightly higher returns than similar-quality U.S. bonds over the next few years. With respect to all these "defensive" holdings, the good news is that yields are higher than they were a year ago, and these holdings will help mute the fluctuations in equities in an inflation or deflation scenario (though on an absolute basis they will probably do better in deflation). The bad news is that we are forced to maintain relatively meaningful weightings to fixed income despite our expectation that returns will be low on an absolute basis. We hold them because we need their diversification value to mitigate the downside in the event of a negative equity-return environment. Our more aggressive portfolios, by virtue of their higher equity allocations, are more exposed to the fire and ice risks (and risk in general). Again, we believe a benign environment is most likely, and our expectation for equity returns over a five-year time horizon has moved higher and is at a potentially satisfying level, thanks in part to the strong earnings delivered over the past year. If somewhere along the way we become more concerned about the risk from fire or ice, we may need to adjust the allocations in all our portfolios. This is something we regularly think about.

In Closing

As we've been saying for a while, this is not a time to be overly aggressive or overly defensive. It is a time to be patient. We believe that on average, portfolio returns are likely to be quite decent, though not spectacular, over the coming years compared to average inflation levels. But, there are no home runs we can see. At some point along the way some of the risks discussed (or others not discussed) will turn into reality and there will be temporary losses. The good news is that in all balanced portfolios we have some dry powder that can be re-allocated at lower prices if bargains are created. It is these opportunities that result in good long-term returns. This is why truly long-term investors should welcome temporary market declines as an opportunity to buy assets on sale. And that is what we are patiently waiting for.

—Lido Advisors Investment Team (7/1/04)