

Lido Advisors, Inc.

Quarterly Investment Commentary | July 2005

The second quarter saw a variety of returns among the major asset classes. The S&P 500 gained a modest 1.4%, while the smaller-cap Russell 2000 chalked up a solid 4.3% gain. Bonds rallied, with the Lehman Aggregate index moving up 3%. Year-to-date, the S&P 500 is down less than 1% and the Russell 2000 (Small Cap Stocks) is off 1.3%. Going forward, our base-case expectation is that equity returns will average in the high single digits over the next three to five years, whereas bond returns—due in large part to their extremely low absolute yields—are going to have a hard time gaining beyond the low single digits, although they still provide important diversification in the event of a large equity-market decline. (Of course, there is a range of possible outcomes, and our base case is simply the mid point of the outcome we think is most likely.) Among the equity asset classes we are neutral between value and growth (although we have seen some evidence suggesting that growth stocks are becoming more attractive on a valuation basis), and we view foreign stocks as having similar return potential to domestic equities, assuming currency movements are not factored in.

June Benchmark Returns (Preliminary)		
	June	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	0.1%	-0.9%
Russell 1000 Growth iShares	-0.4%	-1.8%
Russell 1000 Value iShares	1.1%	1.7%
Mid-Cap Benchmarks		
Russell Midcap iShares	2.7%	3.9%
Russell Midcap Growth iShares	1.8%	1.6%
Russell Midcap Value iShares	3.3%	5.6%
Small-Cap Benchmarks		
Russell 2000 iShares	3.9%	-1.3%
Russell 2000 Growth iShares	3.3%	-3.6%
Russell 2000 Value iShares	4.4%	0.8%
Other Benchmarks		
Vanguard Total Intl Stock Index	1.3%	-0.8%
Vanguard REIT Index	5.0%	6.2%
Vanguard Total Bond Mkt Index	0.6%	2.5%
Merrill Lynch High-Yield Master	1.9%	1.2%
Salomon Brothers World Govt Bond	-0.9%	-4.0%
DJ-AIGCI (Commodity Futures)	1.4%	5.0%

How Our Assumptions for the 10-Year Treasury Yield Impact Our Return Expectations

Ten-year Treasury yields are often used by long-term investors as a proxy for a risk-free investment and as such become the hurdle that riskier investments must be likely to beat (Why take risk if you aren't getting adequately rewarded for it?). The purpose of this discussion is not to argue exactly what the 10-year Treasury assumption *should* be, but rather to examine how various assumptions impact our broader return forecasts and help us form a portfolio strategy that can address several contingencies.

For the past few years, many smart investment thinkers (we believe, us included) have been expecting interest rates to rise. While this has happened at the short end of the yield curve, as the Fed has repeatedly raised rates, it has not happened at the longer end of the yield curve. In other words, yields on cash are much better, while yields on long bonds are little changed. More recently, some smart bond people (such as PIMCO's Bill Gross) have adjusted their views, and now expect rates to remain low for at least the next several years. We believe the risk of rates going higher, at least temporarily, remains material over the next few years, and that there are good reasons from a portfolio strategy standpoint to consider higher rates in setting return expectations. We explain these reasons in more detail below, but a brief summary goes like this: whether rates rise or stay low has little impact on bond returns over the next five or so years. For equities, plugging low rates into a valuation model generates unrealistically high return expectations, especially given what we know about the kind of economic environment that would be likely if rates were to stay low (it would be a weak environment). In any event, there are specific structural, macro-level risks that we are seeking to hedge in our portfolios that are not impacted by whether rates stay low for a few more years or not. Given how close the call is between rates staying low or rising for a time (as both camps readily admit), we think it more prudent to consider higher rates in allocating our portfolios.

Bond Return Assumptions

Here is more detail on how interest rates impact our return assumptions for bonds. To put it in context, the difference between a 6% Treasury and a 4% Treasury over a five-year time frame isn't huge from the standpoint of expected returns for bonds. First, we should note that our benchmark is the Lehman Aggregate Bond Index, which has a shorter duration than 10-year Treasuries—so our core bond positions are less sensitive to changes in interest rates. In a 6% 10-year Treasury world, the returns for the Lehman Aggregate would be around 3.2% annualized over five years, versus 3.9% in the 4% Treasury scenario. The timing of the rate changes would impact the actual returns (e.g., a sudden move up in rates in the first year would create a higher average return over the five-year period because the higher yield would be in effect for more time), but the differences still are not huge. As a comparison, cash yields are almost 3% right now. So realistically we're talking about very small variations in return from one scenario to another. We have hedged our bond portfolios by investing in Municipal Arbitrage (10% Tax Free Return), Real Estate (6 – 7% Yields) and we are looking at some very attractive Oil & Natural Gas deals for clients. We are allocating assets to these "alternative" asset classes because the risk/reward characteristics are much more attractive than traditional bonds even if we use 6% as our expected yield for Treasuries.

Equity Return Assumptions

From an equities standpoint, the issue is murkier. A 4% 10-year Treasury would probably be accompanied by weak earnings growth. For yields to remain that low, it would likely be in the presence of very low global aggregate demand and significantly lower profits. If we were to assume a historically modest average of 3.5% nominal growth in earnings per share for the S&P 500, and using the 4% Treasury yield, we'd be looking at an expected annualized five-year return of 14.5% to 16.5%, assuming a fairly valued stock market at that point in time. Intuitively, that high a return in that kind of environment just doesn't make sense—investors would not be likely to "pay up" for stocks in the midst of weak growth just because rates are low. The reason the return expectations come out higher than what we think common sense dictates is because most valuation models are based on "discounted cash flow," where the present value of future earnings is based on an interest-rate assumption. When rates are very low, the present value of future earnings is very high. (This is precisely the reason why the Japanese market has perpetually looked "cheap" based on interest-rate-derived valuation models.) Incidentally, even if we assume very slow earnings growth—which we are by no means discounting—the impact of low interest rates still results in a forecast of mid-teens equity returns. So it makes sense to be conservative in our analysis and not ratchet down our interest-rate assumption too far, otherwise we might assume equity returns that common sense suggests are unrealistically high.

What a Lower-Rate Environment Might Look Like

Those in the rates-will-stay-low camp believe rates are not likely to rise given that the only real demand globally stems from U.S. consumers, whose spending is partly fueled by an unsustainable inflation in asset prices such as homes. In the meantime, exporters from overseas are happy to sell us goods and their central banks loan the proceeds back to us by buying Treasuries, which keeps their currencies weaker than they would otherwise be versus the dollar, and keeps our interest rates lower, which in turn keeps asset prices inflating. So maybe S&P 500 returns could be that high for a short time period. But, in this type of environment it is also likely that:

- Weak growth in corporate earnings could easily discourage equity investors.
- Americans would still not be saving enough. This would be a big problem down the road, and it's hard to imagine the market would not be reflecting this.
- The expansion of asset prices—both real and financial—would eventually require a correction at some point. It might not be within our five-year horizon, but frothy asset prices combined with other structural imbalances would be a very dangerous mix and would likely mean much lower returns in subsequent years.
- All of these points could impact the risk premium—or excess return—that investors require in exchange for taking on the risk of owning stocks. *The return expectations generated by*

the mathematics of the model do not assume that investors might be more risk averse in this type of environment.

So while it's possible that low interest rates would keep the global economy on track and generate good stock market returns for a little while, just like musical chairs, at some point the game would end, and there would likely be painful results in the financial markets.

Whether or Not Rates Stay Low, There Are Risks

We have a great deal of respect for some of those who believe rates are likely to stay low over the next several years (there are plenty of smart people on both sides of the argument). But there are risks associated with those assumptions. We have a huge current account deficit relative to GDP. Maybe it's sustainable, but common sense says it is not. The big question is when will it turn around? A declining dollar is a very big piece of how this would be corrected, and while a dollar decline would traditionally lead us to expect an increase in inflation, we think the bigger impact could come from the decline in foreign demand for Treasuries (we have mentioned this possibility many times in the past). The absence of that demand could cause rates to rise, which further down the road might have a deflationary impact if consumption plunges due to the higher interest rates. It is a certainly a risk.

We think the most likely scenario (again, there is a high level of uncertainty in any scenario, so take "likely" with a grain of salt) is that earnings weaken from current levels, and that interest rates remain fairly low. A 10-year Treasury yield of 4% to 5.5% (versus PIMCO's 3% to 4.5% forecast) over a five-year horizon seems quite plausible to us: this would involve low to average inflation of 2% to 3%, lower-than-average real yields, but no global calamity. In this scenario, we would expect the S&P 500 to generate average returns in the high single digits, and potentially the very low double-digits, and for this reason we are very close to our neutral level for equity exposure (we are currently overweighting our opportunistic managers who can be long and short equities, can be in Government or high yielding bonds or can sit in cash).

But as we have mentioned before, there are other scenarios we can easily imagine that would lead to lower returns. For that reason, we diversified some portfolios with small positions in commodities futures. Commodity futures will probably not perform well if a deflation scenario comes about, but in most other instances we expect them to add value. The fixed-income component of our portfolios is also diversified, making use of direct ownership of bonds, investment grade and high-yield bond funds, foreign bonds, Municipal Arbitrage, Real Estate and cash, all of which are aimed at providing ballast in the event of surprise or severe scenarios (e.g., a dollar crash, surprise inflation, etc.).

At the end of the day, no one can know with certainty where things are headed. So knowing that we could be wrong, we are allocating our portfolios to provide some hedge against macro risks that everyone (regardless of their guess on rates) acknowledges are very real and could come to pass—though even with our hedges they would still be a painful experience. As always, we attempt to build client portfolios that will conserve capital during most economic outcomes in a way that does not hurt us materially in the event those scenarios come to pass.

We welcome your comments.

—Lido Advisors Investment Team (7/5/2005)

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