Monthly Investment Commentary | October 2003

After a huge second-quarter move, equity-like assets survived a late September sell-off to post a solid third-quarter return. Smaller-cap stocks and foreign stocks lead the way with large gains. Though returns did not match those of the second quarter they were more than satisfying. Investors who were paralyzed early in the year by fears of war and economic weakness learned that it is not enough to focus on risks; successful investing also requires assessing the degree to which the risks are already reflected in financial asset prices. When risks are regularly in the headlines, more often than not, investors' worries rapidly drive prices lower, thereby pricing in some, all, or more than all of the risk. This lesson has been learned by generations of investors over and over again and underlies our mantra of never underestimating the ability of financial markets to surprise.

Asset-Class Returns During Last Six Months (not annualized)	
S&P 500 (Large-Caps)*	18.4%
Russell 2000 (Small-Caps)	34.6%
MSCI EAFE (Foreign Stocks)	29.0%
NAREIT Equity Index (REITs)	24.1%
Merrill Lynch High Yield Master Index (High-Yield Bonds)	12.4%
Lehman Aggregate Bond Index (Investment-grade bonds)*	2.4%

**Returns based on Vanguard index funds.*

Isn't The World Still A Risky Place?

The world always has been and always will be a risky place. It doesn't take much effort to come up with a long list of economic and geopolitical worries that are troubling investors and citizens of the world at any given time. Sometimes the risks are greater than at other times but it is important to understand that the perception of risk is also volatile, and typically more volatile than the actual level of risk. This in turn affects valuations or, put another way, causes fluctuations in the level of risk that is priced into the financial markets. In March of 2000 nirvana was priced into financial markets—investors, collectively, were utterly unconcerned about risk. Conversely, in March of this year there was an above-average level of risk priced into stocks. But when the worst fears weren't realized, stocks rallied and now, in our opinion, the financial markets are pricing in a middling level of risk—**neither greed nor fear is in control.**

So has the actual level of risk changed? Six months ago we wrote about three primary risks:

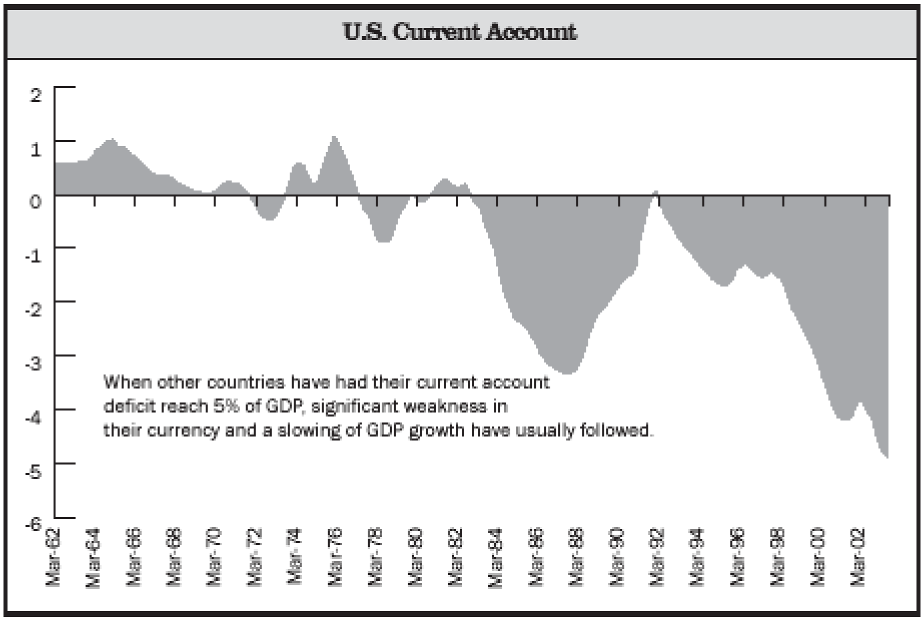
1. The risk that our analysis could mislead us if investors' risk appetites didn't come back in the foreseeable future or if interest rates moved sharply higher.
2. Structural problems with the economy and in particular high debt levels and the widening current account deficit.
3. Geopolitical factors tied to terrorism and war with Iraq.

Most of these risks remain. So why have stock prices moved significantly higher? First, back in March investors were paralyzed by the potential short-term impact of the Iraq war. As the war progressed the concerns declined. Second, investors were concerned with near-term economic prospects. As profits experienced a sharp rebound, fiscal stimulus grew, productivity growth continued to impress, inventories worked lower, and corporate spending increased while consumer spending was robust, it became apparent that the economy was rebounding and, at least in the short-term, the risk of deflation or a return to recession was lower than it had been. Third, and perhaps most important, stocks and other equity asset classes were undervalued six months ago. As noted above, this undervaluation was partly the result of the early year sell-off that was driven by war and economic fears. As these fears subsided stocks and other asset classes moved back to fair value. Yet, the longer-term risks remain and are worth reviewing.

The valuation risk has shifted. We no longer need to be concerned that investors won't rediscover their appetite for risk. That has happened, at least to an extent, as evidenced by the sharp rise in asset prices over the past six months. Now, with stocks and similar assets at fair value, the risk is that the margin of safety is gone. The valuation risk that would come from rising interest rates remains. Indeed rates are higher now than they were six months ago. However, in our opinion rates would have to move higher still, probably by another 100 basis points (one full percent) before stock prices would be vulnerable. However, over the course of an extended recovery that could easily happen.

The structural risks are largely unchanged. Debt levels are still high and the question of what level is too high remains. The current account deficit is our biggest concern. It is driven primarily by our country's massive demand for foreign goods (our imports are about one-and-a-half times our exports). The trade deficit requires us to make up for the shortfall with foreign investment. That's been easy in the past because of the appeal of U.S. investments. But now the current account deficit is in excess of 5% of GDP and growing. Historically, when a country's current account deficit has reached this level it has begun to reverse. The reversal has usually taken the form of a sizable currency decline, which makes foreign goods more expensive and domestic goods less expensive (to foreign buyers). In the case of the U.S. it is quite possible that the current account deficit will expand further before it begins to reverse. The dollar's status as a reserve currency is one reason. However, the math suggests that a currency decline will be required. And, perhaps it's already begun. The dollar has experienced a significant drop against the euro since its peak over two years ago. Foreign investment in the U.S. has declined and the primary financing for the deficit has now come from Asian central banks—largely Japan and China— who have been motivated by a desire to keep their currencies weak in order to maintain strong U.S. demand for their exports.

Why does the current account deficit and the level of the U.S. dollar matter? It is the risk of a dollar crash that is most worrisome. If that happened there could be sudden adjustments to demand for products across borders that could be highly disruptive to the global economy. And a run on the dollar could contribute to a sell-off of U.S. stocks and bonds by foreign investors and a sharp rise in interest rates that would shock the economy. It is hard to be confident in assessing the chances that this will happen in the near future. There are a number of factors which are somewhat comforting. Impressively high productivity growth, the dollar's role as a global reserve currency, the level of foreign debt relative to GDP, and the cost of the debt all suggest that a crisis need not be imminent. But the timing of market adjustments are not always easy to anticipate.



Geopolitical factors remain and are likely to remain for years. The threat of terrorism won't go away and this is a wild card we must live with. We continue to believe that only certain kinds of terrorist acts would have a meaningful and sustained impact on economic behavior and financial markets. Whether terrorist acts that impact spending for an extended time period are likely to occur, we can't say. One thing that is clear is that the cost of the war on terrorism will have an economic impact over the long run to the extent it results in increased spending on activities that contribute less to long-term productivity.

In addition to these risks there is a new long-term risk on our radar and that is the risk of a gradual shift toward protectionist sentiment that could slow the growth in trade and the global economy. The collapse of the recent trade talks in Cancun, threats and pressure directed at China to adjust or float its exchange rate, still rising unemployment (which leads to pressure to protect domestic industry from competition), trade imbalances, and geopolitical tensions are, together, cause for concern on the trade front. Shifts in trade sentiment are unlikely to develop quickly but pose a longer-term risk.

So risks remain. A big part of our job is to think about the likelihood of these various risks playing out and what the impact could be. Of great importance, we must also factor in valuations (the margin of safety) and potentially offsetting positive factors, such as the increasingly strong evidence that productivity growth has ratcheted up to a higher level in recent years. All of this must be weighed in determining what types of defensive hedges might be prudent and what diversification strategy makes sense.

The Balance between Taking Risk and Hedging Risk

In the past we've often written about return expectations and since the late 1990s our general message has been that expectations must be ratcheted down. As time has passed we've continued to repeat the message, though our range of expected returns has shifted up and down a bit as the market has bounced higher, lower, and higher again. However, it's fair to ask how it can be that we continue to maintain single-digit return expectations for the intermediate and longer-term when the S&P 500 and the NASDAQ, despite their sizable rebounds, continue to trade at levels (as we write this in late September) around 35% and 65% below their peak of 42 months ago. The primary reason is that stocks were grossly overvalued—a fact we've dwelled on enough already in our writings of the past few years. They are no longer grossly overvalued, **but they are not cheap either.** The recent rebound has moved them back to fair value. But there are other reasons besides valuation that stocks are not set up for a long and powerful secular bull run like the one that lasted over 20 years. Interest rates are very low so we won't have the tail wind of falling rates pushing P/Es and stock prices higher (and if rates fall below current levels it would imply a dangerously weak economy that would not bode well for profits). Second, stock ownership, though down, is not at the low levels one might expect after a secular bear market (meaning that there is less latent demand). Third, foreign investors were a meaningful source of demand for U.S. stocks during the 1990s. This demand is showing signs of going away. So it's not likely that we are set up for a sustained run of big returns.

Assessing return expectations is hugely important for several reasons. First, though there is always risk that our return-range expectations will be wrong, we are most confident when return expectations are significantly different for various asset classes. The significant difference provides a margin for error that is important given the reality that forecasting returns is an inexact science. When return expectations are significantly different between asset classes, "fat-pitch" opportunities are usually present.

Second, the absolute level of expected returns ties back to valuations. When we believe an asset class is undervalued, its return potential will be higher because we will expect it to move back towards fair value eventually. When an asset class is overvalued the reverse is true. When expected returns are low, risk is higher because there is little or no margin of safety to protect against unexpected risks or expected risks that turn into reality. *If there is little margin of safety we must seriously consider what risks are of greatest concern and how we can hedge against them, given the lack of a cushion.*

Third, when expected returns are low and there are no fat-pitch opportunities, there is great incentive to focus on high value-added managers, especially those operating in potentially less-efficient markets (e.g., smaller-cap, overseas), while focusing less attention on getting asset class weightings perfectly fine-tuned.

As we write this at the end of September, return expectations over the next few years are back down to the 5-8% range for most equity-type assets. In a low-inflation world these are not bad returns. However, the nominal return potential does not offer much likelihood for great upside as an offset to risk, and the lack of undervaluation means that there is not much margin of safety.

The lack of a safety margin and ho-hum return potential is a concern given the long-term risks, particularly the structural risks mentioned earlier. The improvement in the economy is encouraging. And profits have rebounded strongly, which is very important to the economy (the profit recovery bodes well for corporate spending). However, given the structural risks, the strength of the recovery remains a question. It is worth noting that every past economic recovery started with a current account surplus.

.So how does this impact our thinking? As noted we are evaluating the risks given our views on expected returns and safety margins. We are thinking about the type of defensive hedges that are needed to control risk, given the targeted level of risk for each specific portfolio type. Recently, investment-grade bonds, cash, and an underweight to stocks (in favor of REITs and some high-yield bond exposure) have been the primary tools for managing risk. Of these, bonds and cash are by far the most defensive assets. However, they offer extremely low expected returns (sub-5%) and are likely to be a drag on long-term performance. More specifically:

September Benchmark Returns (Preliminary)		
	Sept.	**YTD**
Large-Cap Benchmarks		
Vanguard 500 Index	-1.1%	14.6%
Russell 1000 Growth iShares	-1.1%	17.3%
Russell 1000 Value iShares	-1.0%	13.7%
Mid-Cap Benchmarks		
Russell Midcap iShares	-1.3%	22.7%
Russell Midcap Growth iShares	-2.0%	27.0%
Russell Midcap Value iShares	-0.8%	19.6%
Small-Cap Benchmarks		
Russell 2000 iShares	-1.9%	28.4%
Russell 2000 Growth iShares	-2.6%	31.6%
Russell 2000 Value iShares	-1.2%	25.2%
Other Benchmarks		
Vanguard Total Intl Stock Index	2.8%	19.7%
Vanguard REIT Index	3.4%	24.1%
Vanguard Total Bond Mkt Index	2.7%	3.8%
Merrill Lynch High-Yield Bonds	2.7%	20.2%

- We are continuing to research fixed-income alternatives that might provide better returns then investment grade bonds without the interest rate risk we have discussed in the past. Holenpark (Municipal Arbitrage) and SSI Hedged Market Neutral (Convertible Bonds) are two investments we have begun to make for some client's. They have risks, but different risks then the interest rate risk we perceive in investment grade bonds. We have spent a tremendous amount of time doing due diligence on these organizations and now feel comfortable with an allocation to them.
- We are unlikely to ratchet up the risk exposure in any portfolios given low expected returns and an absence of fat-pitch opportunities.
- As always we are focused on efforts to identify managers and funds that have the potential to generate higher returns.
- We continue to invest in our alternative investment class. Our two arbitrage funds, Merger (+8.1% YTD Thru 9/30/03) and The Arbitrage fund (+10.1% YTD Thru 9/30/03) have positive returns this year with very little correlation to the market. Our long/short funds, Caldwell & Orkin (-4.4% YTD Thru 9/30/03) and Boston Partners L/S (-4.1% YTD Thru 9/30/03) have both posted negative returns for the year. Although we are disappointed with the performance of these two funds, these long/short funds offer our portfolio "insurance" during volatile and negative periods. Ideally, these funds would have made a little money for the first 9 months of this year, but it is important to remember why we use "alternative strategies" in our portfolio's. They are used not to increase return, but to decrease risk, and over time we are confident all our alternative managers will reduce the risk of our portfolio's while generating positive returns.

Patience Needed

The run up in REITs and High-Yield Bonds this year has moved these asset classes back near equilibrium with other equity-type assets. Small-caps have also had a powerful run and are no longer mildly undervalued. That puts these asset classes in the same general fair value range as the global stock market (whether the stocks are small- or large-cap, growth or value). We are always happier when fat-pitch opportunities are abundant. While that's usually not the case, we also know that nothing is constant in the investment world. Markets will again be driven by fear or greed, from which significant asset class mis-pricings will arise. *We must simply be patient and wait for the opportunities to come to us.*

REITs: REITs still look somewhat undervalued relative to stocks and bonds. In a low-expected-return environment a 6% dividend yield remains attractive. However, relative to underlying property values REITs are somewhat richly priced. A key question is whether underlying property values are too low. Some real estate experts think not; they worry the property is overvalued (we're talking about income-producing property, not housing) because prices have been stable in a weak fundamental environment. However, relative to stocks and bonds real estate does seem to us to be somewhat undervalued and there is evidence that institutional investors agree and are increasing their real estate allocations (which could drive underlying property values higher). Either way, we can no longer make the case that REITs are grossly undervalued. We continue to assess whether their small undervaluation combined with their diversification benefit is enough that they should continue to be held in our portfolios.

High-Yield Bonds: This asset class is no longer a bargain. At a yield of just under 8.5%, high-yield bonds are priced at a level that could result in slight principal losses over a period of several years, assuming that investment-grade bond yields rise somewhat. However, the interest-rate yield is high enough so that even with a slight decline in price, high-yield bonds can deliver a decent pre-tax return compared to stocks and a better pre-tax return, and somewhat better after-tax return, compared to a combination of stocks and bonds. However, the return premium is not significant, so, as with REITs, we are considering whether the diversification-benefit and slightly higher expected return justifies continuing to include the asset class in our portfolios.

Closing Comments

This past quarter was a sad one for the mutual fund industry. As you've probably read, New York's attorney general filed a complaint alleging misdeeds involving several mutual fund companies. Though it does not appear that investors were materially damaged, the allegations (which are almost certainly true) are representative of a troubling lack of regard for shareholders on the part of the identified fund companies.

–Lido Advisors, Inc. Investment Team (10/06/03)