

Monthly Investment Commentary | *October 2004*

September was a solid month for equity markets and, generally, a very strong month for our active managers. Small-cap stocks, foreign stocks, and growth stocks were particularly strong. For the full quarter, however, equity markets were under water. Concerns about oil prices, geopolitics, the election, employment, and earnings all contributed to equities' weakness while fueling a bond rally.

With the end of 2004 in sight we continue to have only lukewarm enthusiasm toward the available investment options. Nothing comes close to catching our fancy so, like Barry Bonds, we must stay disciplined and refrain from swinging at pitches not to our liking. Or put another way, in the words of another superstar, the great Warren Buffett, "the stock market is a no-called-strike game. You don't have to swing at a questionable strike—you can wait for your pitch. The problem when you're a money manager is that the crowd keeps yelling, 'Swing, you bum!'"

Why We Are Rationalists

For optimists and pessimists, their views can influence what they see. For rationalists, what they see determines their views. Our job is to weigh the arguments put forth by both optimists (Bulls) and pessimists (Bears) and assess them rationally and without bias. As we have mentioned numerous times we talk to a number of portfolio managers across all investing disciplines. Although some make strong arguments why we should invest in their asset class now, I have never spoken to one who has said "Our asset class looks out of favor right now. Why don't you invest in another asset class for 6 months and I'll call you when our asset class looks better." This simply won't happen because portfolio managers get paid for having assets under management. Our job is to analyze all this information and make sound decisions to benefit our clients. **Sometimes doing nothing is the best decision.** In light of our refusal to "swing," the optimists might argue (some of these points are specific points made by bullish investors we know and respect):

The economy is healthy

- Global economic growth is likely to come in at a 30-year high in 2004.
- Unemployment claims are low enough to be consistent with a growing, fairly healthy economy.
- Credit card delinquency rates have been declining for over a year.
- The consumer is in better shape than many think, if you take into account household assets, rather than just debt levels. Asset levels have increased significantly so that consumer balance sheets are solid.
- With all the talk of the heavily indebted U.S. consumer, debt as a percentage of disposable income is actually quite a bit lower than it is in either the U.K. or Japan.
- Productivity growth remains encouraging.

Corporations are flush with cash

- Corporate earnings have surged and as a result, cash on balance sheets is extremely high. In fact, for the S&P 500 companies it is roughly double the level it was at the end of 1999. This bodes well for spending (hiring and investment) though the private sector has been cautious in the expansion to this point.

Valuations are quite reasonable

- With stock prices down slightly and earnings up this year, valuations are much improved and quite reasonable with P/E multiples in the mid-teens on a forward basis. Multiples haven't been this low in over seven years.

Fear can result in excessive pessimism and missed opportunities

- There are always things to be afraid of. Investors become paralyzed and miss out on the benefits of long-term economic growth if they allow themselves to be frightened by non-quantifiable, big-picture risks.
- There is a good chance that this will be a benign cycle, with interest rates and inflation moving higher but still staying low enough to be accommodative. That, coupled with slowing but still strong productivity growth, will contribute to a reasonably attractive investment backdrop.
- The short interest ratio (this compares short sales to total stock market volume) is extremely high and suggests excessive pessimism on the part of investors.

On the other hand the pessimists might say:

The economy has improved but continues to have serious and dangerous structural problems

- The economy is walking a tightrope between inflation and deflation. If easy monetary policy ignites inflation, interest rates will rise, possibly leading to a sharp slowdown in consumption. A competitive global economy that still suffers from overcapacity could, ironically, eventually result in deflation—not a healthy scenario for stocks or other equity-type assets. There is great pressure on the Fed to make sure interest rate levels are “just right.”
- Household debt levels are high. If interest rates reverse their 20-year downtrend, consumption could slow because of a reluctance to use higher-cost debt. Even though household balance sheets look healthy enough, higher interest rates could cause house prices to decline along with stocks, possibly inflicting severe damage to household finances.
 - The current account/trade deficit remains huge, at around 5% of GDP and nearing \$600 billion (annualized). Asian central banks can't support the dollar forever. There is risk of a dollar crash that could result in a severe global recession.
- The growing budget deficit is troubling. Budget deficits usually lead to inflation.

Stocks don't have much upside and there is little margin of safety

- Stock multiples may be low when compared to the latter half of the 1990s but they are still high relative to the rest of history. And given the recent generational bear market, investors are not likely to feel comfortable with valuations that are much higher than today's levels. If true, stock-market returns will be capped at a rather modest level. And it also suggests that if anything goes wrong stocks are not priced with much margin of safety.
- On a long-term basis, earnings are now above their trend line and therefore are likely to grow at a below-average rate, on average, over an extended time period. Profit growth is still okay but is already slowing sharply.

The geopolitical situation amounts to a security tax at best and a potential economic shock at worst

- Terrorism is an ongoing risk that won't go away soon. The mere existence of the threat imposes costs to our economy that are the equivalent of a security tax. And at some point an economically damaging terrorist attack seems inevitable. In the meantime, the costs of U.S. involvement in Iraq and Afghanistan add to the budget deficit.
- The sharp rise in oil prices is equivalent to a tax on oil consumers. And while it's true that oil prices are not high on an inflation-adjusted basis relative to past peaks, the percentage increase compared to the recent past has been sharp and does result in a marginal drag on the economy. Some of the price rise reflects a geopolitical risk premium. It's hard to know how long that will stick—but it's the risk-premium portion that has pushed prices to a level

where they really have some economic bite. Some of the increase is also demand-driven (China) and so prices are unlikely to return soon to levels of the last decade.

Whew! The optimists and the pessimists can have at each other. **Our job is to be neither optimists nor pessimists. We are paid to be rationalists.** Rationality requires us to recognize what we can confidently assess and what we can't. And for those things that we can't assess we must determine if they have the potential to undermine our ability to meet our portfolio objectives. With respect to these issues, our views and conclusions have held constant throughout 2004:

We are most comfortable (as always) assessing valuations. At present, based on our analysis, equity-type asset classes are generally in a fair-value range, neither overvalued nor undervalued. That suggests that a normal level of risk is reflected in stock prices. For the most part bonds look a bit pricey.

- Stocks of large companies in the U.S. (large-caps) are, based on our analysis, in a fair-value range. Some of our valuation work suggests five-year returns could be as high as 11%, while other metrics suggest mid-single-digit returns in a base-case scenario.
- Stocks of small companies (small-caps) are priced in line with large-caps. In other words, they appear neither cheap nor expensive compared to large-caps or on an absolute basis.
- With respect to value stocks and growth stocks, we have no clear favorite. Most of the metrics we look at show that they are in a fair-value range relative to one another, although there are a couple of measures that suggest growth stocks have a slight relative valuation advantage. (Growth stocks always sell at a price/earnings premium to value-type stocks, however, the amount of the premium fluctuates. When the premium is very high, growth stocks are probably overvalued relative to value stocks. When the premium is historically low, they are probably undervalued relative to value stocks.)
- Looking overseas, many countries don't have the structural imbalances the U.S. has (huge trade deficit, low savings rate, and high debt levels). And based on most metrics, foreign stocks look undervalued relative to U.S. stocks. However, they often (usually in the case of Europe) sell at a discount to the U.S. and outperformance has not always followed periods when the discount was wide. We also have less confidence in the quality of the data available on foreign stock-market valuations.
- REITs have surged this year, up over 14%. They are no longer undervalued and by most metrics they appear to be a bit pricey, although probably still within a fair-value range.
- High-yield bonds have moved into overvalued territory. With yields below 8% and a narrow interest-rate differential (spread) vs. 10-year Treasuries, high-yield bonds don't have much price upside and have potential downside in both a clearly weaker or stronger economy—the former would result from weakening fundamentals and the latter from rising interest rates.
- Investment-grade bonds are priced at very low yields. For example, the 10-year Treasury yield is about 4% as we write this. Compared to inflation, yields are below their long-term average and this suggests that investors are somewhat pessimistic about the economy. Looking out over the next few years it wouldn't be surprising to see interest rates drift higher, resulting in low single-digit returns for bonds. (Indeed, modestly higher rates would be welcome because they would go hand-in-hand with a healthy recovery.)
- Foreign bonds also continue to offer low yields on average. However, inflation pressures are more muted in Europe and thus there is a good chance that European bond markets will outperform U.S. bond markets. In addition, if the dollar weakens on a long-term basis, as seems likely to us given the huge current account/trade deficit, currency gains would add to returns from the foreign bond funds we use. We retain exposure to foreign bonds (with a primary emphasis on Europe) not as a fat-pitch play, but rather as a risk-management tool by serving as a dollar-crash insurance policy. See below for more discussion of these holdings.

We are NOT confident in assessing macroeconomic and geopolitical developments. These variables are extremely difficult to confidently and accurately assess. So they are not primary drivers of our asset-allocation strategy. However, we don't ignore them. Rationality also requires us to assess what could happen and how different scenarios would impact our portfolios. So as part of our risk-management process we seek to identify and understand scenarios that could significantly damage our portfolios. In turn we attempt to come up with diversification strategies to hedge against these risks *in a way that balances the need for downside protection against the "cost" (in the form of foregone returns) that results from this reduction of portfolio risk.*

A good example is the foreign-bond exposure mentioned earlier. For quite some time we have stated our concerns about the huge U.S. current-account deficit, which is driven by a massive trade deficit. We import about twice as much as we export and this causes an imbalance in the supply and demand for dollars. That imbalance has been plugged by foreign investment and recently mostly by Asian central bank investments in U.S. bonds. However, the risk is that the deficit will continue to grow and foreign sources of capital will not be available indefinitely to plug the gap. We again draw on the succinct wisdom of Warren Buffett who said "anything that can't go on forever will end." The worst-case scenario is a sharp decline in the dollar that could destabilize the global economy. Obviously this would not be in the interests of our global trading partners and is one reason that a sharp decline seems unlikely—foreign central banks would be highly motivated to step up and buy dollars. However, this scenario remains a risk. But as noted above, it is a risk we can provide some protection against by owning a foreign bond fund (Payden ST Global) that we expect to provide us with the same recession hedge we get from a domestic bond fund, while also providing a dollar hedge

September Benchmark Returns (Preliminary)		
	Sep	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	1.1%	1.4%
Russell 1000 Growth iShares	0.9%	-2.8%
Russell 1000 Value iShares	1.5%	5.4%
Mid-Cap Benchmarks		
Russell Midcap iShares	3.2%	5.6%
Russell Midcap Growth iShares	3.7%	1.2%
Russell Midcap Value iShares	2.8%	8.8%
Small-Cap Benchmarks		
Russell 2000 iShares	4.7%	3.6%
Russell 2000 Growth iShares	5.5%	-0.7%
Russell 2000 Value iShares	3.9%	7.9%
Other Benchmarks		
Vanguard Total Intl Stock Index	3.0%	4.5%
Vanguard REIT Index	-0.2%	13.7%
Vanguard Total Bond Mkt Index	0.2%	3.3%
Merrill Lynch High-Yield Master	1.4%	6.0%
Salomon Brothers World Govt. Bond	1.4%	1.7%

Another example is our concern about the inflation/deflation risk. As we've discussed in many of our commentaries, unexpectedly high inflation and deflation are both risks, with the economy balanced between both scenarios. Neither of these alternatives are positive for stocks, but bonds would do well in a deflation scenario. So despite the probability of rising rates, we continue to hold some bonds in balanced accounts as a deflation hedge and as protection against other events that could result in big losses for equities. This insurance policy is important to managing overall portfolio risk. However, given what has amounted to very stimulative monetary and fiscal policy, we are cognizant of inflation and interest-rate risk and for that reason we hold some cash in lieu of a portion of the bond allocation. We also continue to use our hedge funds as "insurance" and as an alternative to our normal bond allocation. We are continually looking for and analyzing alternative strategies to help reduce the risk of our portfolios without giving up too much upside. This past quarter we added a private real estate deal to some client portfolios. We are currently researching 4 other low volatility, non-correlated strategies. We are "thinking outside the box" now more than ever as the investing landscape has gotten more difficult to make money.

Conclusion

Fairly valued equities suggest that stock-market investors are not placing a high probability on the troubling structural imbalance risks. As a result, the margin of safety in stock prices seems no better than average. At the end of the day we are concerned enough about the structural imbalances that we are not willing to overweight equity-type securities vs. bonds, even though bonds are somewhat overvalued. However, we also recognize that a fairly benign cycle still seems a quite-possible outcome. Probabilities are hard to accurately assess but we believe a fairly supportive inflation/interest-rate environment and continued gradual growth is the most likely outcome. Our

view is influenced by healthy levels of cash on corporate balance sheets, muted inflation, and consumer spending that remains solid though there has been some slowing.

So we remain at our neutral allocation, postured neither overly aggressively nor ultra-conservatively. And while it's frustrating to stand in at the plate with the bat on our shoulder, the one thing we can say with certainty is that opportunities will come. The world will always be a volatile place and at some point something will cause investors to act irrationally. **So we must be willing to be patient for however long it takes.** While we are patient, if the environment is benign, returns may be just fine. And of course we have enormous confidence in the stock pickers we rely on, though that confidence is high over the long-term (periods of at least three years) but always lower in the short-term. In fact, our view at present is that we may be in a particularly tough period for active managers to add value because there appear to be few clear pockets of opportunity in the market. But, that could change at any time. **Again, patience is essential now.**

As always, we thank you for your confidence. We continue to work very hard, employing creativity, an open mind, and intellectual honesty in researching new investments, monitoring existing positions, and building sensible portfolios.

—Lido Advisors Investment Team (10/7/2004)

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