Strategic Financial Management Group

Investment Strategies & Insights

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The Narrowing Path

When the financial markets reach a turning point, as they did in the 1st quarter of 2003, and begin to move up in tandem with an expanding economy, the horizon appears to be distant…visibility is great…and the road is wide and the bumps are few and far between. We have been traveling down this road for several years, and with a few exceptions, it has been relatively easy to read the signs along the way and stay on course. However, we are reaching a point where the road conditions are beginning to change and the last sign that we passed said “Bumps Ahead”.

The “bumps” that we are referring to is the return of volatility to the financial markets that has been uniquely absent for the last few years. A basic tenet of investing is the concept of risk premium…the amount investors are willing to pay for potential return in excess of a risk free yield. One of the concerns that we have had is that the risk premium for financial assets had been reduced, indicating that investors perception of risk had greatly diminished.

The recent problems in the sub-prime mortgage market and the corresponding issues with two hedge funds investing in these loans has suddenly brought the reality of risk back into the marketplace. As usual, the magnitude of risk taking is only revealed when a problem occurs. Investors have reassessed the risk associated with these investments and are demanding higher yields, as well as diverting funds to other investment options.

In the stock market, the use of borrowing to buy stocks (margin loans) has increased due to a rising market and low interest rates. This margin debt relative to the overall stock market value has now exceeded the peak reached in the “tech bubble” of the late 1990’s. With rising interest rates on margin loans, any drop in stock prices will add additional selling pressure to the markets. The financial environment has become more volatile, but there are few signs at present that it will challenge economic stability or stall the cyclical bull market in stocks. The ride is not over, but the road is not as smooth as it used to be.

The Allure Of Foreign Treasure

Over the last year, an interesting trend has become apparent from the data tracking the flow of funds into the various markets. During that period, the net redemptions (funds out) of U.S. equity funds totaled $12 billion, even as the U.S. stock market continued to rise. On the other hand, year-to-date investment in Foreign equity funds is at an unprecedented high of $88 billion. It appears that the retail investor in the U.S. has not completely recovered from the collapse of tech stocks in 2000 and is chasing returns in foreign markets that are perceived to be safer than here at home.

In sharp contrast, investment in domestic exchange traded funds (ETF’s), used more by professional investors, has increased by $7 billion year-to-date. What we draw from this divergence in where money is being invested by Main Street vs. Wall Street again comes back to the perception of risk.

We believe that the global economy will continue to grow, even as the U.S. economy is beginning to slow, since the changes in market dynamics are structural not cyclical developments. Opportunity exists and we agree that we need to participate in those markets. However, opportunity does not come without risk and increased volatility must be endured, especially in the emerging markets of Asia and India.

“When you come to a fork in the road, take it.”

Yogi Berra

Summary:

Volatility in the financial markets is increasing.

Flow of funds Y.T.D. is out of U.S. stocks and into International equities.

Inflation concerns and continued troubles in housing market is keeping the Fed on the sideline.

Better economic numbers expected in the 2nd quarter, but slowing in last half of the year still expected.

Stocks rebound in 2nd quarter…but the next move will depend on upcoming earnings reports.

Hedge fund problems with sub-prime mortgages have increased the spread between high quality bonds and riskier issues.

Commodities continue to go up and could correct, but long term demand should persist.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.

So What Is The Economy Really Doing?

Inside the Economy

Inflation and Interest Rates

- Inflation concerns persist as each month the data tells a different story as the major components of the Consumer Price Index have been changing, both up and down.
- The year-over-year rate remains low at 2.7%, but the impact of higher global inflation on U.S. imports could result in higher prices, especially in the 4^{th} quarter.
- Interest rates have broken above the 5% level, for the 10 year Treasury, as the turmoil in the credit markets has begun to push longer-term yields up.
- The Federal Reserve has remained on the sidelines and kept its rates constant.
- The tension that has been created by the weak housing market and rising inflation will force the Fed to wait until they get a better handle on the direction of the economy before they make their next move.

Economic Output and Direction

- After dismal 1^{st} quarter growth of only 0.7% year-over-year, the economy is expected to rebound in the 2^{nd} quarter, based upon preliminary data.
- However, below trend growth is projected in the second half of the year as the weakness in the housing market and higher energy prices weigh on the economy.
- Consumer credit remains extremely high, but as long as the labor market holds up, spending should slow, but not collapse.
- Key indicators to watch for an indication of economic direction are the wage and unemployment numbers.
- The U.S. economy has long dictated the direction of the global economy, but that correlation appears to be changing as the foreign markets show continued strength.

Business and Consumer Indicators

- Capital spending in the U.S. is on the rise, but remains below previous levels.
- New orders for both services and manufacturing increased in June.
- Personal income is up 6.5% year-over-year and retail sales remain steady, up 5%.
- As always, the U.S. consumer is the key and economists have been counting them out for years…but they keep on spending.

Inside The Markets

The Stock Markets

- The U.S. markets experienced a very nice rebound from the February correction, with the S&P 500 up 6.2%. for the quarter.
- The broad market's advance has become dominated by fewer and fewer stocks as the large companies are beginning to diverge from the small companies that are showing rapid deterioration in earnings growth.
- In addition, the ratio of companies reporting earnings that exceed estimates is declining, putting greater significance on the upcoming earnings reports.
- The most favorable valuations remain in large companies, with the biggest earnings growth coming from those with foreign revenue sources.
- The buy-back of stock by companies has helped fuel the upward momentum of stocks, but as prices reach fair value this should subside.
- Increased weightings to the international markets will be continued with a focus on value stocks in order to protect against potential volatility.

The Bond Market

- The risk premium is back in the bond market as the spread between high quality and junk bonds has increased sharply.
- Corporate balance sheets remain solid, but the increased use of debt and rising interest rates does increase the risk of default.
- In foreign markets, central banks have been raising rates to slow economic growth and inflation.
- Global bonds are at fair value and provide higher yields, with the potential for greater appreciation due to a weaker U.S. dollar.

Commodities & Alternatives

- Commodity prices remain high and could experience a short-term pullback.
- However, prices remain well below their historical levels and the demand abroad shows no signs of abating.
- Production bottlenecks have kept supplies below demand, placing upward pressure on prices for both base metals and energy.
- The argument for long-term demand remains compelling.

Closing Thoughts

The traditional approach to portfolio design that is dominant in the investment arena is focused on diversification between cash, bonds, and stocks. Within the stock allocation, attention is given to domestic and international exposure, as well as the segments of the markets based upon the size of the companies. The conventional approach to management was to hold for the long-term and rebalance the portfolios to the desired allocations at regular intervals.

In recent years, with the advent of technology and the availability of research and information, the dynamics of the markets have changed, requiring the management to be more tactical and active. This was a variation on a theme, but the asset classes were the same. Sometimes the course was easy to navigate, while other times the signs were difficult to interpret and the path seemed to narrow. But at least the path was familiar and we had been down it before, regardless of the conditions.

There are times, however, when the relationships of the markets shift due to structural changes in the global economy that warrant looking at new approaches to investment management. A comparison of investment allocations of pension funds and foundations reveal that something has changed…at least for the foundations.

Pension funds have maintained the more traditional approach with approximately 30% to cash and bonds, 60% to equities, and 10% to real estate and alternative investments. The Yale Foundation, the most consistent performer of the group, has made a tactical shift of 6% to cash and bonds, 23% to absolute return strategies, 12% domestic equity, 15% foreign equity, 16% private equity, and 28% to real assets.

David Swensen, the manager of the Yale Foundation attributes his performance to increased levels of diversification into investment areas that are not directly correlated to the U.S. capital markets, thereby reducing volatility and creating consistent returns. The additional asset classes of alternative investments and real assets, as well as the increased exposure to international markets, is reflective of the impact of global forces on all financial markets.

Erik Peterson, with the Center for Strategic and International Studies, has developed a view towards the future that questions which global forces will drive change the most over the next 20 years. The project, referred to as the Seven Revolutions, reveals some interesting trends. Over the next 20 years, 80% of the world's population growth will occur in the countries least capable of supporting it. When that is coupled with an increase in demand for global food by more than 50% and energy by 55%, the problems with those trends become apparent.

At the same time, breakthroughs in technology, communications, and healthcare will be available to greater percentages of the world population, enriching and prolonging many lives. Opportunities will become more accessible to people in developing countries as our world flattens, but the disparity in the wealth of those at the top and the bottom will remain. It will take creative approaches from leaders, both in and out of government, to avoid potential conflicts.

Our view is that over the next 20 years, the investment markets will not be unlike the rest of the world. It will be a time where there are troubling trends and risks, but tremendous opportunities as well. We have already seen the impact of globalization in recent years and we will need to continue adapting our investment approach in the future to take advantage of new opportunities. An ever-changing world will require a willingness to venture down new paths to find the creative solutions needed to capture returns and overcome the potential risks that we may encounter.

Best Regards,

David White

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is written by the scribes at Strategic Financial Management Group.

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