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First Quarter 2002 Investment Letter

Dear Client

The past four bear markets were followed by strong bull markets, but a look at the fundamentals shows there are notable differences in our starting point in this new economic cycle.

Today's far lower interest rates and higher multiples suggest that multiple expansion.....the primary driver of past bull markets.....is unlikely to fuel similar level gains in coming years. Low dividend yields won't help much, and it is unlikely that earnings growth alone can fuel double-digit gains.

We think returns for the traditional assets classes of large-cap domestic stocks and high-quality intermediate bonds are not likely to be much above mid-single digits. But other asset classes offer better opportunities, and with a flexible approach and hard work we think we can do better.

### **So How Do We Deliver Better Returns?**

Many investors have a strong rear-view-mirror bias when they invest. That's why small-cap stock funds were so popular in the early 1980s at the tail end of a massive run for small-cap stocks. And that's why foreign stock funds were hot in the early 1990s, after a huge run for foreign stocks. This is also why value investing was so heavily promoted in the mid-1990s after value investing had outperformed over 20 years. More recently, that is why growth and technology stock funds were the rage in 2000 even after huge returns resulted in off-the-charts valuations. In each case the hot asset class went on to drastically underperform. Rear-view-mirror investing is a poor strategy. Periods of huge out performance can't last forever for any asset class. The good news is that when there are winners there are also losers and sometimes opportunities are created in the losing asset classes that are forgotten or out-of-favor. It's important to stay open-minded and flexible so that new opportunities won't be missed because of bias toward what worked yesterday.

Investors who are willing to be flexible in their thinking, somewhat contrarian, and who are open to investing in less-traditional but still legitimate asset classes are in a position to make the most of the environment we are now in. Though there is not much out there that is in screaming-buy territory there are a few good



opportunities that excite us in areas that are at bargain levels. And there are other solid opportunities that are at the cheap end of a reasonably valued range. Our allocations to asset classes reflect this view.

Here's a specific rundown of our thinking:

**Small and Mid-Caps in the U.S.:** Smaller and mid-cap stocks continue to be attractively priced compared to large-cap stocks. The valuation levels are not in "screaming-buy" territory but they are still appealing by historical standards. And, small-caps have consistently delivered good performance in the early part of past economic cycles. Value continues to appear more attractively priced than growth based on P/E relationships, compared to historical levels.

**Foreign Stocks:** There are a number of compelling arguments that are hard to ignore when it comes to the opportunity outside the U.S.

- **Valuations.** Europe, which makes up the majority of the exposure in most foreign stock funds, is selling at a 40% discount to the U.S. based on price-to-cash earnings (the best way to compare valuations across countries). There have been only three other instances in the last 32 years in which Europe has sold at a discount of 40% or greater (the long-term average discount is 25%). In each case European stocks soon delivered strong out performance.
- **Relative economic performance.** Some observers make the case that the relative economic out performance of the U.S. versus much of the rest of the world may narrow. While uncertain, we think the arguments have some merit. Compared to Europe, the U.S. has much higher debt levels and a very high current account deficit. And there is a lot of catching up to do with respect to technology investment, which may lead to some catch up in productivity rates relative to the U.S. This will likely lead to takeovers which normally enhance equity values.
- **Currency and Diversification.** By most measures the U.S. dollar is 10% to 20% overvalued. We believe there is a good chance that currency will be a tailwind to foreign stocks held by U.S. investors over the next five to ten years.

**High-Yield Bonds:** We continue to believe that high-yield bonds have a double-digit return run coming. Yields have come down but they are still a healthy 11.5% as we write this. And, with the economy strengthening, the default picture should improve, so there is a good chance that most of the yield will be captured. Over several years we expect the gap (spread) between yields offered by high-yield bonds and investment-grade bonds to move back toward the levels usually seen in periods of economic growth. As this happens it is likely that high-yield bond prices will appreciate and deliver some additional return relative to the yield.



## Less Attractive Asset Classes

Investment-Grade Bonds: Because bond yields are already low, we know that over the next several years, returns will be low. Even if rates dropped 2% over the next five years—a highly unlikely development given the current 5.3% yield on 10-year Treasuries—five-year average annual returns would still not exceed 8% and would probably be less, depending on how quickly yields declined. A more likely scenario is a mid-single-digit return, with 5% to 7% a likely range. While these are not terrible returns, especially in what could turn out to be a very low-inflation environment, they are also not particularly exciting, especially on an after-tax basis. So we will continue to maintain some exposure to investment-grade bonds in balanced portfolios but we are underweighting this asset class early in this economic cycle when the diversification benefits are somewhat less likely to be needed.

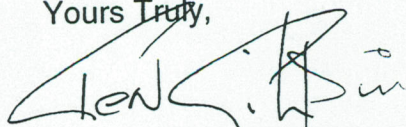
Large-Cap U.S. Stocks: As noted above, U.S. large-cap stocks are not cheap. Based on our valuation model the S&P 500 is about 19% overvalued. While we continue to hold these investments we are underweighted in these areas.

Given the current valuation levels and our expectation that there is no reason to believe earnings growth rates will be far higher than they have been in the past, we once again come back to an expectation of returns in single digits—probably around 6% to 8%. However, just as there is some chance that returns could be higher, there is also the chance that returns could be lower. Some combination for reduced foreign demand, disenchantment on the part of U.S. investors, and lower-than-expected earnings growth could result in a higher risk premium, which would further restrain prices. We continue to underweight large-cap U.S. stocks.

## Closing Thoughts

Winston Churchill said "a pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty." Despite our belief that returns will be lower over the next few years than they have been, on average, over the last ten, we see opportunities and we believe decent returns can be attained. And as long-term investors we expect volatility to be our friend by occasionally creating opportunities to buy asset classes at bargain prices. Finally we continue to expect the stock and bond pickers that we employ to add value over and above their benchmarks, based on the extensive due diligence we have done and continue to do.

Yours Truly,



Kenneth A Gilpin CFP