# Client Newsletter

**Sound Investments / Kenneth A Gilpin CFP** — **Second Quarter 2003**

**SUMMARY:**

**Markets rebounded sharply in the second quarter and our models continued to perform well against their benchmarks.**

Most asset classes are now close to reasonably priced. Market is currently experiencing a bear market rally. We are currently trimming our more Aggressive Positions.

At this point we don't view the tax changes as reasons to pursue certain types of investments over others. From a portfolio-strategy standpoint, now more than ever, portfolios will be much more tax efficient if bonds, REITs and investments that throw off lots of short-term capital gains are in retirement plan accounts.

***The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.***

## Investment Review and Outlook

What a difference a quarter makes! The powerful second-quarter rebound more than offset a tough first quarter, rewarding investors with sizable returns during the first six months of 2003. So far this year our models have out-returned their benchmarks and participated strongly in the rebound. Three months ago we wrote about all the economic and geopolitical negatives. But after that rather depressing discourse we also wrote "...there are powerful positive forces at play which must not be forgotten at a time when the glass seems mostly empty." Many times in the past we've written that investors should never underestimate the ability of the stock market to surprise.

Our respect for the stock market's ability to humble investors over the short-term is part of the reason why we put so much faith in valuation analysis, which we believe is a primary driver of investment returns over periods of several years and longer. The other reason for this emphasis is that we believe we can analyze asset values with enough accuracy to lead us to return-enhancing decisions more often than not. So, despite economic and geopolitical worries, three months ago we believed that the stock market and other "equity-like" assets were clearly undervalued. For this reason, despite our big-picture worries we believed the odds were high that we would be rewarded either sooner or later for maintaining equity exposure. In essence we relied on that which we could confidently assess (valuations) and were influenced less by factors that we could less confidently assess (geopolitics and the timing and strength of an economic turnaround). This allowed us to resist the temptation to get more defensive. Now, three months later, the returns from equity asset classes have been impressive.

We believe that our value added to you is a function of the quality of our research and our ability to share our discipline. If we don't have the discipline to follow what our research tells us then the research loses its value. At times of extreme greed and fear this is particularly difficult because emotion clouds judgment. And for that reason we view one of the most important parts of our job as helping you to deal with the same emotional challenges.

## Have Stocks and Bonds Gone Too Far?

We always get nervous when financial asset prices move sharply higher over a short time period. Contributing to our discomfort these days is the bullishness of financial advisors and investment strategists. According to several polls of both groups, optimism is higher than it's been at any time since 1987. Huge optimism is usually a bad sign because it suggests that if investors have acted on their optimism, stock prices will have been bid too high. However, investment sentiment is just one factor and a temporary one at that, so it rarely factors into our investment-decision-making process. To reiterate, most important is the valuation picture. And what is the picture now? We believe that Large-Cap Stocks are overvalued and Small-Cap Stocks and Foreign Stocks are under valued. Also we like High-Yield Bonds for income. We are looking for Funds that relie on fundamentals (i.e. dividends and earnings) to separate winnings from losers.

## Reasonable Return Expectations and Ways to Add Value

Current asset prices suggest returns of 6% to 9% for equity-type assets on average, over the next five years. Of course that's a base-case forecast and assumes that assets are at about fair value at the end of the period. The reality is that returns could be significantly different if growth rates are abnormally high or low or if assets become over- or undervalued. Given our expectations, return potential relative to inflation is decent but on a nominal basis these returns may not seem exciting. After a horrible three years don't we deserve more? The sad reality is that returns were so high in the 1990s that they effectively borrowed from the future. The bear market brought things back to reality and beyond and now we've had a bounce back to fair value. So as we write this at the end of the second quarter, returns look likely to be okay but not spectacular. How can we do better, or at least ensure that we don't fall within the lower end of the broader range?

There are no guarantees but as we focus on the important question of how we can continue to add value we would like to point out the following:

Tactical asset class plays are limited *today*: Taking advantage of market overreactions is one of two primary ways we expect to add value. For much of the last three years we've been pounding the table about opportunities in high-yield bonds, value stocks and small-cap stocks. High Yield Bond Funds that have done well Pimco Total Return and Vanguard High Yield Corporate Bond Fund. But, today there are no table-pounding opportunities. High-yield bonds are borderline fat-pitch opportunities and after strong recent performance they don't offer the potential they did up until recently.

But while no area is hugely compelling right now, there is one area of overreaction. Investment-grade bonds are clearly unattractive and we are adjusting our portfolios accordingly (more on this below). And, just because there are no great opportunities today doesn't mean there won't be any tomorrow. In fact we can guarantee that there will be good opportunities in the future because they always come and go as a byproduct of investors' ongoing swings between fear and greed. We will be patiently awaiting opportunities we can take advantage of.

Adding Value via Manager Selection: The second way we add value over time is through manager selection. Over the long run this has been a material factor in our performance. And just as we take advantage at the asset class level of the mis-valuations arising from fear and greed-driven volatility, our managers similarly benefit at the security selection level. Volatility is the long-term investor's friend.

## What We Are Doing Now

As all financial assets have moved higher we've been debating some tough decisions.

Are high-yield bonds still Good? High-yield bonds are still quite competitive with stocks but they no longer qualify as a clearly superior alternative. However, everything—including high-yield bonds—is a fat pitch compared to investment-grade bonds and that's why high-yield bonds continue to be interesting. Their risk is similar to the risk of an equal mix of stocks and investment-grade bonds. Over the next five years, our pre-tax return expectations for a stock/bond blend is about 5% compared to 7.5% for high-yield bonds. After-tax return expectations are about 4.5% compared to about 3.7% (assuming maximum tax rates on interest and assuming a high-tax state). Investors who hold their high-yield bonds in retirement accounts have the potential to have even better comparative returns on an after-tax basis.

In other areas, we are sticking with our small-cap and foreign equity positions, which we think, offer somewhat better value than U.S. large-cap stocks. Funds that have done well in this are area are the American Century Small Cap, Oakmark Select and Oakmark Global. In my twenty years as a student of the market I have never been a big fan of Gold but for some accounts a 5% of a portfolio is warranted as a hedge against the currency.

## Thoughts on the Tax Bill

The impact of the tax bill was a positive one for investors and it does have some ramifications on asset allocation and portfolio management decisions. Though rates have effectively dropped for all investments, they dropped more for capital gains and qualifying dividends thus benefiting stocks more than most other assets.

From a portfolio-strategy standpoint, now more than ever, investors with both taxable and retirement plan portfolios will benefit from emphasizing investments that throw off income taxed at high ordinary rates in their retirement plans.

## Conclusion

Unlike most of the last five year's financial asset values are not currently disconnected from reality. So in this environment we rely on

1. Our ability to identify exceptionally skilled stock pickers who continue to add value, and
2. Our ability to be patient in waiting for the next fat-pitch (tactical asset allocation) opportunity.

Over the years we think we've developed a clear understanding of our circle of competence and we've learned the importance of staying there; and part of that circle of competence involves focusing on that which we can confidently analyze, such as valuations, and staying away from the type of big-picture analysis that is so hard to get right.

Yours Truly,

Ken Gilpin CFP

P.S. Once a year we are required to ask our clients if they wish to have a copy of my registration with the Sate of Kansas. This year I thought I would enclose it. However some clients have more than one account so I may have to put it in another envelope, which I will mail concurrently.