

**SUMMARY:**

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Equity asset classes continued to advance in the third quarter, despite the market's retreat in late September.

In terms of valuations, the risks have shifted. The danger of investors having a low appetite for risk following the bear market has softened as stocks have climbed, but the valuation cushion has also dissipated.

Most longer-term structural risks remain. Debt levels remain high and the current account deficit is large, suggesting that a weaker currency is necessary. A sharp decline in the dollar could lead to a withdrawal of foreign investment, putting pressure on stocks and bonds. Geopolitical and terrorism risks are unlikely to go away any time soon.

While the economy has shown a lot of strength, current higher valuation levels suggest only average (mid-to-high single-digit) returns from equity-type investments over the next several years.

Given the unexciting return prospects and the risks that still exist, we are evaluating investment options that will give us defensive hedges with better return prospects than our current cash and bond positions.

*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

After a huge second-quarter move, equities survived a late sell-off to post a solid third-quarter return. Smaller-cap 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; success also requires assessing the degree to which the risks are already reflected in financial asset prices. When risks are regularly in the headlines, investors' worries can 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 and underlies our mantra that you can never underestimate the ability of financial markets to surprise.

**We are pleased that our client accounts outperformed their benchmarks during the quarter, and over longer trailing periods have outperformed by significant margins.**

### Isn't The World Still A Risky Place?

The world always has been and always will be a risky place. 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, while in March of this year there was an above-average level of risk priced into stocks. Now, in our opinion, the financial markets are pricing in a middling level of risk—neither greed nor fear is in control.

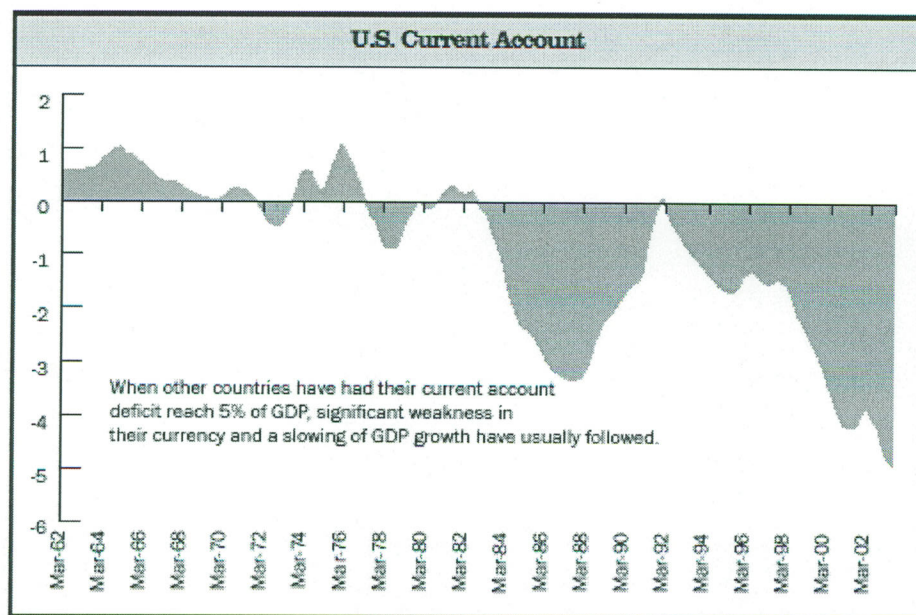
**Many of the longer-term risks that existed six months ago still remain.** So why have stock prices moved significantly higher? First, back in March investors were paralyzed by the potential short-term impact of the Iraq war. Second, investors were concerned with near-term economic prospects, and strong economic performance has alleviated those concerns for now. Third, and perhaps most important, stocks and other equity asset classes were undervalued six months ago. As war and economic fears



subsided, stocks and other asset classes moved back to fair value. Yet, the longer-term risks remain and are worth reviewing.

**There are several important structural risks.** Debt levels are still high and the question of what level is too high remains. But the current account deficit is our biggest concern. It is driven primarily by our country's massive demand for foreign goods. 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). Perhaps this decline has 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 is not always easy to anticipate. So this is a risk we continue to be cognizant of.



**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. 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 in-

creased 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.



As mentioned previous newsletters we **believe for the first time in 20 years that Gold deserves some consideration to balance out the above forces.**

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 see the kind of huge tailwind from rates that drove the last bull market, and foreign demand for U.S. stocks seems to be waning. So it's not likely that we are set up for a sustained run of big returns.

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. 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.

### **Patience Needed**

The run up in 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.*

**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. Without the diversification benefit high-yield bonds can't be justified based on our fat-pitch philosophy.

As always we are focused on efforts to identify managers and funds that have the potential to generate higher returns.

Yours Truly,

Ken Gilpin CFP

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