

Sound Investments Inc.

Kenneth A Gilpin CFP

First Quarter 2004

In the first quarter we decided to reduce the position in high-yield bonds, bringing our equity exposure back to neutral.

Equity valuations are in a fair-value range and it's unlikely that these asset classes will return much more than their dividend yield plus earnings growth. If true, intermediate- to long-term returns will likely be in the 5-7% range.

While stocks are not over-priced, we are not motivated to take above-average risks in light of the nominal returns that we expect. Furthermore, there are a number of structural risks, as well as geopolitical risks that make us somewhat cautious. But we are not at the point where we believe it makes sense to get defensive.

Looking forward, our long-term return expectations are not high for the underlying markets, and our ability to add value at present is somewhat limited by the lack of compelling asset-class opportunities. The coming months may require some patience. Inevitably, the market will again present us with compelling tactical-allocation opportunities. Until then, we remain confident that our managers will continue to add value.

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.

First-Quarter Investment Review and Outlook

The powerful stock market rebound that started just over a year ago continued in the first quarter, though most of the gains occurred during the first few weeks of the year. Small-caps and foreign stocks were especially strong, and both outperformed the S&P 500. High-yield bonds managed to deliver good returns on the quarter, while investment-grade bonds did quite well as interest rates declined in January, February, and March. Foreign bonds also delivered positive returns in the first quarter, though they were generally lower than U.S. bond returns.

Our investment approach is patient and long-term-oriented, and as a result portfolio turnover is normally infrequent. However, this month we made changes to our portfolios by adding FPA New Income to gain greater diversification in our bond holdings. This fund (symbol FPNIX is a load fund but as I am a registered investment advisor we purchase it on a no-load bias).

FPA New Income Fund is an eclectic investment-grade bond fund run by Bob Rodriguez and Thomas Atteberry. Currently the fund is positioned very conservatively, with an average duration of only 1.1 years and a meaningful allocation to cash, as the team expects interest rates to increase significantly over the next 12-18 months; this is why we partially funded the purchase of this fund from the dedicated cash positions, even though our official cash allocation remains unchanged. The appeal of this fund is partially due to our long-term expectation that interest rates are likely to rise. Equally important, we have a high degree of confidence in this fund's management team and like their highly flexible approach to seeking value over a market cycle.

The investment landscape today is very different than it has been during much of the past five years. During that period, we experienced an unusual abundance of good opportunities, as the tech bubble left large swaths of the financial asset market ignored and undervalued. At various points over this period of time we established tactical over-weightings to value stocks, international

funds, small-cap stocks and high-yield bonds. Each of these asset classes provided incremental outperformance during the full period that we held them and this contributed to the performance of our portfolios. The ability to put in place multiple "fat-pitch" plays also allowed us to diversify them so that very high exposure to any one asset class was unnecessary. This helped to reduce volatility and during this same five-year time period our equity portfolios exhibited much less volatility and downside risk than the equity market and much higher risk-adjusted returns.

But all good things come to an end. We have reduced our high-yield bond holdings this month for the following reasons:

1. **Yields offered by high-yield bonds have been steadily declining for well over a year now and are near all-time lows. Spreads (the difference between yields on high-yield bonds and Treasury notes) have narrowed tremendously in the last couple of years.**
2. **While the economy has improved which led to a drop in default rates this improvement is already reflected in bond prices.**

The Investment Climate: Should We Be Cautiously Optimistic or Just Cautious?

For some time now our forward-looking view of the investment climate has been driven by several factors:

Valuations for equity-type asset classes are in a fair-value range. This means that over an extended time period it is unlikely (though not impossible) that these asset classes will return much more than their dividend yields plus their earnings growth. If true, this puts intermediate and long-term expected returns in a 5-7% range. Also important is the level of interest rates because this can have an impact

on stock prices. As we all know, interest rates are exceptionally low. Using the 10-year Treasury as a reference point, if rates rise much above 5%, stock prices could be adversely affected, resulting in lower returns. The 5% level may seem like a long way away from today's 4.0% yield, but from a historical frame of reference 5% is still a very low rate, and rates have the potential to spike up to that level in a matter of months. (In 2003, rates were as low as 3.1% in June and as high as 4.6% less than three months later.)

Structural risks continue to be an intermediate- to long-term risk factor. These risks include:

- The current account deficit, which is mostly driven by the trade deficit. We import about 50% more than we export and as a result we need to "import" foreign capital to help us pay for it.
- Public and private debt levels. The question is whether the collective "we" that make up the net worth of the United States hold too much debt. Absolute debt levels are very high historically but low interest rates make the servicing of this manageable. A concern is what will happen when rates rise? Will it slow borrowing and spending growth? This would dampen economic growth.

Inflation is another risk down the road. The substantial monetary stimulus provided by the Fed for some time now raises the risk of inflation. And China's booming economy is another factor that adds to that risk. However, outside of commodity price inflation (which over the years has become a relatively small component of overall inflation), inflation remains muted at present. But, if the economy continues to improve it's possible that inflation could move significantly higher

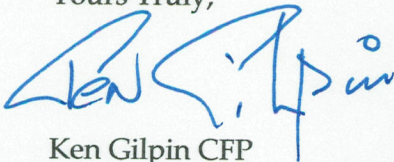
(though we don't expect 1970's style out-of-control inflation) in coming years.

Geopolitical risks have not gone away. Terrorism risk impacts costs for governments and some companies, and terrorism-related economic shocks remain very much a wild-card.

The economic cycle is relatively early, which suggests that economic growth is likely to continue for several years before another recession. Though the early-cycle gains for stocks have already been strong, normally at this stage of the cycle equity-type investments would still have several more years of outperformance compared to defensive investments (on average—not necessarily every quarter or year). Stimulus remains strong, supporting this expectation.

The message we take away from our analysis is that, though stocks are not overpriced, there is not much margin of safety and the nominal returns we expect don't motivate us to take above-average risk.

Yours Truly,

A handwritten signature in blue ink, appearing to read "Ken Gilpin".

Ken Gilpin CFP

After their strong run last year and into the first few weeks of 2004, stocks were approaching overvalued territory. But, after cooling off in February and March (stocks declined then bounced back in late March) and amidst strong corporate earnings, stocks are comfortably in the middle of our fair-value range. And though there are no guarantees, we expect the equity funds we own to do better than the market averages over the long run (though over shorter periods of time, such as one year, we are less confident in their outperformance). However, looking forward from here our long-term return expectations are not high for the underlying markets, and our ability to add value at present is somewhat limited by the lack of any hugely compelling asset class opportunities. So it is also very possible that the coming months will require patience as we wait for more exciting investment opportunities. Investing isn't easy and the need for patience is one reason why. But we know that sooner or later there will be a catalyst that will cause investors to overreact and push one or more asset classes into bargain territory—to our potential advantage.

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Why Legendary Investors Are Drowning in Cash

Thursday March 25, 6:00 am ET

By Gregg Wolper

Great investors tend not to jump in and out of the market based on where they think the Dow Jones Industrial Average will be in 12 months or whether they consider the S&P 500 slightly undervalued. They recognize that trying to time the market's ups and downs will more likely lead to frustration than to long-term success. Ordinary investors would do well to have the same mind-set.

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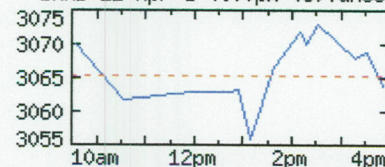
By the same token, when several of the very best managers all say they are having an extremely difficult time finding anything to buy at prices that make sense—not just in the U.S. stock market, but in the bond arena and foreign markets, too—it's worth paying attention. In fact, it's remarkable how many top-flight managers currently have more than 20% of assets in cash and say they find compelling opportunities scarce to nonexistent.

The most prominent cash-hog is Warren Buffett. He's not a mutual fund manager, but he does have to decide where to allocate the substantial pile of cash generated by Berkshire Hathaway's (brk.b.B) insurance businesses. Lately he has been putting that cash into... well, mostly nowhere. We've discussed Berkshire's recently released annual report elsewhere, so I won't go into detail here. Suffice it to say that at the end of 2003 the percentage of Berkshire Hathaway's total investments languishing in cash was 22%—up sharply from the single-digit levels of the previous four years. That adds up to roughly \$31 billion sitting on the sidelines.

Buffett considered most stocks too expensive even in early 2003, when the market indexes were far lower than they stand now. As he said in Berkshire's 2002 annual report, released one year ago: "Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us." And stock prices have soared since then. Bond prices also leave him cold right now. In Berkshire's new annual report, he says the junk-

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Inside Yahoo! Finance

bond arena, which he considered quite cheap in 2002, doesn't look that way anymore. "The pendulum swung quickly..." he writes, "and this sector now looks decidedly unattractive to us. Yesterday's weeds are today being priced as flowers."

Bob Rodriguez, a two-time winner of the Morningstar Manager of the Year award, also knows something about bonds—and about stocks, too. And like Buffett, he's keeping plenty of money off the table these days. Rodriguez has a flexible mandate with FPA Capital (Nasdaq:[FPPTX](#) - [News](#)); though stocks typically dominate that portfolio, he can look elsewhere, too. Lately he has found very little to his liking. At the end of February 2004, the fund's cash stake stood at nearly 26% of assets. That's not a first here—FPA Capital had roughly the same amount in cash in mid-1997. Still, it's rare for this fund to have more than 20% of assets sitting in cash.

In a mid-January 2004 letter to shareholders, Rodriguez explained that he and his colleagues have tried every which way to find attractive stocks, and have come up empty. "However we slice and dice Mr. Market," he wrote, "the result is the same, Slim Pickings." That goes for bonds, too. At FPA New Income (Nasdaq:[FPNIX](#) - [News](#))—which, unlike FPA Capital, focuses on fixed-income securities—the fund's cash pile at the end of February was a staggering 38% of assets.

Managers Jean-Marie Eveillard and Charles de Vaulx of First Eagle Global (Nasdaq:[SGENX](#) - [News](#)), who also have a Morningstar Manager of the Year award to their credit, report similar troubles. Two weeks ago, de Vaulx told us that the lack of appealing, decently priced securities isn't limited to the U.S. stock market, but is widespread across asset classes and around the globe. Aside from a few small caps in Japan and Europe, he says he and Eveillard can't find anyplace to invest the fund's cash, which then stood at 23% of assets. And this for a fund that can freely invest in bonds, too. Sounding like Buffett, de Vaulx said high-yield bonds are overpriced now, too.

De Vaulx added that while bargains are scarce everywhere right now, the U.S. market is the most barren of all. As a result, First Eagle Global currently has a smaller percentage of assets devoted to U.S. stocks—less than 20%—than at any other time in the 25 years that Eveillard has been running the fund.

The list goes on. The cash-heavy club includes Clipper Fund (Nasdaq:[CFIMX](#) - [News](#)), run by other former Managers of the Year, and Longleaf Partners (Nasdaq:[LLPFX](#) - [News](#)), managed by past runners-up for that award. At year-end 2003, Jim Gipson, Michael Sandler, and the rest of Clipper's disciplined team had 26% of assets in cash and short-term notes. Meanwhile, at the end of February, Longleaf's Mason Hawkins, Staley Cates, and John Buford had 20.6% of Longleaf Partners' portfolio in cash. (The Longleaf trio also had nearly 19% of assets devoted to foreign securities—a rather high level even for those adventurous managers.)

When so many justly respected managers are sounding the same cautious note, it makes sense to listen. No need to overreact; don't shove all your money under the mattress. But take care if you've got a chunk of money to invest. Consider even more strongly than usual the option of putting it to work gradually—for example, dollar-cost averaging, or spacing investments out over time—rather than investing it in one fell swoop. Hesitate even more than usual if tempted to try to chase hot sectors. Even the greatest managers can't consistently predict the direction of the markets—and by and large, they don't try to. But right now, their words—and deeds—speak volumes.

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