

# Sound Investments Inc. / Ken Gilpin CFP

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In this quarterly commentary we discuss how important it is to be in the right sectors of the market.

Over the last 4 years if you weren't in the small cap value sector you had a difficult time making any money at all.

With the decline in the US dollar International Value Funds have done well.

Stock valuations are reasonable, helped by strong earnings growth, and our return expectation for stocks over the next three to five years is decent: in the high single-digit to low double-digit range.

*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.*

## Quarterly Investment Commentary:

The great player and baseball coach Yogi Berra had it right when he said "Forecasting is very difficult especially when it involves the future". This is because, as Berra pointed out, "*the future ain't what it used to be*".

Yogi knew his stuff. He said "baseball is 90% mental. The other half is physical". I couldn't agree more especially about the mental requirements to be an investor.

Much of investing is mental psychology. I am largely a trend follower, and it takes the mental discipline to stick to the rules. Some may not like what the trend does or the trend does not fit their notion of what the market should do. But if you follow the trend and understand what the market is trying to say, you shouldn't be too far off the mark.

Even through "the future ain't what it used to be" it doesn't mean we can't follow a trend. As investors we have to be flexible and follow the trend, regardless of which way it moves.

The small-cap value category performed best for the year. This is getting to be an old story, as small-cap value has been the best performing category since 2000, returning more than 16% on an annualized basis for the trailing five-year period through Dec 31<sup>st</sup> 2000. For comparison, the Russell 2000 small cap index, which is composed of both growth and value, had an average gain of just 5.3%, while the S&P 500 had an average loss of 2.3% for the same 5-year period. We were well represented in this small-cap group

The small cap leadership that started over 5 years ago continued last year with an average gain of 15% versus 8% for large-cap funds. As a matter of fact small-caps around the world excelled in 2004. We again were well represented in this group with Dodge & Cox International Fund and Artisan International Value Fund.

Lately we have been investing in developed foreign markets so I thought I would spend some time reviewing it. Comparing the 65-year history to ours, the long-term records are



nearly identical. European and US markets both returned about 11% over their entire histories. But these long-term records are comprised of many easy-to-identify periods of over and under performance. There has been only 4 periods when it paid to be in internationals since 1988. Outlined as follows, there are:

#### PERIODS WHEN INTERNATIONALS OUTPERFORMED

	5/89-93	2/93-7/94	3/99-3/00	6/03-12/04
T Rowe Price International	40%	39%	44%	54%
Vanguard 500 Index	15%	5%	12%	38%


As can be seen by the above chart the average duration is about 2 years and the average excess return was about 25%. Of the \$3 trillion of US assets held in equity funds about 20% is pegged to overseas assets. As the world moves closer to a single global economy, stock values are determined more by industry sector and productivity than by country or region. Geographic location will be secondary as the dominant players expand their manufacturing and marketing reach.

One of the reasons internationals have done so well is the falling dollar. A declining dollar increases the value of international funds even if their underlying portfolios stay flat. For instance, import autos prices rise in the US when the dollar weakens, and US manufactured goods become more competitive abroad.

The global economy is vastly more interrelated than even 10 years ago and the factors that influence currency rates are numerous and complex. Inflation, political forces, interest rates, trade flows, movement of capital supply and demand, and economic growth all have an impact on the value of money. *I would like to tell you I am a genius but I am not I just try to follow the trends.*

As I finish writing this I believe there is upward incline to the market and we should hold our positions. I expect a trend change soon moving from the Value area to the Blend/Growth area. As always I will try to keep you informed.

Yours Truly,



Ken Gilpin CFP