



Where Do We Go From Here?

(A Strategic Perspective on Asset Allocation as of January 2001)

*After a decade of the tech and telecom revolution, the New Economy, and the productivity miracle, the 10-year annualized returns of the S&P500, the Russell 1000 Growth and Russell 1000 Value indices are **all** 17.4%. Different paths, but the same long-term result.*

Slowdowns in business investment and consumer spending, rising consumer and corporate debt burdens (now above the peak levels seen in 1990), and the consequent pressure on corporate earnings growth have all been expressed concerns of ours for some quarters. We saw market valuations as unsustainably high in a reduced growth environment, and thus were not surprised at all by the record outperformance in 2000 of “value” versus “growth” (well, the magnitude was surprising). Perhaps it was because we observed very early in the year so many investors clamoring to increase their portfolio’s allocation to absolutely the most volatile and concentrated tech stock managers. In effect, everyone that was going to “leave” value stocks had done so by the end of March 2000.

Despite the year’s style swing, we don’t see the pendulum as back to neutral. Although the difference has been cut sharply, growth stocks remain very expensive compared to value stocks in terms of Price-to-Earnings, implicitly projecting much higher future earnings growth rate differentials than have really been achieved in the past. If the actual earnings environment weakens from here, as is being predicted, why emphasize high P/E stocks that aren’t demonstrating fast growth? So, we would try to suppress the impulse to overweight growth versus value as a strategic matter, even though we might be seeing a quick snap-back effect this month.

On the same basis, small-cap stocks continue to remain relatively attractive versus large-cap, even though they have moderately outperformed during the past 2 years. It is “simply” a matter of relative valuations vs. relative growth rates. However, this is the one equity sector where we see strategic benefit in being style-biased (toward value), due to the inherent uncertainties of overpaying for future growth in an asset class that has at times been overwhelmed by credit conditions and investor sentiment. The long-term historical performance record of small value dominates that of small growth stocks. A true contrarian might therefore choose to emphasize small growth stocks at this point, but that course seems very aggressive for our mainly institutional clients.

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One development that took us by surprise in 2000 was the sharp drop in market interest rates, particularly at the long end of the maturity range. No one seems concerned about inflation any longer, which is understandable if we head into a recession, even though prices increased at a faster pace in 2000 than they had for 10 years! Energy costs certainly played a big part, and people **hope** oil and gas prices will decline, but energy producers see things differently than users. If the US\$ stops rising relative to other major currencies, or begins to fall, OPEC won't be happy getting *fewer* Dollars/barrel.

Further, our very strong Dollar has had a positive impact on the cost of all imported goods. Since we run huge trade deficits, the strong US\$ has been a significant inflation fighter. That run may be over.

Therefore, at this point we think long-term Treasury yields could be a little bit "ahead of themselves" and aren't apt to decline much this year from last December's levels, even as the Fed is cutting the target Fed Funds rates (in response to the early January 50bps cut, long term rates rose). Conversely, corporate bond and mortgage-bond prices look a bit cheap relative to similar maturity Treasuries. In the high yield area, a big January rally is in process after credit spreads ballooned last year. All in all, as a strategic matter we favor broadly diversified fixed income portfolios, including some high yield and foreign bond exposure. This is an aggressive posture if we truly head into a recession (lots of credit defaults and downgradings). Ultimately, we see the Fed enabling short-term rates to fall quite a bit, which will reduce corporate debt service burdens.

Nonetheless, 2001-2 bond portfolio *returns* are quite likely to equate with current bond portfolio *yields*. Accordingly, at this point we don't see any compelling strategic reasons for long-term oriented institutional investors to over-weight fixed income relative to equities. This was something we counseled clients to consider in late 1999, when it was decidedly unfashionable. Now, the strategic opportunity has likely passed. Said differently, last year's fixed income versus equity return differential of +21% makes overweighting bonds at this stage look a bit late.

We have been consistently high on the long-term benefits of international diversification (equities and bonds), only to see the US\$ strength undermine otherwise attractive local market returns. Fully hedged portfolios have performed reasonably well, although the list of foreign equity managers with performance exceeding the S&P500 is admittedly very short indeed. It sounds a little like a broken clock, but we see the benefits of international diversification even more strongly today. The US Dollar is quite unlikely to stay at its current real valuation levels, let alone rise further.

The Dollar's future path is a very important strategic issue, for lost amid all the recent high tech, TMT, growth stock hype is this fact - the broad international equity MSCI EAFE index has provided investors with a modest 2-year cumulative return of 9.53%, but the domestic large-cap Russell 1000 Growth index has returned **only 3.3% during the same timeframe**.