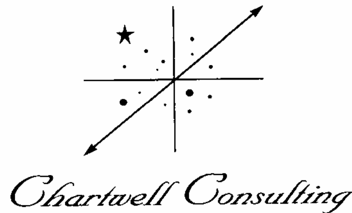

CHARTWELL REVIEW

April 2004 | FIRST QUARTER 2004 | Volume XI, Issue No.1

Who's on First?

Our title this quarter pays homage to the new baseball season (which began just as the 1st quarter ended), and to one of the great comedy routines of all-time, first performed by Abbott & Costello.

While we do think baseball is a useful metaphor for investing (and not just because the pro players are all juiced up and swinging for the fences), the title has an added meaning at this juncture. We suggested almost one year ago that long-term investors were at a strategic inflection point. Interest rates had bottomed, the economy was again expanding, and corporate profit growth had resumed for long enough to have some confidence it would continue (and it has). The storm was over, but in its wake were the vivid realities of "capsized" net funded ratios and spending policies. Given the environment, fiduciaries needed to formulate new *forward-looking* perspectives on the important investment issues, and then use these to drive a re-evaluation of their plan's circumstances.

Table 1 suggests that the overall market may have been quicker to take a fresh view of the new investment paradigm than were many institutional investors. With perfect hindsight, our late 2002 recommendations to downsize bond positions and upsize equity holdings also looks pretty darn good. But, it's already time to re-load. Investors need to decide what their most important performance issues are for the next 2-5 years. To determine, in effect, "who's on first, and what's on second?" Because, "I don't know" is still stuck at third!!

Table 1. Index Benchmarks

Market Index	Q1 2004	1Yr	Trailing Returns * 3Yr	5Yr	10 Yr
S&P 500	1.7	35.1	0.6	(1.2)	11.7
U.S. Large-cap Stocks	0.8	31.8	(1.2)	(3.3)	11.5
U.S. Mid-cap Stocks	5.1	50.8	9.2	8.4	13.1
U.S. Small-cap Stocks	6.3	63.8	10.9	9.7	10.4
International Stocks	4.4	58.2	3.7	0.8	4.8
T-bills (3 month)	0.2	1.0	1.9	3.3	4.2
1-3 Year Treasuries	1.0	2.3	4.7	5.4	5.8
Aggregate Bonds	2.7	5.4	7.4	7.3	7.5
High Yield Bonds	1.8	22.4	9.2	5.5	7.3
Global Bonds, ½ hedged	1.9	8.6	10.2	7.2	7.7
CPI, **annualized**	**5.1**	1.7	2.1	2.6	2.4

* Annualized trailing returns for periods ending 3/31/04.

Table 2. Average Fund Returns

Fund Category	Q1 2004	1Yr	Trailing Returns * 3Yr	5Yr	10Yr
U.S. Large-cap	1.7	35.0	0.0	(0.4)	10.2
U.S. Mid-cap	4.3	46.2	5.2	7.3	11.7
U.S. Small-cap	5.3	61.0	11.6	13.3	12.1
International Lg. Cap	4.6	55.7	4.2	3.2	6.1
International Sm. Cap	9.1	77.8	13.9	12.6	10.2
Emerg. Mkt. Equity	7.9	78.5	17.5	12.3	2.3
Balanced/Hybrid	2.2	23.4	3.7	3.4	8.7
General Bond	2.5	6.2	7.0	6.7	7.0
Government Bond	2.2	3.5	6.1	6.3	6.5
High Yield Bond	1.8	19.7	7.4	4.0	5.8
Hedge Fund Index	*3.3*	*23.9*	*8.7*	*11.8*	*11.0*

* Annualized trailing returns for periods ending 3/31/04.
Source of fund's data: Morningstar; Hennessee

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What's **Driving The Economy?**

We began the first quarter with a considerable amount of positive economic momentum. As Table 3 reflects, the Federal government's final estimate of 4th quarter GDP real growth was a seasonally adjusted annualized rate of 4.1%. This was above the theoretically inflation neutral "sustainable growth rate" which most economists figure at 3.5% these days, but lower than the blow-out 8.3% growth rate for the third quarter.

The most positive contributors to 4Q03 GDP growth were a 10% real increase in fixed investment, especially by businesses; a 20% real increase in exports, and a $9.0 billion increase in inventories, following similar decreases during each of the two prior quarters. While personal consumption spending always accounts for the biggest share of GDP, its growth decelerated to only a +3.2% rate in the quarter (compared to +6.9% in the third). This, plus a very sharp 16.4% rise in real imports, held down 4th quarter growth.

Table 3. Contributions to Fourth Quarter GDP

Factor	Contributed …	…By Rising
Personal Consumption	**2.29%**	**+3.2%**
Fixed Investment	**1.48**	**9.9**
(- by Businesses	*1.08*	*10.9)*
(- by Consumers	*0.40*	*7.9)*
Chg. in Inventories	**0.71**	**na**
Exports	**1.81**	**20.5**
Imports	**(2.14)**	**16.4**
Government Spending	**(0.01)**	**(0.1)**
Real GDP	**4.1%**	**4.1%**

Consumer spending – Its growth fell to a quite moderate 3.2% rate for the 4th quarter, as durable goods purchases flattened out because of declining auto sales. Disposable personal income grew at an annualized rate of only 1.5% during the 4th quarter, after rising at an 8.7% rate in the 3rd. When all reports are out, we'll see this weakness continued into the first quarter of 2004. This is because growth in real weekly earnings, by far the biggest component of personal income growth for most people, declined by 0.5% in the first quarter. Can't spend what you don't earn for long, unless savings rates go negative (i.e., net borrowing occurs) or tax rates keep falling.

Employment growth – Serial readers of "*Chartwell Review"* will recall we've been shaking our heads for some time about the following - payroll employment numbers were flat for 2003, and had *fallen* over the recent three years. But, total employment (based on household data) grew by 1.5%, or 2 million persons, in 2003, and had *risen* over the past 3 years. The only explanation seemed to be that 2 million delusional people thought they were employed, but weren't.

April's report of the March '04 employment situation provided another explanation - our government has simply got to do something about those old computers. Thus, nonfarm payroll employment was reported to have grown by a very large 308,000 persons in March, with January and February figures re-stated upward by 205,000. Yet, total employment measured by the household survey was flat, and the unemployment rate actually ticked up to 5.7%.

Having tracked this stuff for so long, I feel better knowing that at least 500,000 fewer people are no longer fooling themselves by going to the park each day and calling it work. More importantly, we think the quarter's employment reports, including March's, revealed little new information. Employment has been growing moderately for the past 18 months, and it continues to do so. Its growth rate may be poised to accelerate, but seeing is believing. What makes the topic important right now is this – market reaction, especially bond market reaction, to the March report was hugely negative. The feeling is that an improved labor market will allow (force?) the Federal Reserve to start raising the target Fed Funds interest rate.

Business spending – This is an important swing factor for GDP, and it has swung decidedly to the positive over the past two years. While business spending on structures remains moribund, each of the past 7 quarters have seen at least modest growth in spending for equipment and software. The past 3 quarters have each averaged double-digit real growth. Most economists say continued business spending growth is tied to favorable after-tax corporate profit growth, after inventory adjustments (got to make it, to spend it). Here the news remains favorable, with 4Q corporate profits again rising versus 3Q, and up 29.0% versus the year ago quarter.

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Our trade account and fiscal deficits – After what was a major currency realignment in 2003, the expectation was our monthly trade deficit would by now be moving in the "right" direction (down, indicating less dependence for current financing on foreign entities). Thus, investors were disappointed by the April report that February's total exports exceeded imports by $42.1 billion, down only marginally from January's all-time record deficit of $43.5bn, and up $3.5 billion from February 2003. In 2003, exports climbed $9.7b, or 11.7% year-over-year, but imports rose $13.2bn, or 10.9%.

The broadest measure of our international transactions, the current account deficit, gets reported with a lag. Thus, we learned in mid-March that our 4th quarter deficit was $127.5 billion, down from $135.3bn in the prior quarter, but resulting in another record full year deficit of $542 billion, up from $481bn in 2002. An increased 4th quarter's deficit on goods and services was offset by a large increase in the surplus on income (companies making more profits from their direct foreign investments).

The inflation picture – Anyone who eats, drives, heats their house, buys a house, goes to the doctor, or even the dry cleaner, knows that "anecdotal" inflation has been rather virulent the past year. As such, the first quarter's monthly reports of CPI were simply confirmation of our observations. The index rose 0.5%, 0.3%, and 0.5%, respectively, for Jan-Mar. This equates to a compound annualized rate for the quarter of 5.1%. Ironically, for the full year ended March '04, the CPI rose just 1.7%.

Combined with the aforementioned April 2nd jobs report, the April 14th CPI report sent the bond market into a tailspin. If jobs are plentiful and inflation is getting out of control, the Fed will really have to aggressively raise interest rates, won't they? Perhaps, but you probably ought to keep this factoid in mind - the annualized quarterly rate of inflation has peaked in either March or April of every year in the past decade. Last March, it spiked to a 7.5% annualized rate (largely due to oil and other commodity prices), only to moderate in the summer months. Maybe this time is different, because commodity prices around the world have risen so sharply again this year.

The Bond Market . . . Out in *Leftfield?*

(As we go to print, the 10-year Treasury bond has risen to a yield of 4.44%)

There have been two distinct market environments for domestic bonds in 2004. The first one, which extended into mid-March, saw risk-free interest rates smoothly retrace their 4th quarter's upward climb. The 2-year Treasury note declined more than 30bps, while the 10-year Treasury yield dropped 58bps, from 4.26% at year end, to 3.68% by March 14th.

All this helped lead to net investment gains each month this quarter for investors in government bonds. Further, with yields of the investment grade credit bond index falling in tandem, returns were even more attractive in that area. Only the mortgage sector, which is subject to "extension risk" as interest rates fall, lagged (see Table 4).

Table 4. Fixed Income Sector Returns

Periods ended March 31, 2004; indices are cap-weighted

Index (% of Aggregate)	**1Q04**	**1 Yr.**	**3 Yrs.**
Aggregate Bonds *(100%)*	**2.7**	**5.4**	**7.4**
US Gov't, all *(35%)*	2.9	4.2	7.1
- US Treas, long (6%)	*5.3*	*6.5*	*9.0*
Mortgages *(35%)*	1.9	4.1	6.4
Inv. Grade Credit *(26%)*	3.3	8.6	9.2
- "BBB" Bonds (11%)	*3.4*	*11.8*	*9.9*
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High Yield Bonds, all	2.2	22.2	8.3
- "B" Bonds	*2.0*	*20.3*	*8.1*
Global Bonds, Unhedged	1.9	13.5	12.6
Global Bonds, Hedged	2.0	2.7	5.1
Emerging Market Bonds	3.3	23.6	13.9

The second market environment arrived in late-March, and may be here for some time. It was fueled by continuing concerns regarding the external financing required of our "evil twin" deficits – fiscal and current account. It caught fire when February's extremely strong retail sales report was released (up 7.8% year/year), then ignited when the March jobs data hit the wires. Thus, we saw the 10-year bond's yield rise from 3.68% on March 16th, to 4.47% on April 20th. In the process, long-term bonds lost nearly 7% of market value, thereby wiping out their entire first quarter return. Diversified portfolios have done somewhat better.

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A few quarters ago we identified emerging market, non-Dollar foreign and diversified high yield portfolios, essentially the "plus" in core-plus, as strategically attractive fixed income sectors. This was a good call, with a mild let-up evident in the 1st quarter. But in the process, credit spreads may have narrowed too much. Junk bond spreads, and even investment grade credit spreads, are now close to historically narrow levels versus Treasury bonds. But, emerging market and non-Dollar bonds remain attractively priced relative to credit quality.

U.S. Equities . . . . *Tomorrow's* Choice?

(As we go to print, the S&P 500 index stands at 1124)

The S&P 500 index of companies started the quarter with a value of 1112, rose by 1.8% (including dividends) in January and 1.5% in February, only to decline by 1.5% in March. It ended the first quarter at 1126. Hardly the stuff of dreams or nightmares. Market technicians call numbers like these "range-bound". A quick look at Table 1 helps reveal why. We've been in the middle of a huge equity rally, and some investors are anxious to take profits.

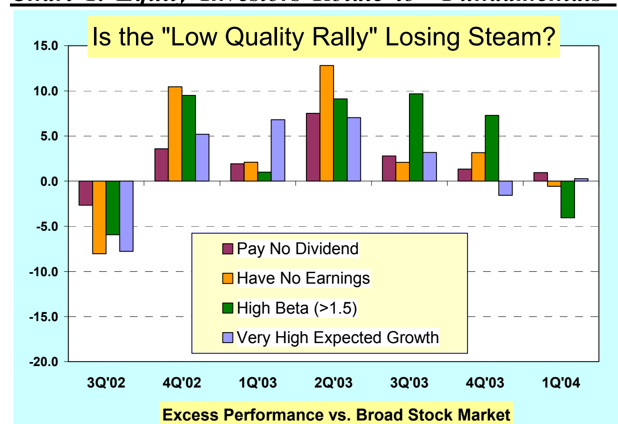
As we see from Table 5, there was much more to the domestic equity story last quarter than the S&P 500. The "market cap/style differential" was 7.2% for the three months. Of the two, "cap effect" (favoring *small*) was a much stronger positive than "style" (favoring *value*), which is consistent with the last 12 months' trends. However, over the three year period, style has been more important.

Table 5. Equity Returns by Style/Market Cap

Periods ended March 31, 2004; indices are cap-weighted	1Q04	1 Year	3 Years
Growth			
Large Cap	(0.3)	28.0	(3.3)
Mid Cap	4.8	49.7	5.0
Small Cap	5.6	63.1	5.4
Value			
Large Cap	2.0	36.3	1.2
Mid Cap	5.3	51.6	11.7
Small Cap	6.9	64.5	16.0

We've recently been tracking the performance of stocks with certain unambiguously risky characteristics, like no current earnings, a history of extreme share price volatility, and a current expectation of very high growth (realized high growth is great, of course, but projecting it is risky). In 2003, the most successful equity investors evidenced a notable risk preference. This makes sense if you expect a rising economic tide to lift some boats quicker than others. Chart 1 explores this theme for the first quarter of 2004. For the first time in more than a year, we saw real signs of a turn toward more traditional fundamentals.

Chart 1. Equity Investors Rotate to "Fundamentals"



Contrary to the fourth quarter, large-cap stocks in sectors highly sensitive to the economic cycle (technology, capital goods, raw materials, transportation, and consumer durables) retreated during the first quarter. For the most part these sectors had been at the front of the pack for many months, as the 1-year numbers in Table 6 attest.

Table 6. U.S. Equities – Selected Sector Performance

(Cap-weighted data; Vestek- 6,900 stocks)	S&P 500		Non S&P	
Sector *(% of S&P)*	**1Q04**	**1-Yr**	**1Q04**	**1-Yr**
Financial Srvcs *(21%)*	4.8	44.9	7.3	49.8
Technology *(17%)*	(2.9)	44.2	0.5	72.9
Health Care *(13%)*	(0.6)	12.9	8.1	72.5
Cons. Non-Durables *(9%)*	5.2	32.6	8.4	46.3
Retail *(7%)*	7.0	33.7	9.8	67.1
Utilities *(6%)*	5.1	34.0	3.6	50.4
Energy *(6%)*	5.2	31.5	9.4	41.7
Consumer Services *(5%)*	(3.1)	31.5	0.9	29.6
Business Srvcs *(3%)*	1.4	43.9	3.6	62.0
Capital Goods *(3%)*	1.0	65.5	2.9	65.4
Raw Materials *(2%)*	(2.5)	47.3	5.2	58.8
Transportation *(2%)*	(5.5)	21.3	(0.4)	50.2
Shelter *(1%)*	6.9	51.8	11.8	63.0
Consumer Durables (*1%*)	(4.0)	53.9	3.3	73.3
Universe	***1.7***	***35.1***	***5.8***	***56.8***

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Among the biggest economic sectors, large-cap health care stocks were again sharp underperformers, just as they were in 2003. Conversely, small-cap health care stocks advanced smartly in the quarter, as they did in 2003. The difference maker has been drug companies, with the 17 "big pharma" stocks in the S&P up only 10% the past year, and the 330 little pharma names up 84%.

International Investing . . . *Because*

International equities have not left investors out in left field during the past two years, but have kept them solidly on base. Their winning streak over domestic large cap equities continued in the first quarter, with EAFE turning in a 4.4% return. Emerging market equities continued to be the strongest sector of international investing, advancing 9.7% for the first quarter. Small cap stocks continued to outperform large caps, value stocks remained ahead of growth stocks and highly-valued tech stocks continued to lead the market's advance. International equity markets hit a peak mid-quarter, almost exactly one year after they hit bottom, but retreated in March.

Table 7. International Equity Markets

Cumulative % returns for the periods ended March 31, 2004

	1Q04		One Year	
	Return In US$	Change in Currency	Return In US$	Change in Currency
EAFE *(100%)*	**4.4%**	**0.3%**	**58.1%**	**14.0%**
- EAFE Growth	4.0	-	49.6	-
- EAFE Value	4.8	-	66.9	-
Europe *(67%)*	0.9	(0.8)	54.6	13.2
Pacific *(32%)*	12.8	2.5	66.0	15.3
- Japan *(22%)*	15.2	3.0	70.0	14.0
MSCI EMF	**9.7**	**2.0**	**82.3**	**7.5**

Data Source: Capital Guardian

Geopolitical events like the Madrid terrorist attacks and continued Middle East conflict may have overshadowed the broad optimism for a US-led global economic recovery. A mild "recovery" of the US$ against a number of currencies was a headwind to international markets during the quarter.

But that is not to say that nothing has changed internationally. The batting line-up has indeed been re-written. Europe is clearly behind the curve, while the Far East (including Japan, can you believe it?) is seeing some of the world's highest growth rates. In the quarter, the MSCI Europe index rose a mere 0.9% versus the MSCI Pacific index's 12.8% return. In Europe, growth prospects remain uncertain and should cause the ECB to consider cutting interest rates to spur on a recovery. Growth in the UK is currently ahead of Europe, and the Bank of England has already raised interest rates.

On the other side of the world, Japan appears to be in the midst of an economic recovery, driven by exports to China. In order for Japan's recovery to be sustainable, many feel Japanese consumers will have to step up to the plate and take some of the burden off the "export economy". Still, with a 15.2% return for the quarter, Japan was the third best performing developed country in the world (outpaced only by the very small Austrian and Finnish markets).

Emerging markets also saw some performance rotation. Last year's winners in the Far East (China, India and Thailand) struck out with negative results, while laggards (Mexico and South Korea) hit home runs. From a sector standpoint (Table 8), information technology, industrials and consumer discretionary were strong in both developed and emerging markets. Interestingly, these were poor performing sectors in the US. Conversely, energy and telecommunications were weak sectors in developed markets, but strong in the US and emerging markets.

Table 8. Int'l Equities - Sector Performance

MSCI Sector	1Q04	1-Year
Energy	0.2	38.7
Materials	0.7	64.4
Industrials	8.2	71.5
Consumer Discretionary	6.7	64.5
Consumer Staples	5.2	40.1
Health Care	(0.3)	37.3
Financials	4.4	72.6
Information Technology	12.5	81.6
Telecommunications	(0.1)	45.1
Utilities	7.1	44.8
MSCI EAFE	**4.4**	**58.1**

Data Source: Capital Guardian; Returns in US$

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Perspectives

Some thirty of this country's larger investment managers have been rung out by the mutual fund market timing and late trading "scandal". According to our math, these firms collectively manage over $1.5 trillion for clients, counting all product and distribution channels. If nothing else, the last six months should have served you notice that salesmanship has displaced stewardship as the most important consideration in many investment management boardrooms. Do you think it stops with just those 30 names? As a fiduciary, you can't rely on third parties to discharge your responsibilities. To help you gauge what those responsibilities might be, we recommend the following reading –

1. The Uniform Prudent Investor Act
   Introduced in 1994, this 23 page document serves as a drafting guide for the states as they enact their own versions into law. So far, 40 states have adopted a version of this.

2. "The Prudent Investor Act: A Guide to Understanding", by Scott Simon
   Definitive book of the topic

3. "Fiduciary Focus – Parts 1-4", by Scott Simon. Issued in MorningstarAdvisor.com

   A series of 4 highly readable articles, to get you started. You'll find copies of these on our website, at www.chartwellusa.com

As you review your asset mix, consider the long-term investment implications of our country's high twin deficits. While the daily trading implications might not be clear, we think the future *strategic* implications for investors are. These deficits place continuing downward pressure on the Dollar, upward pressure on interest rates, and, to a lesser extent, upward pressure on prices. You may need to re-evaluate your international market exposure;

The 40-year average yield spread between 2-year and 30-year Treasuries is 0.7%. The highest spread ever was 3.6%, hit last July. Right now it's a very wide 3.1%. Even if Fed Funds rise 2%, don't expect long bonds to follow suit in lockstep. **However**, the latest investment outlook of the CIO at the country's largest bond manager, Bill Gross of PIMCO, is entitled "Anything But Treasuries";

We continue to recommend investors keep above their international equity and international debt allocation targets, and strategically establish or increase emerging market allocations. The following table helps to shows why. Stocks may be reasonably priced across all developed markets, but they are especially so abroad;

Table 9. Global Valuation and Growth Forecasts

	U.S.A.	Europe	Japan	Emerg. Markets
P/E -2004	18.0	16.6	18.5	11.0
Growth - 2004	13.7	17.6	33.4	22.8
P/E - 2005	16.0	14.6	16.8	9.9
Growth -2005	12.2	13.9	9.9	11.6

Sources: JP Morgan, IBES, MSCI, Datastream

We said last quarter it would be unprecedented for the equity markets to simply rise month after month without correction, even in the middle of a roaring bull market. March's 4-5% intra-month correction was hardly a big deal. Expect more equity volatility;

Corporate sales volumes and margins are being favorably impacted by the current recovery. Corporate earnings have been much stronger than anticipated, and are poised to continue this trend for some time. While our tactical "overweight equities" call expired last quarter, we still recommend plans remain "vigilant re-balancers" in the event of any equity market weakness. Despite leads and lags, stock prices follow earnings.

The Entire "Who's On First" Line-up

1st base	*Who*
2nd "	*What*
3rd "	*I don't know*
Shortstop	*Darn*
Leftfield	*Why*
Centerfield	*Because*
Catcher	*Today*
Pitcher	*Tomorrow*

(the Rightfielder was never named!)

See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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