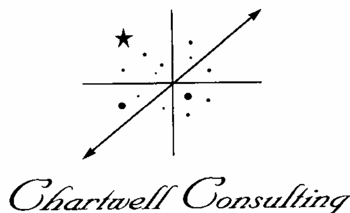
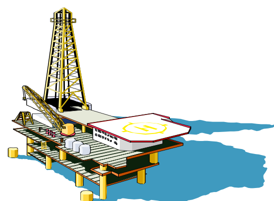


CHARTWELL REVIEW

April 2005 **FIRST QUARTER 2005** Volume XII, Issue No.1



TEXAS TEA

Oil, that is. Black Gold.

As we all are becoming increasingly conscious of, the spot price for a barrel of crude oil hit a record $58 during the first quarter and currently hovers around $54. This is 47% higher than just twelve months ago. Gasoline traded last week for $1.65/gallon on the Merc (wholesale; no taxes), up 42% from this time last year. It's all looking a bit out of control, and the primary investment markets reacted accordingly in the quarter (see at right).

So far, the economic impact has been less real than psychological. The Consumer Prices Index is only 3.1% higher than twelve months ago (more about this later), the economy grew at a 3.8% annual rate in the 4th quarter, and domestic corporate profits are still growing at low double-digit rates. Nonetheless, investment managers we interview are taking the energy "Fifth". It goes something like this – "Depending on future oil prices, we think the *(insert asset class descriptor here)* market will do . . . ." In effect, they're saying that since no one knows where oil prices are heading, don't blame them if your portfolio drops in value this year. It's no wonder portfolios have dropped in value so far this year.

The view from 36,000 feet (academia) has gotten pretty strident. It opines that "Higher energy prices spur inflation, leading the Fed to push up short-term interest rates. Rising inflation also dampens economic growth. Higher oil prices are an unambiguous negative for the stock market, because they raise production costs and leave customers with less to spend. Both undermine corporate earnings, which are the key to stock prices." A $20 trillion investment market completely summed up in one short paragraph. Amazing.

Table 1. Index Benchmarks

Market Index	Q1 2005	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	(2.2)	6.7	2.8	(3.2)	10.8
U.S. Large-cap Stocks	(2.6)	4.7	0.9	(5.6)	10.3
U.S. Mid-cap Stocks	(0.3)	14.1	10.5	5.5	13.4
U.S. Small-cap Stocks	(5.3)	5.4	8.1	4.0	10.4
International Stocks	(0.1)	15.5	12.1	(0.9)	5.7
T-bills (3 month)	0.6	1.6	1.4	2.6	3.9
1-3 Year Treasuries	(0.2)	(0.3)	2.8	4.6	5.3
Aggregate Bonds	(0.5)	1.2	6.0	7.1	7.1
High Yield Bonds	(1.5)	6.5	11.0	7.3	7.6
Global Bonds, ½ hedged	(0.8)	4.7	10.0	7.9	7.4
CPI, **annualized**	6.5	3.1	2.6	2.5	2.5
DJ Commodity Index	12.0	30.0	19.3	13.3	9.5

* Annualized trailing returns for periods ending 3/31/05.

Table 2. Average Fund Returns

Fund Category	Q1 2005	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	(2.4)	6.0	2.4	(2.5)	9.8
U.S. Mid-cap	(1.7)	9.0	6.7	1.1	11.7
U.S. Small-cap	(3.6)	6.9	8.2	5.8	12.3
International Lg. Cap	(0.3)	13.2	10.7	(0.4)	7.6
International Sm. Cap	3.4	19.7	21.4	4.8	12.2
Emerg. Mkt. Equity	1.2	16.2	17.9	4.7	5.9
Balanced/Hybrid	(0.8)	4.7	4.8	2.3	8.6
General Bond	(0.5)	1.1	5.9	6.7	6.8
Government Bond	(0.2)	1.0	4.9	6.0	6.2
High Yield Bond	(1.5)	6.4	9.8	5.4	6.4
Hedge Funds Universe	*(0.5)*	*5.3*	*8.1*	*6.3*	*11.6*

* Annualized trailing returns for periods ending 3/31/05.

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Asset Allocation

If our page one mini-rant sounds to you like whistling past the graveyard, you might be right. Oil and gas prices have doubled in 15 months, and this is now quite serious. As we have said before, sustained oil prices above $50/barrel will bite down hard on our economic growth. If anyone tells you that rising imported energy prices "are like a tax increase", they are understating the problem. Tax dollars collected get fully re-cycled here at home, although perhaps not very efficiently. Not so with imported energy. The nations which sell us oil and gas don't have to keep our Dollars. It's not like China or Japan, which recycle their trade surpluses into Treasury bonds to protect their future trade advantage. If the Dollar weakens, and the world clears oil trades in US$, Saudi Arabia just jacks up the price of oil (see 2004). What are we and China gonna do about it - import less?

So, we're mindful to not be Pollyannish, but it is fact that under 3% of domestic personal consumption spending is currently going to energy consumption costs, a number which has been steadily falling from 5% in 1977. And business expenditures on energy consumption are even less. The reason we're a bit cynical about the oil/inflation hype (headline counts with the I-word are at their highest level in more than seven years), is that it just might be oversimplifying the current issues faced by institutional investors. The logical conclusion from the academic argument is to just hold cash, certain supply-constrained hard commodities (oil, copper, etc.), and perhaps a portfolio of the shares of basic materials and energy companies. Not much prudent diversification there.

Instead, we still like the suggestions made in January: focus on being c*onservatively allocated and aggressively diversified.* Return potentials relative to risk potentials have come down for all equity and related asset classes. We think the best reaction to this is cumulative equity allocations **moderately below** your Plan's long-term target. By aggressive diversification, we mean staking out as many different exposures to return opportunities within each asset class as you find practical. For example, if they haven't already done so, we recommend Plans take a longer look at replacing some of their very traditional liquid market equity allocations with private equity or long/short exposure, and globally diversifying their fixed income portfolios.

Developments in the Economy

In late March, the final estimate of fourth quarter real GDP growth was left unchanged at +3.8%, resulting in a robust calendar year 2004 expansion rate of 4.4%. In nominal terms (before inflation was factored out), growth rebounded to 6.2%, up from a relatively low 5.5%.

The very preliminary "advance estimate" of this year's first quarter real GDP growth has now been released. It indicates a +3.1% annual rate, which is disappointingly lower than was expected. As we reported to you in January, the blue chip economists' forecast was for +3.5%. Table 3 compares the major line items affecting our economic growth over the past two quarters.

Table 3. Contributors to Recent GDP Growth

Factor	Contributed …		…By Rising	
Data is annualized *1st Qtr data is preliminary*	4th Qtr 2004	1st Qtr 2005	4th Qtr 2004	1st Qtr 2005
Personal Consumption	**2.9%**	**2.5%**	**4.2%**	**3.5%**
Fixed Investment	1.7	0.8	10.5	5.0
(- by Businesses	*1.5*	*0.5*	*14.5*	*4.7)*
(- by Consumers	*0.2*	*0.3*	*3.4*	*5.7)*
Chg. in Inventories	0.5	1.2	na	na
Exports	0.3	0.7	3.2	7.0
Imports	(1.7)	(2.2)	11.4	14.7
Government Spending	0.2	0.1	0.9	0.6
Real GDP Growth	**3.8%**	**3.1%**		
Gross Domestic Purchases Price Index, y/o/y			**+2.9%**	**+2.8%**

Personal consumption expenditures account for 70% of GDP, and thusly drive the bottom line number. These grew surprisingly in the 4th quarter, buoyed up by an unexpectedly sharp increase in disposable personal income (the big driver of which was an upward blip in dividend income). Consumer spending grew more moderately in the first quarter, but the picture could have been worse – disposable personal income is estimated to have declined in real terms for the quarter, for the first time since mid-2002. Consumers again needed to reduce their already low annualized savings rate to 0.5% in order to increase expenditures. For reference, Savings-to-DSP was just 1.2% in 2004, down steadily from 4.3% in 1998.

After government spending, ***private fixed investment*** *(business spending* on property, plant and equipment, plus *residential investment* for housing) accounts for the remaining bulk of economic activity. Growth rates for the latter have cooled off a bit in the past two quarters, but remain positive. The current running rate of residential investment has, as we can observe all around us, increased very considerably in the past 2+ years.

The key business stat is equipment and software spending. This accelerated throughout 2004, capped off by an 18% annualized increase in the fourth quarter. Unfortunately, the Q4 blow-off was directly related to an expiring tax credit provision.

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The first quarter saw considerably lower growth in this area, and, as a result, a much lower contribution to GDP growth. This moderation accounted for the entire shortfall in the first quarter's numbers versus the fourth. In effect, some of the 3.8% reported growth for Q4 was borrowed from Q1 because of the tax code.

Business inventories are estimated to have risen rather sharply in the first quarter. This added to the current calculation of GDP, but is very likely to subtract from it in the months ahead. Directly related to this are new orders for manufactured goods (i.e., future inventory), which have decreased for three consecutive months, January-March. That does not bode well for business contribution to 2nd quarter GDP.

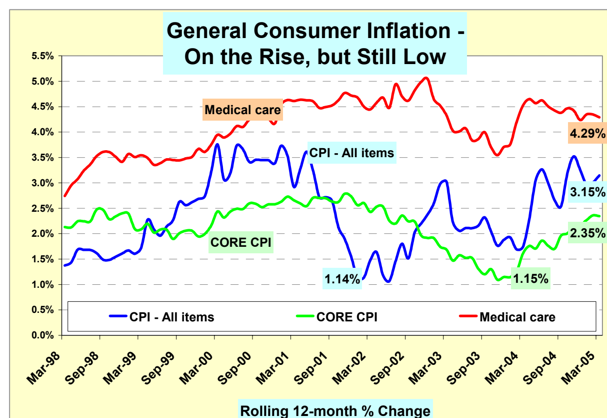
Employment levels in the first quarter reflected a similar pattern with last year's fourth quarter. Compared to December, only 345,000 more people were employed at the end of March (based on household survey data). This is a modest quarterly number, but the increase since March '04 was 2.1 million persons. The unemployment rate declined to 5.2%. Based on payroll data, an estimated 477,000 more people were employed at the end of the first quarter. We note that all of these figures are after what appears to have been significant "seasonal adjustment" assumptions. Without those assumptions, employment declined by 600-900,000 persons.

International trade, or net imports, reduced GDP growth by 1.5% in the first quarter. In essence, our economic growth was cut by 33% because of our international trade deficit. The current quarterly trade deficit is running at $175 billion, up from $166bn the prior quarter and just $137bn for the same period one year ago. This is not all oil related. Only half of the increase was accounted for by *industrial supplies and materials*, the category which includes petroleum.

The Inflation Picture – The all items' Consumer Price Index was up 1.6% in the first quarter. This is a 6.5% annualized rate, giving rise to much hand-wringing and grinding of teeth. Before you get on that ledge, recall the 2004 first quarter figure was also 1.6%, but the full year's rate was 3.1%. The 1Q200*3* figure was 1.8%, but the full year was only 1.9%. There is a clear upward bias to each year's first quarter numbers, which has been the "worst" quarter in 14 of the last 16 years. That said, there's no doubt consumer prices are on the rise from low levels, as the following graph captures. And, it's not just due to energy prices. The Core CPI rate - which excludes the impact of food and energy price increases - is more than 1% higher than it was just one year ago.

Prices for all imports rose at nearly a 14% rate in the first quarter, after being flat in the fourth quarter. On the positive side, non-petroleum import prices rose at just a 2.8% rate, but overall export prices rose at a 6.5% rate.

Chart 1. Inflation on the Rise



Monetary Policy - The Federal Reserve Governors twice raised the target Fed Funds rate by 25bps during the quarter, to 2.75%. They continued to indicate a need to raise short term interest rates "at a pace sufficient to keep inflation expectations at a low level". Depending on which manager you ask, the market is currently projecting a year-end Fed Funds rate between 3.5-4.5%. For what it's worth, we don't see the higher figure unless economic growth is robust during the next six months. Yet, the economic signs are pointing the other way.

The Bond Market – Not a Gusher

Almost all sectors of the bond market were weak in the first quarter (see Table 4). The foreign developed markets provided a positive return, but only if you hedged away the currency exposure. Short-term bonds were weak throughout the first quarter, again reflecting yield increases precipitated by the two bumps in the Fed Funds rate. Longer-term Treasuries flipped from a January rally to losses the remainder of the quarter. Ultimately, market yield of the bellweather 10-year Treasury rose from 4.22% at December's close to nearly 4.5% at the end of the first quarter. Mortgage-backed securities, with their lower duration, fared best of the domestic sectors.

The trigger for this shift seemed to have been Greenspan's mid-quarter remark that it was "a conundrum" and "utterly unprecedented" for long-term rates to fall as the Fed was pushing short-term rates higher (Fed Funds have been raised by 1.75% in the past year). Notwithstanding Greenspan's comments, the spread between the 2-year and 10-year Treasury yields dropped a further 45bps in the quarter, to 0.70%. One year ago, the spread was over 3.0%.

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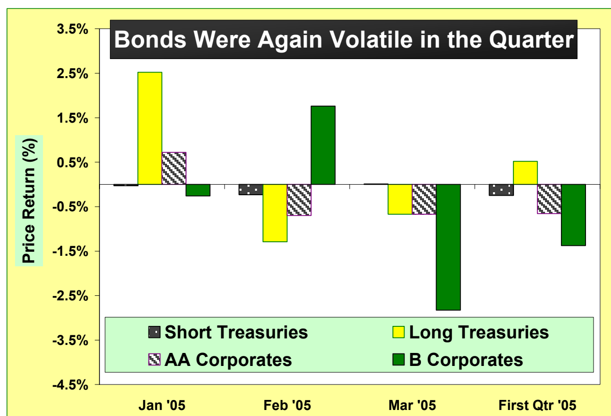
Chart 2. Bond Return Volatility in the 1st Quarter



As Chart 2 reflects, fixed income investors rejected higher credit risk in January, embraced it in February, and fled from it in March. When the dust had settled, lower-rated credit bonds underperformed higher-rated. This was a partial reversal of the very strong trends we experienced the prior two years, during which time yield-starved investors had been readily accepting credit risk in return for yield. A major credit event occurred in March with GM bonds, which went into a freefall and dragged the entire credit universe downward. Even so, investment grade corporate bonds still yield less than 1% in excess of similar maturity Treasuries, with the high yield index yielding just 3.4% over the 10-year.

Table 4. Fixed Income Sector Returns

periods ended March 31, 2005; indices are cap-weighted

Index	1Q '05	1 Yr.	2 Yrs.
Aggregate Bonds	**(0.5)**	**1.2**	**3.3**
US Gov't, all	(0.4)	0.1	1.6
- US Treas, short	*(0.2)*	*(0.3)*	*1.0*
Mortgages	(0.1)	2.6	3.3
Inv. Grade Credit	(1.0)	0.8	4.7
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High Yield Bonds, all	(1.5)	6.5	14.2
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Global Bonds, Unhedged	(2.6)	5.5	9.5
Global Bonds, Hedged	0.9	3.8	3.2
Emerging Market Bonds	(1.2)	6.9	15.0

As April drew to a close, rising bond prices have reduced yields to maturity of 2-year Treasuries to just 3.6%, and have reduced yields on the 10-year by an even greater amount, to just below 4.2%. With the Fed Funds rate set to rise to 3.0% on May 3rd, the increasingly flat yield curve is telling us that at least bond investors don't find much to fear in Greenspan's "conundrum".

U.S. Equities Drill a Dry Hole

Last year's post-election rally saw the broad S&P 500 index rise from 1103.3 in mid-October, to 1212 as the year ended. The first quarter's stock market seemed intent on reversing all of the fourth quarter's gain.

The market started January in a significant selling (profit-taking) mode, reversed itself briefly in February as stronger than expected (again) reported fourth quarter corporate earnings were too compelling to ignore, only to suffer through a difficult March in reaction to rising interest rates. The S&P prices index dropped to 1180.6 at quarter's end, which worked out to a total return of (2.15)% after dividends. April has seen a continuation of the negative trend, as the index dipped below 1140 before a late month rebound. The feature of April which most concerns us, other than the obvious disappointment of falling equity prices, is that they've occurred in an environment of falling interest rates and stronger than expected (again) first quarter corporate earnings growth.

Table 5. U.S. Equity Returns by Style/Market Cap

periods ended 3/31/05; indices are cap-weighted

	Trailing Returns			
	1Q '05	1 Year	2-Years	3-Years
Growth				
Largest Cap	(4.9)	(1.1)	12.5	(2.6)
Mid Cap	(1.7)	8.3	27.3	6.2
Small Cap	(6.8)	0.9	28.3	4.0
All-cap/style	*(2.2)*	*7.1*	*21.7*	*3.7*
Value				
Largest Cap	(0.2)	10.9	23.0	4.6
Mid Cap	0.8	18.3	33.9	13.0
Small Cap	(4.0)	9.8	34.4	11.5

Investment style played a more important role in the first quarter than it did in the fourth. This is consistent with general trends we've seen during the last three years. Specifically, investors clearly favored value-biased stocks over growth, which is also consistent with what we've been seeing. Yet, the growth/value return gap is nowhere close to that which we observed exactly five years ago. Then, the minimum 3-year style differential was 16% *annualized*, in favor of Large Growth over Large Value. Times change.

That the quarter's falling tide hit small-cap stocks the hardest was hardly surprising. What catches our eye is how well mid-cap stocks continued to perform relative to the other size buckets. The sector has been something of a sweet spot, with demand coming from both large-cap and small-cap managers.

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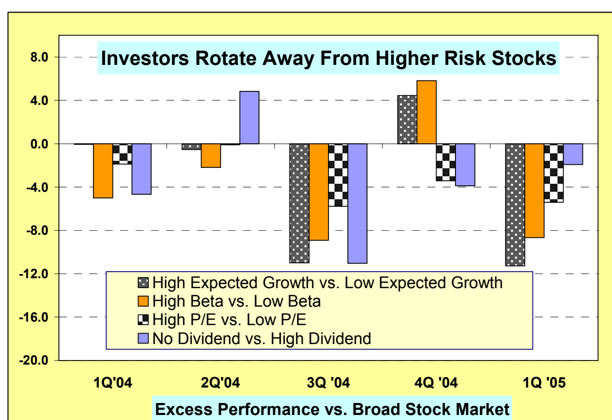
This recent midcap dominance has been driven in largest part by specific differences in the company list comprising each size sector, rather than the broad attributes of midcap stocks. The midcap indices' relative performance was helped in Q1 by what's not in them, like small banks or certain large-cap "torpedo" stocks.

Chart 3 provides a detailed explanation for why value-biased portfolios have outpointed growth accounts, both in the last quarter and past year. Except for last year's "relief" rally late in the fourth quarter (more investors being Republican than Democrat), investors have clearly favored low beta, lower P/E stocks with valuations that are not built on the expectation of very high future growth rates. Investors want their earnings now, and they'd like a fair chunk of it in dividends.

Chart 3. Investors Are Favoring Lower Risk Stocks



The energy sector's worst place finish in the fourth quarter proved to simply be a buying opportunity. Investors and their managers might have seen last Fall's drop in crude oil prices as a rationale to realize some capital gains after the sector's big run-up, but they would have been much better served to be more patient. As even a quick glance at Table 6 will confirm, one really needed to be sizably invested in energy, basic materials, and utility stocks during the first quarter to have much chance of producing positive returns. Beyond that, just two classically "defensive growth" sectors – consumer staples and health care, performed reasonably well for large-cap and mid-cap investors.

If we take the hugely important, but very low market cap, autos & transports out of the equation, the primary drivers of weak investor returns for the quarter were investments in financial services and technology. Financial services stocks account for a large proportion of both the large-cap and small-cap indices, which helps explain their weakness. Technology still accounts for a very large portion of all growth indices.

Table 6. U.S. Equities – 1st Quarter Sector Performance

Sector	Large Cap (R1000)	Mid Cap (RMid)	Small Cap (R2000)
Integrated Oils	17.7%	29.1%	3.1%
Other Energy	19.1	19.8	12.9
Materials & Processing	2.2	4.3	(1.6)
Consumer Staples	1.3	1.1	0.1
Health Care	(0.1)	2.2	(9.6)
Russell Midcap index		**(0.3)**	
Utilities	(0.6)	4.2	1.4
Producer Durables	(1.4)	(2.2)	(6.6)
Russell 1000 index	**(1.9)**		
Consumer Discretionary	(4.3)	(0.4)	(1.6)
Russell 2000			**(5.3)**
Financial Services	(6.1)	(5.4)	(8.3)
Technology	(7.1)	(7.2)	(12.0)
Autos & Transportation	(8.5)	(4.2)	(10.3)

Unlike the fourth quarter, winning industries were few and far between. Of the 70 industry groups we look at, only **21** enjoyed a quarterly return above 0%. Of these, just 5 non-energy or utility industries returned more than 4%. They were aircraft, railroads, cosmetics, hospital supply, and retail food stores.

International Stocks Pump Out Better Returns

First quarter international equity returns were a far cry from the stellar double-digit results of the fourth quarter, but again landed ahead of domestic equity markets. Developed and emerging country stock markets performed well in January and February, only to drop sharply in March. A number of factors unsettled non-U.S. markets toward the end of the first quarter: oil reaching $58 per barrel, higher interest rates in the US and signs of slowing economic growth in the Eurozone. To these, subtract the currency effect of the US$ posting modest gains against most foreign currencies.

Table 7. International Equity Markets

	1st Qtr 2005 % Return In Local	1st Qtr 2005 % Return In US$	Year 2004 % Return In US$
MSCI EAFE	**3.4%**	**(0.1)%**	**20.7**
- EAFE Growth		(0.8)	16.5
- EAFE Value		0.6	24.9
Europe	4.1	0.5	21.4
Pacific	1.9	(1.5)	19.3
Japan	2.0	(2.3)	16.0
Emerging Mkts	**3.0**	**1.8**	**26.0**

periods ended March 31, 2005; indices are cap-weighted

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Non-U.S. equity markets turned in mixed, but generally positive, results in the quarter. The United States ranked just 28th out of 34 world equity markets. European markets rose a very respectable 4.1%, although currency depreciation knocked the US$ return to a modest 0.5%. Conversely, Japan's modest 2.0% advance was converted into a loss by currency effects. The top developed country markets were Denmark, Norway, and Canada. The worst was Ireland.

Within the developed countries, energy, basic materials and industrial companies enjoyed the best stock market performance. Financial services and technology stocks were the laggards (same as in the States).

Table 8. International Equities - Sector Performance

MSCI Sector	% of EAFE	Developed Markets: 1st Qtr 2005 (% return)	Developed Markets: Year 2004 (% return)
Energy	*8.6%*	7.3%	24.8%
Materials	*7.4*	3.7	21.4
Industrials	*9.9*	3.0	22.5
Consumer Staples	*8.1*	1.7	18.4
MSCI EAFE		**(0.1)**	**20.7**
Utilities	*2.3*	(0.2)	34.4
Consumer Disc.	*12.5*	(0.8)	18.3
Financial Services	*27.4*	(1.4)	24.1
Health Care	*7.8*	(1.7)	14.6
Telecom Services	*7.2*	(4.6)	19.1
Information Tech	*5.9*	(6.0)	6.9

data Source: Capital Guardian; returns in US$

Volatility continued to thrive in emerging markets, and it was easy to get a little burnt chasing the sector. After posting two very strong months of performance, emerging markets fell 6.6% in March. Nonetheless, emerging markets were still the quarter's strongest performing equity market segment, posting a +1.8% advance *after* currency effects. Once again, location mattered. Select Eastern European and Far Eastern markets posted strong gains, with South Korea(+11%), Philippines(+8%), and Indonesia(+6.8%) all doing quite well. Latin American markets cooled off after last year's strong showing. The very narrow Venezuelan market fared worse, declining 14%. Ironically the natural resource-rich South African market declined 9%.

Energy stocks were the top emerging markets performers, with telecommunications services and consumer discretionary stocks at the back of the pack.

Style Fatigue

This term was coined by a plan sponsor, as she attempted to convey the impact of hearing one too many presentations explaining why a particular part of her plan's investment mix didn't do well because of the asset class niche it was invested in, or the specific investment discipline being consistently pursued by an active manager. Style fatigue increases whenever value- or growth-biased investment benchmarks underperform the other for an extended period. It reaches its peak when these large performance differentials also coincide with generally weak absolute returns.

For example, international value stocks have been outperforming growth stocks for the past 5 years. In the past quarter, the EAFE Value index was up 0.6% versus the EAFE Growth index result of (0.8)%. During the past sixty months, the rolling 3-month return of the Growth index has exceeded the Value on only 13 occasions. The 5-year annualized return differential is a nearly unprecedented 10.8% (+4.6% versus –6.2%). Going back to February 2000, the height of the "growth stock bubble", the 5-year return differential between EAFE Growth and Value was only 2.2%, in favor of Growth.

Right now, style fatigue is extremely high with regard to U.S. large-cap stocks (S&P 500 or Russell 200). The entire sector has provided negative returns over the past three and five years, so every investor is intently focused on the area. Rolling 3-month returns for Growth have exceeded Value in only 20 of the past 60 months, and the last time you could walk into a meeting and report that long-term trailing Growth returns exceeded those of Value was 4 years ago! Finally, the current 5-year trailing differential favors Value to an unprecedented extent. Perhaps it's finally time to admit our "mistakes" and sell all the growth stocks. We were in a similar situation in February 2001. Only, we were ready to sell our value stock mistakes, having become fatigued from observing Growth's dominant long-term trailing returns vs. Value for every quarter-end since early 1996!

A certain amount of style fatigue might be unavoidable, and the past decade has certainly been remarkable for the extent of the pain. There are viable plan management alternatives one can explore to reduce, or even eliminate, the syndrome. The key, we think, is to systematically evaluate each source of the fatigue, what the general implications for action are, and how those might best be applied to your specific situation.

See you next quarter!

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

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