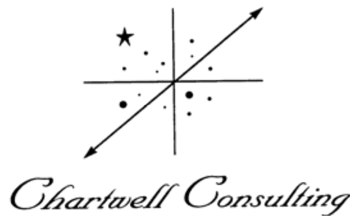

CHARTWELL REVIEW

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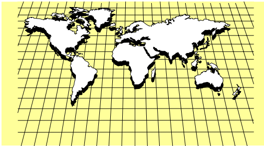

The World is (getting) Flat

Our apologies to Thomas L. Friedman, who (literally) wrote the book on this quarter's theme. What he says he meant is that the playing field is being leveled. Several technological and political forces have converged, producing a global, Web-enabled playing field that allows for multiple forms of collaboration without regard to geography or distance - Globalization 3.0.

What we mean is that this has been accompanied, even facilitated, by a robust increase in the free flow of financial capital across nation-state boundaries – for both long-term investment and short-term speculative purposes. Being able to walk around Minneapolis and Riyadh with a cell phone/PDA where you can have all of Google in your pocket clearly makes the world a small place. So does being able to buy $50mm of a new local currency Polish corporate bond issue from your trading desk in Kansas City.

The current global economic expansion is extraordinarily broad. According to a presentation given by Alan Greenspan in late April, in 2005 *every* major country in the world (developed or emerging) reported increased economic activity from the prior year. Aided by the same technological forces Friedman writes about, and largely unimpeded by capital control regulations (most countries wanting to get their share of the good stuff), liquidity has generally been able to seek its own level. Cross-border equity flows (as a % of World market cap) are at their highest levels in more than 20 years. The result has been a significant re-alignment of investment returns. Five years ago, the 5-year trailing return of the S&P was 14.5%, while that of International Stocks was only 3.7%. Check out the tables at right for where the opportunities have apparently been over the last 5 years.

What will these tables look like in 3-5 years?

Table 1. Index Benchmarks

Market Index	Q1 2006	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	4.2	11.7	17.2	4.0	9.0
U.S. Large-cap Stocks	3.2	9.9	14.9	2.1	8.1
U.S. Mid-cap Stocks	7.6	21.5	27.9	12.5	12.7
U.S. Small-cap Stocks	13.9	25.9	29.5	12.6	10.2
International Stocks	9.5	24.9	31.7	10.0	6.8
T-bills (3 month)	1.0	3.2	1.9	2.1	3.7
1-3 Year Treasuries	0.4	2.3	1.4	3.2	4.8
Aggregate Bonds	(0.6)	2.3	2.9	5.1	6.3
High Yield Bonds	2.8	6.5	11.6	8.1	6.8
Global Bonds, ½ hedged	(0.7)	(1.0)	3.9	6.0	6.0
CPI, annualized	1.6	3.5	2.8	2.6	2.5
DJ Commodity Index	(2.4)	5.7	15.9	11.8	7.9

* Annualized trailing returns for periods ending 3/31/06.

Table 2. Average Mutual Fund Returns

Fund Category	Q1 2006	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	4.2	13.6	17.7	5.1	8.5
U.S. Mid-cap	7.8	21.1	25.2	9.6	11.0
U.S. Small-cap	12.3	24.6	28.9	13.2	11.9
International Lg. Cap	9.9	26.9	31.0	10.3	8.5
International Sm. Cap	12.8	34.6	41.7	18.9	13.7
Emerg. Mkt. Equity	12.7	44.9	44.2	22.3	8.0
Balanced/Hybrid	3.3	10.1	13.0	5.6	7.8
General Bond	(0.4)	2.4	3.8	5.3	6.0
Government Bond	(1.0)	2.0	2.4	4.5	5.8
High Yield Bond	2.6	7.0	11.0	7.1	5.8
Hedge Funds - Broad	*6.0*	*14.6*	*14.3*	*9.1*	*11.2*

* Annualized trailing returns for periods ending 3/31/06.

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The Domestic Economy – not flat yet

You may recall that real GDP advanced at a surprisingly low annual rate of just 1.7% in the 4th quarter, after absorbing the effects of last year's deadly hurricane season. The government has just released its initial estimate of 1st quarter GDP growth, preliminarily indicating a very healthy 4.8% annualized advance in real terms (8.2% before adjusting for inflation). Much stronger growth in personal spending (especially for durable goods), business fixed investment in equipment and software, exports of goods, and federal government spending accounted for the good quarter. Import growth and business inventory management held growth back. Table 3 details the major contributing factors.

Table 3. Contributions to First Quarter GDP

Factor	Contributed …	…By Rising
Personal Consumption	**3.8%**	**5.5%**
Fixed Investment	**1.1**	**6.5**
(- by Businesses	*1.5*	*14.3)*
(- by Consumers	*0.2*	*2.6)*
(- Change in Inventories	*(0.5)*	*??)*
Exports	**1.2**	**12.1**
Imports	**(2.0)**	**13.0**
Government Spending	**0.7**	**3.9**
Real GDP Growth	**4.8%**	
Gross Domestic Purchases Price Deflator		***2.7%***

- Last quarter, it appeared consumers simply stopped buying cars and appliances once gasoline hit $3.00/gl. Instead, it seems they just deferred their purchases. Consumer durable goods spending in the first quarter jumped 21% (annualized rate);
- Disposable personal income increased 3.8% (annualized), versus the 4th quarter's 6.7% rebound in the aftermath of hurricanes Katrina and Rita;
- Total personal outlays again increased even faster than disposal income. As a result, personal savings was increasingly negative in the 1st quarter;
- In an expected turnaround from the 4th quarter, businesses decreased inventories. But, they didn't do so nearly as much as seasonal factors would have led one to expect. This is interpreted as a positive;
- Both imports and exports increased sharply in the 1st quarter. But, the gap is now so large that exports need to increase almost twice as fast as imports in order to have just a neutral impact on economic growth;
- Finally, Federal government defense spending resumed it double-digit growth path, after having declined in the 4th quarter. Nondefense spending rose by 11.7% for the second consecutive quarter.

A few other observations about the current economy that might be useful in shaping our investment thinking -

Employment levels in the 1st quarter increased at a faster pace than previous experience. On a seasonally adjusted basis (very important for the first quarter), household survey data indicates total employment rose 862,000 (nonfarm payrolls rose just 590,000). The unemployment rate declined from 4.9% to 4.7%. It was 5.1% a year ago. Overall employment levels increased by a little over 3.0 million persons during the last 12 months (nonfarm payrolls have increased 2.1 million);

Inflation expectations increased during the quarter. For the first three months of 2006, consumer prices increased at a seasonally adjusted annual rate of 4.3%. This compared unfavorably with an increase of 3.4% for all of 2005. "Core" CPI (excludes food and energy) rose at a 2.8% annualized rate, following a 2.2% increase in all of 2005. Producer prices for finished goods (PPI) *fell* during the 1st quarter, following a 5.4% increase last year. But, much of the decline had to do with energy price volatility. Prices for "core" finished goods rose at a 3.1% annual rate, after being flat in 2005;

Industrial Production rose at an annual rate of 4.5% in the 1st quarter, and is 3.6% above its year earlier levels. Capacity utilization for total industry moved up to 81.3% in March, well above the 2001-2 low of 74%. The long-term average is 81.0%, and the recent high was 85% in 1994-95. Increased production from current levels may be less efficient, placing pressure on margins and spurring increased investment in new capacity;

Compensation Costs for employers rose only 0.6% in the first quarter, despite robust economic growth and rising employment. This was the slowest quarterly gain in nearly seven years, and followed a 0.8% advance in the fourth quarter. Wage and salary growth was unchanged at +0.7% in the first quarter, and pay scales are only 2.7% higher than a year ago. That is considerably less than the rise in overall consumer prices over the same timeframe;

Monetary policy - The Federal Reserve Governors twice raised the target Fed Funds interest rate during the quarter, to 4.75%. They are expected to do so again in late May, to 5.0%. Our bet is they then may take a time out, after having moved short-term interest rates up 4% in just short of two years' time. The markets generally see things the same way, ascribing a less than 40% probability to another rate hike in June.

More importantly, the past quarter saw the retirement of Alan Greenspan as Chairman of the Fed after almost 19 years in the position. His replacement, Ben Bernanke, has enormous shoes to fill. That this transition occurred with such little market impact is a testament to how benign the capital market environment has become.

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The Bond Market – flat on its back, for now

The first quarter saw one weak month, one mediocre month, and one very weak month for bonds. The result was the worst quarter since, well, just last Spring. It's been a pretty rocky stretch for investment grade bondholders the past two years – even after taking into account "Greenspan's conundrum" (short rates rise sharply higher, but long rates move hardly at all).

Table 4. Bond Market Returns

periods ended March 31, 2006;

Bond Index	1Q '06	Trailing Returns 1 Year	3 Years
Aggregate Bonds	**(0.7)%**	**2.3%**	**2.9%**
US Gov't, all	(0.9)	2.1	2.2
US Treas, long	*(3.6)*	*2.1*	*3.8*
Mortgages	(0.1)	2.7	3.1
Inv. Grade Credit	(1.2)	1.8	3.7
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High Yield Credit	2.9	7.2	11.9
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Global, Unhedged	(0.4)	(4.6)	4.4
Global, Hedged	(0.9)	3.1	3.2
Emerging Markets	1.7	15.2	15.0

March was a particularly difficult month for traditional "core" bond portfolios. All broad sectors lost 1% or more *after* taking coupon income into account, with long-term paper hit particularly hard. The driving factor was an upward shift in the yield curve. The bellwether 30-year Treasury bond lost over 6% in market value during March, as its yield rose from 4.50% to 4.90%. The 10-year Treasury bond declined 2.4%, as its yield rose to 4.85%. The yield curve (3mo-to-30yr) ended March with a +27bps upward slope, compared to a -20bps inversion at the end of January. This pattern has continued into April, with long bond yields rising to over 5.1%.

For all the recent yield curve machinations, absolute interest rate levels have been fairly range-bound over the past year. In such an environment, mortgage-backed securities are generally regarded as an attractive source of spread income, and such was the case in the first quarter. The sector could not avoid March's carnage, but the quarter's returns outperformed those from straight bonds.

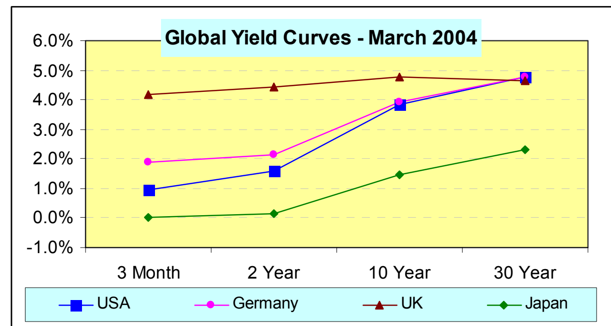
Credit spreads in the investment grade market widened out modestly during the quarter. There appeared to be a flight to quality, with AAA paper outperforming A and BBB bonds. Instead, returns were dominated by interest rate sensitivity, and the index composite of BBB bonds has a much longer duration than AAA's (i.e., is much more negatively affected by rising interest rates).

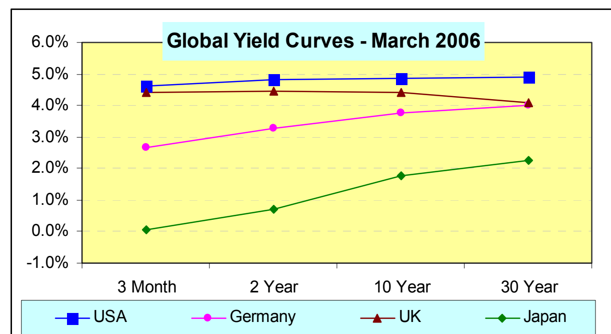
Where it gets interesting (pun intended, I guess) is in the high yield corporate sector. It was yet another blowout quarter, as Table 4 reveals. Digging deeper, we learn that highly speculative C and D-rated bonds (not on death's door, but close) did spectacularly well in the quarter (+12.5%), followed in order of success by CCC, B, and BB-rated bonds. In this economic environment there are very few C and D bonds out there, because corporate financials are quite healthy. Thus, short-term returns are largely a function of supply/demand bottlenecks.

It fascinates us that high yield returns for the past quarter, the past year and the past three-years show a perfect inverse correlation with credit quality. It's been a "take more credit risk, receive higher net returns" environment.

The following charts explore the gross yield curve shifts which have occurred among the world's largest bond issuers, since the eve of the Fed's tightening phase (Spring 2004) to today. Japan has been in another world, with its deflationary economy and quantitative easing policy. Rates in Germany and the U.K. have shifted up at the short-end and considerably down at the back-end. This has produced capital gains, leading to outperformance compared to US bonds. But, recent currency effects have overwhelmed these rather subtle shifts (see table 4). The past year has seen the Dollar rally against the other "majors", with the prior two years a completely different story. These yield curves suggest to us that currency movements will continue to dominate global fixed income returns as we move through 2006.

Charts 1 & 2. Global Yield Curves: 2004 and 2006





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U.S. Equity Markets - "Boo-Yah"

The domestic stock market began 2006 with a bang in January. Small-cap names in particular had a fabulous month. February was flat-to-down for our stock market, as investors came to grips with the inverted yield curve (historically a precursor of weak economic activity), Greenspan's departure, and rising oil prices (the current "go to" explanation for everything financial). Matters sorted themselves out in March, as the quarter's strong economic rebound came into focus and analysts re-affirmed their optimistic views of corporate profitability.

Table 5. U.S. Equity Market Returns

periods ended March 31, 2006;

	Trailing Returns		
	1Q '06	**1-Year**	**3-Years**
Growth			
Large Cap	1.4%	9.6%	14.9%
Mid Cap	7.6	22.7	25.8
Small Cap	14.4	27.8	28.1
Value			
Large Cap	5.2	10.3	18.6
Mid Cap	7.7	20.3	29.2
Small Cap	13.5	23.7	30.7

We had expected market optimism to visit itself most squarely on large-cap growth stocks, but this was not the case. The market's 100 largest growth stocks simply didn't attract much interest during the January rally and, as we see in Table 5, lagged rather badly for the quarter. However, if we lower our sights to mid-cap and small-cap stocks, we see exactly the phenomena we anticipated. For the first time in many years, the last 12 month period has seen better returns from "growth" stocks compared to those considered "value", except among the market's very largest stocks.

Table 6. U.S. Equity Market P/E Ratios

periods ended March 31, 2006;

	Price/Earnings Ratios		
	1Q '06	**1Q '04**	**2Q '02**
Growth			
Large Cap	21.5x	25.0x	26.2x
Mid Cap	22.6	25.2	26.5
Small Cap	24.6	25.1	22.3
Value			
Large Cap	14.9x	16.3x	23.4x
Mid Cap	17.2	17.2	17.7
Small Cap	19.1	19.6	17.7

Table 5 sets out recent trailing returns from each market sector (by size/style), while Table 6 looks at what has happened to the relative value of each of size/style sector. We start with the bottom of the bear market (June 2002), when stocks prices were compressed and trailing earnings had just started to turn upward. In that environment, we'd expect PE's to be comparatively low. They were, but only when viewed against bubble valuations. Fast forward to today, after a 14-quarter (and counting) bull market. One would expect current market P/E's to be a bit elevated, but that is simply not the case. Instead, P/E's are lower than in mid-2002, except for small-cap stocks. In a nutshell, domestic corporate earnings have risen faster than domestic stock prices, especially in the large-cap sector.

The top performing economic sector of the S&P 500 during the first quarter was telecommunication services, as Table 7 indicates. But, telecom services is a very small sector in both the large-cap and small-cap space, so its contribution to index returns was modest. Among large cap stocks, strong returns in the larger industrials and energy sectors contributed most significantly to the quarter's returns. The largest sector, financial services, was moderately weak, as were health care and consumer staples companies. Only the large-cap utility sector did not enjoy at least some success. The very strong small-cap space was led higher by industrials and information technology shares, although materials companies (of which there are not that many) took overall return honors. Small-cap utility shares advanced less than any other sector.

Table 7. First Quarter Sector Performance

Sector	**Large-caps (S&P 500)**		**Small-caps (Russell 2000)**	
	Return %	Contribution %	Return %	Contribution %
Industrials	7.0%	**0.8%**	19.0%	**2.9%**
Energy	9.0	**0.8**	12.0	0.8
Financials	3.3	0.7	9.9	2.1
Info Tech	4.1	0.6	17.5	**3.3**
Telecom Srvcs	**14.5**	0.4	25.2	0.3
Consumer Disc.	3.2	0.3	9.7	1.4
Materials	7.4	0.2	**28.5**	1.3
Consumer Staples	1.6	0.2	11.8	0.3
Health Care	1.3	0.2	10.7	1.4
Utilities	(1.2)	(0.0)	6.0	0.2
S&P 500	4.2%	4.2%		
Russell 2000			13.9%	13.9%

From the "who woulda thunk it" department – Since the fall of 2002 (beginning of our bull market), the S&P 500 stock index is up 59%. There are only four country markets which have performed <u>worse</u> during that period – Malaysia, Botswana, Slovenia, and mainland China (excludes Hong Kong).

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International Equities - anything but flat

International equities had a good *year* in the first quarter, or so the saying goes. The broad developed markets index (MSCI EAFE) was up 9.5%, the broad emerging markets index (MSCI EMF) advanced 12.1% and the newly minted BRIC index (**B**razil, **R**ussia, **I**ndia, **C**hina), which is a big part of the EMF, was up 23%.

Table 8. International Equity Markets

	Local Currency Return %		U.S. Dollar Return %	
	1st Qtr 2006	Year 2005	1st Qtr 2006	Year 2005
MSCI EAFE	**8.3%**	**29.5%**	**9.5%**	**14.0%**
- Int'l Growth			*9.1*	*14.6*
- Int'l Value			*9.9*	*15.1*
- Europe	8.8	25.5	10.8	9.9
- Pacific, ex-Japan	8.6	38.1	6.7	23.0
- Japan	6.8	44.7	6.8	25.6
- Germany	11.0	27.4	13.9	10.2
- United Kingdom	7.2	20.1	8.3	7.4
- Canada	8.4	25.6	8.5	28.9
EAFE Small Cap			**10.7**	**26.2**
Emerging Mkts	**9.7**	**35.8**	**12.1**	**34.5**
- EM Asia	7.1	28.7	9.7	27.5
- EM Europe	16.5	52.6	17.3	45.2
- EM Latin America	12.2	38.0	15.7	50.4

Three major global trends are providing the foundation for a positive environment for international stocks: a favorable economic climate, lack of inflationary pressure and accelerating merger and acquisition activity. Currency provided a slightly positive translation effect for US investors, as the US$ declined approximately 1.1% versus a basket of EAFE currencies during the quarter. All 10 MSCI sectors generated positive returns. Materials were the best performing sector, with a 14.0% return. Financials, utilities and industrials all posted double-digit results. The weakest sector was telecom, rising a mere 0.3%.

Within developed markets, many countries turned in double-digit returns, with continental Europe leading the way. Norway's 23.4% return was the best in the EAFE index. Oil exports are the linchpin of this country's economy, and the continued strength of oil prices has propelled the local market. The Finnish market rose 19.6%, as capital good stocks with exposure to Eastern Europe and Russia surged. Germany was the best performing major market within EAFE, rising 13.9%. The German IFO business confidence index, a strong indicator of economic activity in Germany, hit a 15- year high. France and Spain also posted solid double-digit gains, while the UK lagged with an 8.3% return.

New Zealand was the only market in EAFE to generate a negative return for the quarter, falling 4.2%. This was the result of currency translation effects, as the NZ$ declined 10.3% versus the US$ because of worries about the countries' rising inflation and large current account deficit (sound like any other country we know?).

Japan signaled an end to its five-year deflation-fighting policy known as quantitative easing, and instead began to constrain what has lately been truly rapid money supply growth. This policy shift, which is seen as a very big deal for global capital markets, is expected to lift local short interest rates above zero (but still below 0.5%) by year-end. The 6.8% net gain by the Japanese stock market was attractive in absolute terms, but lagged the EAFE average in the first quarter. Some of Japan's "weakness" was simply a market pause after 2005's stunning 45% local return. This market was also negatively impacted by the collapse of Livedoor amidst fraud allegations. The resulting trading frenzy precipitated a repeat of the trading and settlement difficulties the Tokyo Stock Exchange experienced last year.

Emerging markets generated strong results across regions. Venezuela was the best performing market with a 50% return, while Jordan and Israel were the only negative performing markets (-14.6% and –3.3%, respectively). As noted above, the "BRIC" contingency were among the top performing index countries with Russia posting a 28% return, and China, India and Brazil each contributing 21%. For all the BRIC countries, the performance story is heavily oil and commodity-related. Brazil and Russia are the *producers,* while India and China are *consumers* of the world's oil and commodities, needing those necessary ingredients to fuel their growth.

Table 9. International Sector Performance ($ terms)

GICS Sector	Emerging Markets		Developed Markets	
	1st Qtr 2006	Year 2005	1st Qtr 2006	Year 2005
Materials	**19.2%**	29.9%	14.0%	**28.4%**
Financial Services	12.4	32.2	11.9	15.9
Utilities	18.0	35.5	11.3	11.7
Industrials	12.8	25.5	11.1	**25.3**
INDEX RETURN	**12.1**	**34.5**	**9.5**	**14.0**
Cons. Discretionary	5.2	34.0	9.3	10.9
Info Technology	2.1	32.0	8.3	11.0
Energy	**24.7**	**62.4**	7.5	18.8
Health Care	3.3	26.6	6.6	12.8
Cons. Staples	15.1	**38.0**	5.5	9.3
Telecom Services	7.2	25.7	0.3	(12.0)

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Back Page Perspectives

Tables 1 and 2 reveal that for the most recent trailing five years, international markets have posted low double-digit trailing annualized returns and have outperformed the U.S. large cap market by 6% *per annum*. The last three years have really made the numbers, during which time non-U.S. investment returns have crushed what were otherwise an excellent U.S. experience. Four years ago (our Jan. '02 *Review*) we began to urge clients to aggressively extend their international equity strategic allocations, and soon thereafter added emerging markets exposure to our international song (our April '02 *Review*). At the time these were the worst performing equity asset classes among some very weak "opportunities." We're pleased these recommendations helped make a difference to those who embraced them.

Unfortunately, every investment call has a "shelf life". No tree grows to the sky without interruption. One should expect to see the international equity market's very large positive performance differential begin to narrow. There are very good and logical reasons as to why we do not expect international results to flat-line, including strong organic growth prospects (especially in emerging markets and Asia generally), reasonable valuations (not as low as they were five years ago, but still broadly lower than domestic stocks) and potential currency translation benefits (as our highly leveraged US Dollar continues to weaken). Thus, we still encourage clients to maintain what is probably a more sizable allocation to international equities than our peers do. But, the time for thoughtful reflection is clearly in the air. The first quarter's experience, coming after last year's local market returns, is cause for pause. These markets have become heavily "liquidity driven" (speculative), and the world's central banks are in liquidity mop-up mode.

Those investors who are now overweight already pretty sizable international equity targets, and may be feeling like they should "let it ride" (or perhaps even add more emerging markets exposure) – be careful. The markets have an uncanny way of rebalancing your portfolio for you, and it can be painful. Nobody ever got poor by taking some profits, especially with cash returning 5%.

For those investors feeling they have so far missed out on much of this run, because of a previously low strategic allocation to international – be patient. If you decide to meaningfully raise your strategic targets now, think about funding up the increase over 1+ years.

Why the intensifying interest in hedge funds over the past two years, even as traditional long-only portfolios have outperformed them? Here's one thought: According to the Commonfund, smaller foundations and endowments did worse than larger ones in 2002, which was itself the worst year of the bear market.

In effect, downside risk management in that terrible year was positively correlated with asset size, implying larger funds accessed and employed more effective downside risk control strategies. Mega foundations (with assets >$1billion) averaged an investment loss of 7.7%, while smaller foundations (with assets of $50-100 million) averaged a loss of 10.3%. Since then, both groups have been on a campaign to reduce their "downside capture" during the next bear market, and they've been heartily joined by DB plans. Hedge funds have been a major beneficiary of this pre-planning.

Here's an irony – Chartwell's endowment and foundation clients *without* hedge fund exposure all did better in 2002 than the small fund average, and many did better than the large fund average. Be that as it may, inflation-sensitive spending plans just cannot easily absorb negative returns. For that reason, we continue to encourage hedge fund allocations, even though right now it doesn't look like they are adding any value.

We completely agree that you have recently been better off not making forays into this opaque forest, despite all the hoopla. However, we are now many years from the last bear market, and it is never truly "different this time". Bear markets usually descend very quickly, and certainly without adequate warning. Realized investment gains shortly become extremely hard to source from long-only portfolios. We think the rather benign current investment environment is an excellent time to carefully **consider** alternative investment allocations, perhaps to redeploy some of the gains made since 2002 in the superior performing public equity markets. Multi-strategy hedge funds (which can deliver surprisingly stable returns) and private equity partnerships (which are always risky, but also can produce superior long-term asset growth) can each play very useful roles in a strategic asset mix.

See you next quarter!

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

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