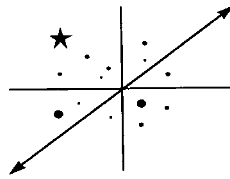


July 2000 Volume VII, Issue No.2

# CHARTWELL REVIEWS ..... SECOND QUARTER 2000

## Diversification or Di"worse"ification ??

*Starting with this issue, we're going to try something a little different in* **Chartwell Review.** *On a familiar note, we'll be summarizing recent results in investor markets, providing an update on the economy, and discussing the near term implications. Then, we'll begin sharing some of our recent research and observations on a fundamental investment strategy that has been under fire recently -* ***diversification****.*

*Simply put, portfolios which are diversified among various asset classes are thought to ultimately reduce investor risk, without unnecessarily sacrificing returns. Over the years, various simulation models have been continuously refined to optimize this process. Over the long term, diversification has "worked" and rewarded its practitioners, but investors' time horizons have drawn shorter in recent years. This has tested the principles of diversification, and the constitution of its proponents. Many wonder if a new investment paradigm exists. It's a critical issue for our clients, which we'll explore the rest of this year.*

### Table 1. Index Benchmarks

| | Q2 | Trailing Returns * | | | |
|---|---|---|---|---|---|
| | 2000 | 1Yr | 3Yr | 5Yr | 10Yr |
| S&P 500 | -2.7 | 7.3 | 19.7 | 23.8 | 17.8 |
| Large Cap Stocks | -3.1 | 8.3 | 21.7 | 25.8 | 18.5 |
| Mid Cap Stocks | -4.5 | 12.6 | 16.2 | 18.7 | 16.5 |
| Small Cap Stocks | -3.8 | 14.3 | 10.6 | 14.3 | 13.6 |
| International Stocks | -3.9 | 17.4 | 10.5 | 11.6 | 8.3 |
| T-bills (3 month) | 1.4 | 5.3 | 5.1 | 5.2 | 4.9 |
| 1-3 Year Gov't Bonds | 1.7 | 4.8 | 5.6 | 5.7 | 6.5 |
| Aggregate Bonds | 1.7 | 4.6 | 6.0 | 6.3 | 7.8 |
| High Yield Bonds | 1.2 | -1.5 | 3.5 | 6.9 | 10.7 |
| Global Bonds, hedged | 1.7 | 5.7 | 7.7 | 8.6 | 8.8 |
| CPI, *annualized* | 0.8 | 3.8 | 2.4 | 2.4 | 2.8 |

*Annualized trailing returns for periods ending 6/30/00

### Table 2. Median Mutual Fund Results

| | Q2 | Trailing Returns * | | | |
|---|---|---|---|---|---|
| | 2000 | 1Yr | 3Yr | 5Yr | 10Yr |
| Balanced | -1.3 | 6.0 | 10.8 | 13.5 | 12.0 |
| Growth & Income | -2.3 | 3.7 | 12.5 | 17.0 | 14.1 |
| Growth | -2.4 | 16.7 | 17.8 | 19.7 | 15.5 |
| Aggressive Growth | -4.3 | 39.3 | 21.6 | 20.6 | 17.0 |
| All Fixed Income | 0.9 | 2.9 | 4.4 | 5.5 | 7.4 |
| Government Bond | 1.4 | 3.8 | 5.0 | 5.2 | 6.7 |
| High Yield Bond | -0.5 | -1.1 | 2.4 | 6.2 | 9.5 |
| International Stock | -7.5 | 24.4 | 7.4 | 10.2 | 8.8 |

*Annualized trailing returns for periods ending 6/30/00
Source of fund's data: CDA/Wiesenberger & Lipper

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## ***So, What's Up?***

After an unexpectedly positive climate for equity investing in 1999, and a quite poor one for anything else, the new Millennium so far may be best described as a transition period. The markets' 2nd quarter gyrations caused many domestic investors and investment managers to re-evaluate their positions in a number of areas. As the 3rd quarter's "summer doldrums" kicked in, these are some of the issues occupying investor's "share of mind" :-

1. *The U.S. economy's growth rate looks to finally be declining from extremely high levels of the past year. Will this slowdown prove to be temporary or sustaining? Will inflation increases moderate? Are we in for a "soft" economic landing or a hard one?*
2. *The bond markets absorbed something of a beating while the Fed was raising target short term rates during the past year. Is that process over? Are real bond yields now attractive enough to justify an increase in fixed income allocations?*
3. *Overall U.S. corporate profits increased sharply in the 1st quarter, and appear to be on track to meet or exceed 2nd quarter expectations. Will rapid earnings growth continue if economic growth slows down?*
4. *Despite a recent pause in the domestic equity market's advances, it remains expensive relative to historical norms. With our economy possibly slowing down, is now the "right" time to increase international equity exposure?*
5. *Despite a slowdown in May, year-to-date net inflows to equity mutual funds topped $188 billion, compared to only $71Bn last year. With a new full year record (1997 = $227Bn) almost inevitable, will this fresh demand be all that's necessary to push stock prices higher?*

Investment returns may look like they're stuck in neutral, but we expect this will change considerably as the market frames answers to these questions during the next 3 months.

Is the Economy Finally Shifting Gears?

In April, we predicted 1st quarter GDP growth would be over 5%, and further spook already skittish domestic investors. The figure turned out to be 5.5%, and securities markets took it on their collective chins for the months of April and May. It gives us no pleasure to have been even the least bit right with that call.

Fortunately, nothing is more constant than change itself where investor markets are concerned. Thus, when late-May and early-June government reports pointed toward a slowing in some elements of the economy's growth, the bond and equity markets were quick to rebound. The consensus thought process is pretty straightforward: slower growing economy ⇨ reduced concern about increasing inflation ⇨ no more Fed Funds increases ⇨ flat or declining interest rates ⇨ soft landing for economy ⇨ corporate profits continue to rise, thereby enabling stock prices to rise.

This consensus view, while totally appealing, has enough assumptions built into it that we ought to at least be cautious in framing the first two. As we see it, the evidence of a *sustainable* shift to slow economic growth with little inflation is still a little thin on the ground.

For example, growth figures for April and May consumer spending were lower than forecast, up 0.4% and 0.2% respectively. Related retail sales figures were also softer than expected. But 1st quarter consumer spending had surged +7.7%, the largest quarterly advance since 1983. How long can you shop 'til you drop?

Another harbinger of a slowing economy has been the recent initial jobless claims figures. By quarter's end these had risen to a 4-week average of 300,000 (up from 280,000). Further, May's reported unemployment rate rose to 4.1%. On the other hand, weekly jobless claims averaged nearly the same during the first half of 1999, and May's unemployment rate was up only because April's 3.9% figure set a 30-year **low**. June saw the rate again decline to 4.0%.

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On the business front (for example), April and May's industrial production rate advanced only moderately even as durable goods *orders* declined 6.4% in April, which was the sharpest such one-month drop since 1991. However, this latter figure points up just how dangerous it can be to draw conclusions from short data periods. May's durable goods orders rose 6.0%, or twice expectations. A 26% increase in orders for electronics equipment accounted for much of the gain, just as a record *fall* in such orders made up most of April's decline. June durable goods orders were forecast to decline modestly, but instead rose 10%!! (highest since 1991).

There were plenty of other cases during the quarter when early reports pointed to slowing economic activity only to have the June data point the other way, but you get the picture.

What has all this done to affect costs and inflation? The pretty picture remains intact for unit labor costs, which rose only 1.6% in the first quarter. Hourly compensation rose 4.3% y/y, but was largely offset by productivity gains.

On the price front, which is the Fed's main concern, the second quarter definitely was a mixed bag. For the 3 months **only**, price increases moderated and June's high CPI figure can be dismissed as one last energy cost blip. However, the following table suggests we're by no means out of woods on this issue.

| | ***CPI*** | ***PPI*** |
|---|---|---|
| 1st Half 1999 | 2.4%, p.a. | 2.6%, p.a. |
| 2nd Half 1999 | 3.0 | 4.3 |
| 1st Half 2000 | 4.2 | 4.8 |
| 1st Quarter 2000 | 5.8 | 8.6 |
| 2nd Quarter 2000 | 2.6% | 1.2% |

## ***Are Bonds a Buy?***

The quarter's biggest investment irony was wrought by the Federal Reserve. On May 16th , they jumped the Fed Funds target by 50 basis points, to a nine-year high of 6.5%. Not even a week later, the first government reports suggesting a slower economy were being issued. Then, at its late-June meeting the Fed took no rate action for the first time since mid-1999. Almost immediately, reports of a strengthening economy start to be issued!

During the first quarter, when someone asked how bonds were doing you had to know which sector they meant (government vs. corporates vs. mortgages), and whether they meant short or long maturities (long was strong). During the second quarter, you also needed to know which month they were talking about! Table 3 reflects how difficult the bond market was for investors during April and May, only to rally in June.

***Table 3. Fixed Income Sector Returns***

***For periods ended 6/30/00***

| | **April - May 2000** | **June 2000** | **Y-T-D 2000** |
|---|---|---|---|
| **Aggregate Bonds** | **(0.34)%** | **2.08%** | **3.98%** |
| Treasuries 1-10 yrs | 0.39 | 1.43 | 3.60 |
| Treasuries 10+ years | -1.13 | 2.28 | 9.12 |
| Corporate Bonds * | -1.25 | 2.51 | 2.68 |
| Mortgage Bonds | 0.12 | 2.14 | 3.67 |
| High Yield Bonds | -1.00 | 2.25 | -1.42 |
| Global, unhedged | -2.51 | 2.43 | 0.03 |
| Global, hedged | 0.90 | 0.82 | 4.38 |

** investment grade only*

So far, 2000 has proven quite difficult for fixed income investors. The Government's announced plan to begin an aggressive debt retirement program drove many fixed income managers to load up on 30-year treasury bonds, just in time for April/May's sharp decline. Additionally, increasing corporate bond spreads induced others to increase allocations to this sector at the beginning of the 2nd quarter. But credit spreads continued to widen through May, to levels not seen even during the summer of 1998 (remember the Long Term Capital debacle?). Just as some managers could stand the pain no longer, June saw a rally in corporate bonds.

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When the dust had settled, short term market rates as of June 30th were unchanged from 3 months earlier, despite a 50bps rise in the Fed Funds rate. Yields on 1-5 year bonds actually *declined* and long term rates were unchanged.

Which brings us to the question posed at the beginning of our review. Is it time to increase one's allocation to fixed income? On balance, we say no. However, for those concerned about the effects of a hard economic landing on our domestic equities markets, we see a good case for increasing one's cash equivalent position. Why?

- *Long term treasury rates are actually lower than one year ago, despite six increases in the Fed Funds rate and a 1% rise in core inflation. So, real interest rates have declined, except in the 0-2 year range.*
- *Accordingly, long term bonds aren't likely to show much capital appreciation until inflation rates start to decline. The relatively high yielding short term end of the market looks attractive by comparison.*
- *If a soft economic landing can be engineered, demand for stocks is apt to stay as strong as it has been (despite valuations that are hard to comprehend). If so, you're likely to be better served by simply maintaining a neutral fixed income allocation.*
- *We think the odds **favor** further Fed action in 2000. Playing good defense may be the key to near term investment performance.*

## ***Tech Wreck***

The equity market's tech sector experienced a severe correction during the 10 weeks from mid-March through the end of May. While the NASDAQ should not be confused for a broad market index, it certainly is poster child for the New Economy. At its low, the NASDAQ had declined 41%. Even after a strong June rebound, it was still 20% off its 1st quarter high.

The equity market's weakness during the first half of 2000 was accompanied by unprecedented daily volatility. Through June, the S&P moved up or down 1+% in 43% of this year's trading days. In the same timeframe, the tech, telecom, and media heavy NASDAQ has seen 79% of this year's trading days rank as high volatility (+/- over 1%), with 33% considered extremely volatile (+/- over 3%). These frequencies have no historical equal.

***Table 4. U.S. Equities - Sector Performance***

***Cap-Weighted: For periods ended 6/30/00***

| **Sector** *(% of Market)* | **Non -S&P 2Q** | **S&P 2Q** | **Total Y-T-D** |
|---|---|---|---|
| Technology *(29.1)* | -12.2% | -8.8% | 6.1% |
| Financials *(13.8)* | -4.5 | -2.9 | -1.3 |
| Health Care *(11.0)* | 9.5 | 23.7 | 24.0 |
| Utilities/Telecom *(8.8)* | -12.6 | -8.4 | -5.3 |
| Bus. Equip. & Serv. *(6.2)* | -26.6 | -14.6 | -30.1 |
| Cons. Non-Durables *(5.2)* | -0.8 | 12.6 | -6.4 |
| Cons. Services *(5.1)* | -8.0 | -5.4 | -7.9 |
| Capital Goods *(5.0)* | 1.7 | -0.3 | 2.8 |
| Energy *(5.0)* | 3.9 | 2.5 | 9.4 |
| Retail *(4.9)* | -8.0 | -9.4 | -14.5 |
| Raw Materials *(1.5)* | -6.9 | -11.1 | -17.1 |
| Totals | -10.5% | -2.9% | -1.4% |

*Data Source: Vestek*

Normally, weakness in the stocks of one sector does not define the broad market's results. Yet, even after the 2nd quarter's weak returns (see Table 4, above) technology stocks represent over 29% of the total market's capitalization, and telecom stocks another 7%. The style-sensitive S&P Growth index is now comprised 54% by tech & telecom stocks. Five years ago, the combined weight of tech & telecom sectors in the S&P 500 was 21%, and 24% in the S&P Growth. Obviously, getting the tech & telecom sectors "right" has become a critical driver of equity managers' relative performance. For growth-style managers, it is the critical issue.

Style-sensitive indices group companies into market cap, P/E or earnings growth buckets. Table 5 explores how companies with differing fundamental characteristics have fared in the past 12 months.

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The second quarter again favored very large cap firms, after the first quarter's rotation toward smaller cap names. Not unexpectedly, companies with lower expected growth rates have attracted very little interest during the past year, and the recent quarter proved no exception. Equity investors appear to remain confident risk-takers.

The quarter did see a shift away from firms expected to grow the very fastest, which is quite the opposite of previous quarters. This may reflect some questioning of the projected growth figures, but it more likely demonstrates concern about valuation levels. Consistent with that, high P/E and the infamous "undefined P/E" (i.e., no earnings) companies suffered the most during the 2nd quarter. So far this year, the deepest of value companies (ultra-low P/E's) have performed best.

***Table 5. Equity Returns by Market Cap/Style***

***Periods ended 6/30/00; indices are cap-weighted***

| | | **2nd Q 2000** | **Y-t-d 2000** | **Past 12 mos** |
|---|---|---|---|---|
| ***Capitalization Sectors*** *(% of total)* | | | | |
| Above $5bn | *(81)* | -4.8% | -1.9% | 9.6% |
| $1bn – 5bn | *(13)* | -5.5 | -1.6 | 8.4 |
| $.5bn – 1bn | *(3)* | -5.5 | 4.6 | 20.9 |
| < $0.5bn | *(3)* | -9.9 | 3.1 | 14.6 |
| ***Growth Sectors*** *(% of total)* | | | | |
| < 8% | *(3)* | -2.9 | -4.1 | -9.2 |
| 8-12% | *(15)* | -3.8 | -7.7 | -14.7 |
| 12-16% | *(33)* | 2.1 | 0.8 | 0.0 |
| 16-20% | *(14)* | -1.0 | 17.6 | 35.4 |
| > 20% | *(35)* | -12.3 | -4.9 | 39.6 |
| *P/E Sectors (% of total)* | | | | |
| < 8x | *(2)* | 5.8 | 7.0 | 8.1 |
| 8-12x | *(7)* | -4.7 | -3.4 | -9.5 |
| 12-16x | *(6)* | -1.9 | -2.8 | -11.4 |
| > 16x | *(72)* | -3.1 | 0.9 | 12.9 |
| undef. | *(13)* | -16.4 | -10.0 | 22.3 |

## ***Foreign Markets – Is it safe yet?***

Domestic popular media leaves the impression that U.S. equity market continues to outperform the rest of the world, but it's not quite true.

***Table 6. Foreign & Global Investments***

***In US$ terms; equity returns are cap-weighted***

| | **2nd Qtr. 2000** | **Latest 12 Months** |
|---|---|---|
| MSCI Japan | -6.2% | 26.8% |
| *- Yen* | *-3.4* | *14.5* |
| MSCI Europe | -3.1 | 15.4 |
| *- Euro* | *-0.1* | *-6.7* |
| *- Pound Sterling* | *-4.8* | *-3.8* |
| Pacific, ex-Japan | -2.8 | 3.1 |
| *- Australia* | *-1.8* | *-10.8* |
| *- Taiwan* | *-0.9* | *5.1* |
| Emerging Markets | -10.2 | 9.5 |
| *- Mexico* | *-5.8* | *-4.8* |
| **MSCI EAFE** | **-3.9** | **17.4** |
| Global Bonds | -0.2 | 3.1 |
| Global Bonds, hedged | 1.7 | 5.7 |

As Table 6 reveals, the broad developed market EAFE index advanced 17.4% during the year through June, more than 10% ahead of domestic large cap stocks. The 2nd quarter wasn't any better than here in the States, however, with negative currency effects playing a big part. As has been the case since early 1999, the European equity markets have performed very well in the face of a considerable currency "headwind." For all the country's fundamental economic problems, *someone* has been buying Japanese equities, because the country index is up 27% since June 1999 (the S&P 500 has returned only 7.3% in that time).

Table 1 suggests that Global bond portfolios have bettered domestic ones during the past year, but that's also not quite the case. It was true only on a fully hedged basis, where one assumes away any currency effects associated with holding foreign bonds. Otherwise, weakness in European currencies (Euro and Sterling) undermined local bond market returns.

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## ***DIVERSIFICATION***

Let's not mince words: diversification is not the best way to maximize the total return of your portfolio over a given time frame. Concentration is. You make the most money by picking the asset class (or style-adjusted asset class) that's going to do the best, and then put all your funds into that class. When the original time frame is up, you pick the best performing asset class for the *next* time period and put all your (increased) pile of money in that class. Keep doing this for each successive time period. Pretty simple stuff.

The above process presents just two problems: selecting time frames that are right for your situation (hardly insurmountable) and then picking the right asset class every time (absolutely impossible). Table 7 captures the essence of our problem. Assuming you decided to use calendar year time periods, during the past 20 years your chances have been no better than 3 to 1 **against** picking the best performing asset class each time.

***Table 7. Primary Asset Class Returns, 1980-99***

***Periods ended 12/31/99; indices are cap-weighted***

| | **# years best** | **# years worst** | **Avg. Return** |
|---|---|---|---|
| *Primary Asset Classes* | | | |
| U.S. Large Caps | 5 | 1 | 18.2% |
| U.S. Small Caps | 4 | 4 | 15.2 |
| Diversified Int'l | 7 | 4 | 15.9 |
| U.S. Bonds | 3 | 5 | 10.3 |
| U.S. Cash | 1 | 6 | 7.2 |
| ***Growth vs.Value – U.S. Large Caps*** | | | |
| Large Growth | 11 | 9 | 18.9% |
| Large Value | 9 | 11 | 17.5 |
| *U.S. Equity vs. International Equity* | | | |
| U.S. Large Caps | 4 | 3 | 18.2% |
| U.S. Small Caps | 3 | 2 | 15.2 |
| Europe | 3 | 3 | 17.9 |
| Japan | 7 | 6 | 17.0 |
| Pacific Rim | 3 | 6 | 15.1 |

The task wouldn't have been any easier if you restricted yourself to just the equity markets. You also couldn't have reliably used reverse selection (i.e., pick the worst and avoid it) to help you out, because every developed equity market has been the worst performer almost as many times as it's been the best. Finally, the penalty for being wrong has been pretty stiff, with the minimum one year difference between high and low over 10%.

Of course, on December 31, 1979 an investor could have simply decided to put *all* her money in U.S. Large Cap stocks, *each and every year for the next 20 years*. No deviation from the plan; no second guessing; and no cashflows. Even better, she might have decided to dedicate the funds to only Large Cap Growth stocks. After the first **16** years, the results would have been a little disappointing (Small Cap, International, and even Large Value would have all been better choices), but today, only 20.5 years later, she'd look pretty smart.

Portfolio diversification issues are many and complex, and the above vignette merely scratches the surface. We'll be writing on the topic's other facets throughout the year. As they say, *watch this space!*

See you next quarter!

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