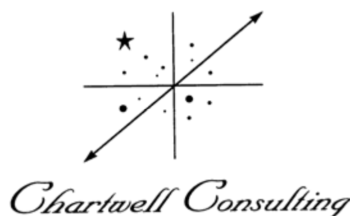

CHARTWELL REVIEW

July 2006 **SECOND QUARTER 2006** Volume XIII, Issue No.2

RISK / return

The current bull market for stock investments, which officially began very early in October 2002, has been notable for its relatively slow pace (in most previous bull markets, stocks had advanced much more by the time 3.75 years passed), but relatively steady pace. In this bull market, the worst monthly return for the S&P 500 occurred in December 2002, as war preparation concerns precipitated a (5.9)% decline, while the worst quarterly decline was (3.2)% in Q1 of 2003 (same issue). By historical standards, these are moderate numbers.

2003 seems like a long time ago, so investors were a bit shaken by the S&P's 2.9% decline in May, which led to a 1.4% quarterly loss. Even more disconcerting were peak-to-trough declines exceeding 10% for small-cap and emerging market stock indices, in just the few weeks from May 9th. A 10% "drop from a top" is the classic definition of a *correction* (a 20% drop earns the *bear market* handle). Domestic equity markets average about 225 trading days between correction phases, and had gone more than 800 days since the last one. They were past due, for sure, but after awhile one tends to forget that any asset class providing long term returns in excess of 3-month Treasury bills come with some risks.

We see the 2nd quarter as a *relatively* gentle reminder (trailing 1-year returns ain't so bad, especially in the uber-performing small-cap and emerging markets sectors) we're not in Kansas. Most investment terrain has valleys as well as hills. As we've noted in each of the last three "*Reviews,*" 2006 seems like the perfect time to make sure your strategic asset allocation is consistent with your ability to absorb the downside baggage that will naturally come with it. The time to repair your roof isn't when it's raining (as those of us in the Northeast know all too well this year).

Table 1. Index Benchmarks

Market Index	**Q2 2006**	**Trailing Returns *** 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	(1.4)	8.6	11.0	2.3	8.2
U.S. Large-cap Stocks	(1.3)	7.3	9.2	0.8	7.5
U.S. Mid-cap Stocks	(2.6)	13.7	19.9	9.9	12.1
U.S. Small-cap Stocks	(5.0)	14.6	18.7	8.5	9.1
International Stocks	0.9	27.1	24.4	10.4	6.7
T-bills (3 month)	1.2	3.6	2.2	2.1	3.7
1-3 Year Treasuries	0.3	1.5	1.3	3.0	4.7
Aggregate Bonds	(0.1)	(0.8)	2.1	5.0	6.2
High Yield Bonds	0.2	4.7	8.5	8.3	6.6
Global Bonds, ½ hedged	1.6	(0.2)	3.5	6.5	6.0
CPI, ***annualized***	6.3	4.3	3.4	2.7	2.6
DJ Commodity Index	6.1	18.1	17.2	13.7	8.1

* Annualized trailing returns for periods ending 6/30/06.

Table 2. Average Mutual Fund Returns

Fund Category	**Q2 2006**	**Trailing Returns *** 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	(2.4)	8.7	11.3	2.5	7.9
U.S. Mid-cap	(3.8)	12.9	16.6	6.7	10.2
U.S. Small-cap	(5.2)	13.9	18.5	9.0	10.7
International Lg. Cap	(0.5)	26.8	23.2	10.1	7.9
International Sm. Cap	(2.5)	32.0	31.5	17.8	13.2
Emerg. Mkt. Equity	(3.9)	33.3	33.2	20.0	7.3
Balanced/Hybrid	(1.0)	6.9	8.8	4.6	7.5
General Bond	(0.2)	(0.5)	2.6	5.2	6.0
Government Bond	(0.5)	(1.7)	1.6	4.5	5.8
High Yield Bond	(0.1)	4.9	7.9	7.6	5.6
Hedge Funds - Broad	*0.1*	*13.6*	*11.2*	*8.4*	*10.6*

* Annualized trailing returns for periods ending 6/30/06.

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The Economy – risk of a slowdown increases

The government's final estimate of *1st* quarter GDP growth was a surprisingly high 5.6% annualized advance in real terms (and +8.9% before adjusting for inflation). Not one of the 51 blue chip economists surveyed by the Wall Street Journal in January guessed the economy would grow so robustly in the quarter. Major contributing factors were –

- a sharp rebound in personal consumption spending, especially for durable goods. Many now surmise that government transfer payments to hurricane Katrina and Rita victims were spent aggressively, as people began to rebuild their lifestyles;
- a surprisingly large increase (12.5% annualized) in the rate of business investment in buildings, after otherwise growing very slowly the past 3+ years;
- a similar rebound in business equipment spending, after pausing a bit late in 2005;
- a 15% (annualized) rate of increase in exports, after mostly single-digit advances since 2002;
- A double-digit increase in Federal gov't spending;
- a considerable pullback in inventory spending, or the GDP number might have been 1.5% higher.

If it seems like this was an outlier quarter compared to trends over the past 2 years, you're in good company. Expectations for the GDP's 2nd quarter growth rate have come down notably since January, when the consensus guess was +3.3%. The current "whisper" number is for +2.8% when the Government issues its first preliminary estimate on 7/27. More importantly, consensus forecasts for GDP growth in each of the next five quarters are now down in the 2.8% range, compared to actual economic growth of 4.2% in 2004 and 3.5% in 2005.

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

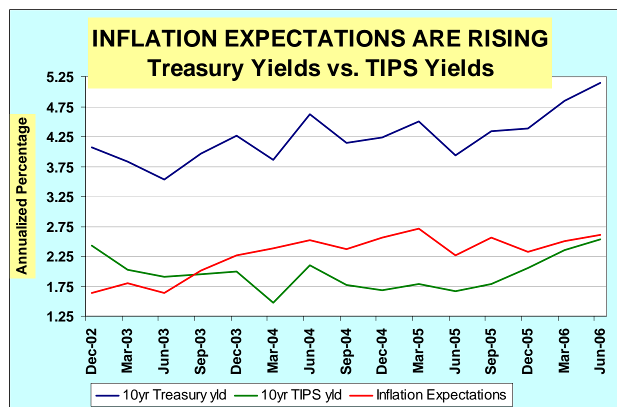
Employment levels increased during the 2nd quarter, but more slowly than during the first. On a seasonally adjusted basis, household survey data indicates total employment rose 722,000, while nonfarm payrolls rose just 325,000. First quarter numbers were 862,000 and 590,000, respectively. The unemployment rate declined marginally, from 4.7% to 4.6%. It was 5.0% a year ago. Overall employment levels have increased by just over 2.4 million persons during the last 12 months.

Adjusted for inflation, ***Disposable personal income*** was flat during the quarter ended May '06 (latest data available), and advanced just 1.4% from one year ago. Conversely, real personal spending rose 0.4% during the latest quarter, and has increased 3.3% from a year ago.

As a result, personal "dissavings" (when personal outlays exceed personal disposable income) is now running at an annualized level of $163 billion. A major reason real income growth has been so modest, despite rising employment levels, is that weekly payroll earnings of nonsupervisory workers rose very modestly in real terms during the last quarter (+0.2%) and year (+0.1%).

The index of ***Industrial Production*** rose 1.8% during the 2nd quarter, and is 4.5% above year earlier levels. Capacity utilization for total industry has moved up to 82.4% of capacity, well above the 2001-2 low of 74%, as businesses have been very cautious about expanding domestic production facilities.

Inflation concerns increased sharply during the 2nd quarter, as reported inflation rates continued to rise. Consumer prices increased during the quarter at a seasonally adjusted annual rate of 5.1%, which compared unfavorably to the first quarter's 4.6% rate of increase, and the past twelve month's 4.3% increase. "Core" CPI (ex-food & energy) rose at a 3.6% annual rate, and reflects a 2.6% year/year increase. Even the most conservative consumer price measure, the "personal consumption expenditures" price index, is up 3.3% year/year (2.1%, excluding food & energy). Producer prices for finished goods (PPI) rose at a 6.7% annualized rate during the 2nd quarter, after *falling* during the first. Much of the PPI's volatility has to do with energy prices. Prices for "core" finished goods rose at a 2.3% annual rate, after rising at a 3.9% rate in Q1.



Monetary policy – The Federal Reserve finds itself trapped between the proverbial rock and hard place. It needs to respond to economic data suggesting a trend of rising inflationary pressures, despite building evidence of slowing economic growth. It responded to these pressures by twice raising the target Fed Funds interest rate, to 5.25%. The second increase had not been expected by many, and was one of the proximate causes of very weak equity markets in May/June.

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The Bond Market – no return, more risk

Domestic bond investors were faced with three basic handicaps as they struggled to improve on the 1st quarter's poor returns. They were (and still are) –

- Relatively low current market yields by historical standards, although higher than a year ago;
- Increasing inflation expectations, which puts a ceiling on price bids and potential capital gains;
- Historically small differences between Treasury yields and credit bond yields of a similar maturity, thereby limiting trading opportunities.

With the short end of the yield curve pushed up 50 basis points by the Fed's actions, and the long end rising by 30 basis points due to rising inflation concerns, government bonds in the second quarter offered no recovery prospects from what you'll recall was a very weak 1st first quarter. Table 3 tells the sorry story.

Table 3. Bond Market Returns

periods ended June 30, 2006;

Bond Index	2Q '06	Trailing Returns 1 Year	3 Years
Aggregate Bonds	**(0.1)%**	**(0.8)%**	**2.1%**
Intermediate Bonds	**0.1**	**0.0**	**2.1**
US Gov't, all	0.0	(1.2)	1.0
US Treas, long	(1.2)	(6.3)	1.7
Mortgages	0.0	0.4	2.9
Inv. Grade Credit	(0.4)	(2.1)	2.0
90-day T-Bills	1.2	4.0	2.3
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High Yield Credit	0.2	4.7	8.5
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Global, Unhedged	3.2	(0.4)	4.2
Global, Hedged	0.0	(0.1)	2.6
Emerging Markets	(2.4)	5.2	10.2

Core bond portfolios targeted at the Lehman *Intermediate* index have been marginally better off during the past year, but only in relative terms. In order to produce inflation-matching returns from "plain vanilla" portfolios, managers needed to avoid long-term bonds altogether. Cash has definitely **not** been trash.

The picture changes a bit if we expand our investment universe to include higher credit risk (high yield bonds), higher country risk (emerging markets bonds), and higher currency risk (unhedged foreign bonds). High credit risk securities continued to outperform lower credit risk paper, and are the only domestic bond sector to beat inflation over the past year.

High country risk emerging market bonds, which are often issued in US$, finally experienced a weak patch in the 2nd quarter, in sympathy with emerging market stocks. Widely considered more volatile than any other primary bond sector, the last five years has seen this higher risk profile consistently working to the upside.

Finally, global aggregate bond indices provided exceptional returns in the 2nd quarter, but only if one left the inherent currency exposure untouched (global aggregate bond indices contain 60-80% non-Dollar bonds). This reflected the U.S. Dollar's depreciation versus the currencies of our primary trading partners.

These three "increased risk, for increased return" strategies have a naturally limited shelf life. Rising prices have caused high yield credit spreads to decline very close to those of BBB bonds. If (when) credit default rates rise (Moody's projects they will begin to jump in late 2007), high yield bonds will underperform. Emerging market bonds suffer from the same narrowness of yield premium, although the country issuers are generally in fine financial condition. Finally, the attractiveness of global bond portfolios hinges almost completely on one's view of the Dollar, as interest rates in Europe and Japan are rising in similar fashion to those in the U.S.

Credit spreads in the investment grade market again appeared to widen during the quarter, as AAA paper outperformed A's, which outperformed BBB's, etc. The overall AAA/BBB performance differential was +0.60% in the second quarter, and adds to the 0.45% differential during the first. At the end of June, the BBB bond sector was trading at a 73 basis point yield premium to the AAA sector, versus 62 bps when the year began. That is not enough of a shift to explain the 1% YTD performance differential. Instead, the index composite of BBB bonds is about 35% more sensitive to interest rate shifts than are the AAA's. In a rising interest rate environment, this hurts returns. But, individual investment managers can mitigate this issue simply by emphasizing shorter-term BBB's in their portfolios. Sort of a "more yield, less duration" thing.

U.S. Equity Markets - risk "returns" to the sector

Large-cap domestic stocks began the second quarter similarly to how they began 2006 - with a bang. The S&P 500 index rose from 1295 at the end of March, to 1327 on May 8th. Small-cap names didn't enjoy quite the same April, essentially breaking even for the month. Even so, no one was especially concerned about the disconnect, since small-cap stocks gained nearly 14% during the first quarter.

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And then, the rains came.

Small cap growth stocks dropped 5-7% in May. Small value indices were down over 4%. Mid-cap stocks dropped 4%, and large-cap stocks declined 3%. The S&P 500 index ended May at 1270, down 4.2% in just three weeks. It ultimately tested 1227, before rebounding to close the second quarter at 1270.

Table 4. U.S. Equity Market Returns

periods ended June 30, 2006;

	Trailing Returns		
	2Q '06	**1-Year**	**3-Years**
Growth			
Large Cap	(3.6)%	3.6%	5.8%
Mid Cap	(4.7)	13.0	16.9
Small Cap	(7.3)	14.5	16.3
Value			
Large Cap	1.1	11.1	12.9
Mid Cap	(0.6)	14.3	22.1
Small Cap	(2.7)	14.6	21.0

As table 4 reflects, the quarter's weakness hit growth stocks the hardest, from top cap to bottom. If we compare these results with the current P/E characteristic of each style/size sector (see table 5), we see a perfect correlation. The higher the sector P/E, the more it declined in the 2nd quarter's market break. It looks to us as if investors simply rotated out of many high priced and high *expectation* stocks.

Table 5. U.S. Equity Market P/E Ratios

periods ended June 30, 2006;

	Price/Earnings Ratios	
	@ June 2006	**@ June 2002**
Growth		
Large Cap	20.7x	26.2x
Mid Cap	22.8	26.5
Small Cap	24.0	22.3
Value		
Large Cap	14.1x	23.4x
Mid Cap	16.6	17.7
Small Cap	17.3	17.7

Courtesy of market data from Vestek on 7,000 stocks, we've been able to scrutinize that observation in more detail. We find that while the entire market was weak in the period, there was a clear rotation away from riskier stocks. For example -

- A clear de-selection of very high volatility (β>1.5) stocks was evident in the quarter;
- Stocks with higher forecasted earnings growth rates underperformed those with lower expected growth rates. At the extremes, the lowest expected growth sector firms outperformed highest expected growth firms by 7% in the quarter. In effect, the market was **not** paying up to capture the "better" future.
- High yield stocks outperformed no yield stocks by 8% in the quarter.

Table 6 breaks down the stock market from an economic sector *and* market cap perspective. We see the top performing economic sectors of the S&P 500 during the second quarter were utilities, energy, and consumer staples firms. The latter two sectors each account for 10% of the S&P's market cap, while utilities account for just 3%. Thus, contribution to total return was higher for energy and staples. Looking at the drivers to the downside, it was all about technology and health care, each of which are large sectors accounting for 15% and 12% of the S&P, respectively. The quite weak small-cap space was led down by the same two underperforming major sectors, to which we needed to add the large consumer discretionary sector.

Table 6. Second Quarter Sector Performance

Sector	**Large-caps (S&P 500)**		**Small-caps (Russell 2000)**	
	Return %	Contribution %	Return %	Contribution %
Utilities	5.7	0.2	2.1	0.0
Energy	4.2	0.4	4.1	0.3
Consumer Staples	2.9	0.3	(0.9)	-0.0
Industrials	0.0	-0.0	(3.0)	(0.5)
Financials	0.0	-0.0	(1.7)	(0.3)
Telecom Srvcs	(0.4)	-0.0	(5.3)	(0.1)
Consumer Disc.	(0.5)	(0.1)	(6.8)	(1.0)
Materials	(0.5)	-0.0	(5.0)	(0.3)
Health Care	(5.0)	(0.6)	(9.4)	(1.1)
Info Tech	(9.9)	(1.6)	(10.6)	(2.1)
S&P 500	(1.5)%	(1.5)%		
Russell 2000			(5.0)%	(5.0)%

One layer down from our size/sector review, the list of weak *industries* during the quarter was very long indeed. Homebuilding, drugs, chemicals, retailing, and high tech hardware companies were notably weak performers. Firms in the transportation, domestic petroleum, steel, banking, and power utilities industries outperformed. Except for pharmaceuticals, all of these industries are very sensitive to economic growth shifts, suggesting the quarter's break was less about a change in attitude about the economy's future path than originally thought.

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International Equities – risk comes home

It wasn't pretty, but the quarter ended positively for developed market international equities. As in the U.S., the period got off to a very strong start amid indications of a seventh consecutive quarter of positive *local* returns for most countries. Economic reports pointed to continuation of the strong synchronous global growth of the past two years. But in early May the Fed spooked investors with cautionary comments about inflation and the continued need to keep raising short-term interest rates. Adding to this concern is the observation that central banks of the world's four largest economies (US, the EU, Japan, and the UK) are now all in a liquidity reduction mode, to combat the prospects of rising global inflationary pressures, while the fifth's (China's) double-digit growth is fueling those pressures.

Table 7. International Equity Markets

	Local Currency Return %		U.S. Dollar Return %	
	2nd Qtr 2006	YTD 2006	2nd Qtr 2006	YTD 2006
MSCI EAFE	**(4.0)%**	**3.9%**	**0.9%**	**10.5%**
- Int'l Growth			*0.3*	*9.4*
- Int'l Value			*1.5*	*9.9*
- Europe	(3.1)	5.7	2.9	14.0
- Pacific, ex-Japan	(0.5)	8.1	2.5	9.3
- Japan	(7.5)	(1.3)	(4.6)	2.0
- Germany	(5.2)	5.2	0.2	14.1
- United Kingdom	(1.6)	5.5	4.9	13.6
- Canada	(4.2)	3.8	0.5	9.1
EAFE Small Cap			**(3.7)**	**6.6**
Emerging Mkts	**(2.9)**	**6.5**	**(4.3)**	**7.3**
- EM Asia	(2.4)	4.5	(2.0)	7.5
- EM Europe	(2.3)	13.9	(3.8)	12.8
- EM Latin America	(1.9)	10.2	(3.1)	12.1

Thus, international equity markets sold off sharply and broadly. Thanks to a late quarter rally *and* a weak US$, developed market indices mustered meager positive returns. In *local* currency terms, only Hong Kong generated a positive return for the quarter (+0.02%), while Sweden (-8.7%) and Finland (-7.9%) were the weakest performing developed market countries. Japan's run of strong performance gave way during the quarter, as their market dropped 7.5%. In *Dollar* terms, Europe was the best performing region, gaining 2.9%, as the UK, France, Spain, Italy and Switzerland all generated returns in the 3 to 5% range. For the quarter, both the MSCI EAFE and World ex-US indices rose 0.9%, and are up 10.5% year to date.

In developed markets, select cyclical sectors (utilities, energy, and materials) are the best performers year to date, and were among the leaders during the second quarter. But, we think the organizing premise with these three top-performing sectors is the energy theme, not economic sensitivity. Because, we note the naturally defensive healthcare and consumer staples sectors also held up well during the quarter, and reflect double-digit gains year-to-date, while the pro-cyclical industrials, consumer discretionary and technology sectors were very weak for the period. In this risk-averse environment, value stocks outpaced growth, and large cap, developed market equities outperformed smaller cap and emerging market equities.

Emerging markets had been on a sustained rally since September 2001. We've commented previously in these columns that the last year reflected clearly speculative activity. Thus, selected emerging markets were particularly hard hit when investors shifted into a risk avoidance posture during the 2nd quarter.

The broad MSCI Emerging Market index dropped 4.3%, pulling the year-to-date return to 7.3% in Dollar terms, which is behind the developed market indices. The best and worst performing country markets were found in Latin America, with Colombia dropping 31%, while Argentina rose 5% and Peru gained 15%. Eastern European emerging markets were the only positive performing region, gaining 1.5%. Russia (+3.2%) and Poland (+2.4%) led the way. Asian emerging markets fell "only" 1.9%, as China and Taiwan both turned in modestly positive returns. The Indian market declined 9.3% over the full calendar quarter, but the "peak-to-trough" drop was over 30%.

Table 8. International Sector Performance ($ terms)

	Emerging Markets		Developed Markets	
GICS Sector	2nd Qtr 2006	YTD 2006	2nd Qtr 2006	YTD 2006
Utilities	(4.1)	13.2	**6.4**	**18.4**
Materials	0.0	19.1	1.4	15.7
Health Care	**(18.8)**	**(16.2)**	**6.4**	13.4
Energy	**1.3**	**26.3**	4.0	12.1
Financial Services	(6.1)	5.5	(0.3)	11.6
Cons. Staples	(5.4)	8.9	4.9	10.6
INDEX RETURN	(4.3)	7.3	**0.9**	**10.5**
Industrials	(3.9)	8.5	(2.2)	8.6
Cons. Discretionary	(11.0)	(6.4)	(2.0)	7.2
Telecom Services	(5.7)	1.1	4.6	4.9
Info Technology	(4.1)	(2.1)	**(5.4)**	**2.4**

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Grizzly Bears vs. Black Bears

If you love the outdoors and have spent any time in the West, you have probably gotten some advice on what to do to if you encounter a bear. Rule # 1 is to determine what type of bear it is, because this largely determines both how you should react, and the potential outcomes.

Grizzlies are aggressive hunters, and react forcefully to a confrontation. Should you encounter one, ***do not take flight***. They can easily outrun you, and will come after you. Instead, curl yourself up into a tight ball position, protecting your vital organs. Your only hope is that after awhile the grizzly gets bored batting you around, and eventually moves on without eating you.

On the other hand, black bears are not carnivores, and generally would rather avoid confrontation. So, ***be aggressive***. If you make noise and raise your arms to appear larger than you are, there is a very good chance a black bear will leave the scene altogether. However, if you passively roll up into a ball, they will be emboldened enough to paw at you with sharp claws.

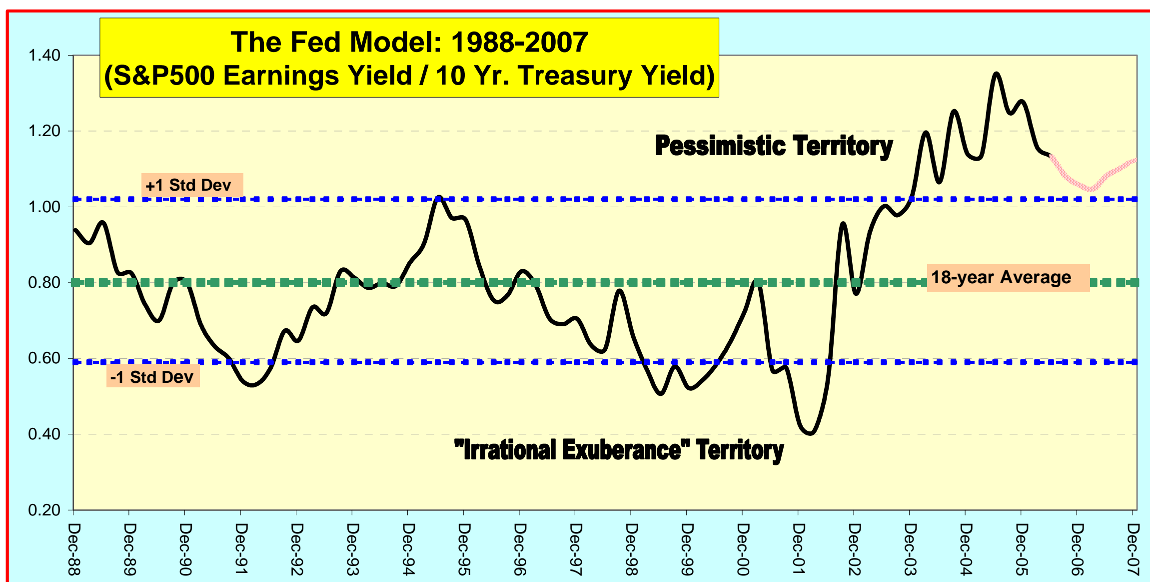
With many investment markets' experiencing a sharp downturn in May and June, some investors are concerned about the onset of a new bear market. The first step is to employ Rule #1, and assess what type of bear you might be facing. If it's a grizzly bear market, the likes of 1973-74 or 2000-02, you'll do best by capitulating early, rolling your portfolio up into a ball (a large dose of conservative cash equivalents) and simply waiting it out. You'll net about 4-6% per annum. All bear markets eventually come to an end, so deciding when to uncurl your portfolio will become important.

If you are instead facing a black bear market, it may be time to get a little aggressive. Each correction will represent an opportunity to re-balance back up to your long-term equity targets. You'll be buying low, and your gains during the forthcoming recovery will thus be much larger than they otherwise would have been. Each correction may leave you a bit fearful, as any encounter with a bear should, but each should be relatively brief. And, your aggressiveness will have already positioned you for the recovery.

So, are we facing either type of bear market as we head toward 2007? To help begin to answer what is a hugely complex question, we turn to the simple Fed Model, graphed below. This compares the stock market's current "yield" (1 ÷ PE ratio) with the 10-yr. Treasury yield. Over the long term, investors have demanded current stock market yields (last twelve months' EPS) averaging 80% of the current Treasury yield, with earnings growth prospects providing the extra return needed to compensate them for the extra risks being taken. Sometimes investor optimism is so great that <60% seems okay, while pessimistic periods dictate >100%. Unsurprisingly, we've been in a pessimistic period ever since the last grizzly bear market ended. But, don't confuse investor pessimism with a fundamentally overvalued market. If Treasury yields jump to 6% by December *and stay there*, the S&P will still be pretty attractively valued at 1300. If you spot a bear, it is very unlikely to be a grizzly.

See you next quarter!

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



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