Chartwell Consulting

CHARTWELL REVIEW

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Who's In Charge Here?

The recently ended quarter saw further instances of poor, perhaps even criminal, corporate governance practices being exposed. We learned the NYSE's board of directors, who are generally chief executives of the firms regulated by the NYSE, have been habitually approving up to nine figure compensation packages for the Exchange's executive management. Given this inherently conflicted structure, it's no wonder the antiquated specialist system perpetuated at the NYSE is now under serious investigation by the New York Attorney General for actions that discriminated against outside investors.

It seems to us that favoring a few shareholders to the potential detriment of many, in order to profit by the action, is a good working man's definition of corporate malfeasance. If so, then the past quarter brought to light the possible criminal activity of a "select" group of mutual fund companies, and their management.

While these mutual fund shops are correct in pointing out that some of their controversial practices are not illegal (although some were), it is also correct that investors **must** be able to rely on the oft-quoted, "we act entirely in the best interests of our shareholders." There are no modifiers in that policy statement, nor can there be if the system is going to keep working.

Table 1. Index Benchmarks

Market Index	Q3	Trailing Returns *			
	2003	1Yr	3Yr	5Yr	10Yr
S&P 500	2.7	24.4	(10.1)	1.0	10.1
Large-cap Stocks	1.9	22.8	(12.8)	-0.4	9.9
Mid-cap Stocks	6.5	32.7	(2.1)	8.1	10.8
Small-cap Stocks	9.1	36.6	(0.8)	7.5	8.3
International Stocks	8.2	27.9	(8.1)	1.6	3.9
T-bills (3 month)	0.2	1.3	3.0	3.8	4.5
1-3 Year Treasuries	0.4	2.6	6.2	5.5	5.7
Aggregate Bonds	-0.2	5.4	8.9	6.6	6.9
High Yield Bonds	2.8	30.0	6.2	4.5	6.7
Global Bonds, hedged	-0.8	3.4	6.8	5.7	7.4
CPI, **annualized**	3.1	2.3	2.2	2.5	2.4

* Annualized trailing returns for periods ending 9/30/03.

Table 2. Average Mutual Fund Returns

Fund Category	Q3	Trailing Returns *			
	2003	1Yr	3Yr	5Yr	10Yr
US Large-cap	2.8	22.5	(10.7)	1.4	8.5
US Mid-cap	5.2	26.7	(11.6)	7.1	8.8
US Small-cap	8.6	33.3	0.1	11.5	10.1
International Lg. Cap	7.4	23.9	(8.2)	2.5	4.9
International Sm. Cap	13.4	36.2	(2.9)	9.9	9.1
Emerg. Mkt. Equity	14.6	42.2	1.8	11.8	0.8
Balanced/Hybrid	1.9	16.0	(2.0)	3.8	7.5
Inv. Grade Bond	0.0	6.0	7.8	5.8	6.1
Government Bond	(0.3)	3.1	7.4	5.6	6.0
High Yield Bond	2.6	24.6	4.1	3.4	5.4

* Annualized trailing returns for periods ending 9/30/03.
Source of fund's data: Morningstar

The Economy

Late in September, the Commerce Dept. issued its final estimate of 2nd quarter GDP growth. Rather than the 2.4% rise originally estimated, a more robust rise of 3.3% was reported. This was substantially higher than indicated in the Wall Street Journal's economic survey just 3 months ago, demonstrating how difficult it is to forecast our huge economy's quarterly growth rate, even in the near term. Thus, we take the past month's heightened optimism (3rd quarter estimates of GDP growth were about 2.8%, but now the "whisper" number is 5-6%), with a grain of salt.

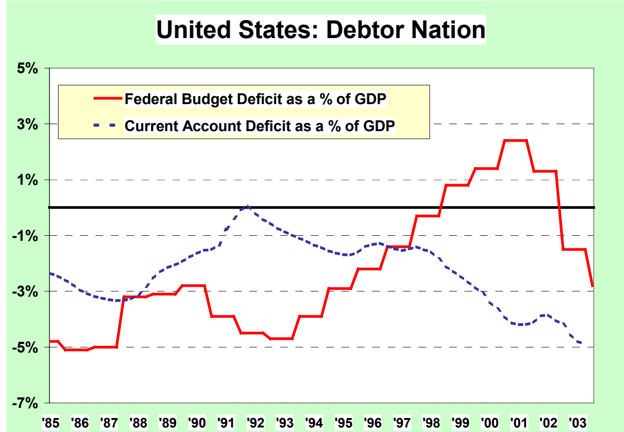
More interesting is where the growth is coming from, and whether any unexpected shifts occurred. Per Table 3, personal consumption grew pretty much as expected for the quarter, but business spending increased quite sharply and government spending, especially on national defense, soared. These latter two factors more than offset another quarter's weak net exports.

Table 3. Contributions to 2nd Quarter GDP

Factor	Contributed …	…By Rising
Personal Consumption	**2.68%**	**3.8%**
Fixed Investment	**1.08**	**7.1**
(- by Businesses	*0.74*	*7.3)*
Chg. in Inventories	**-0.74**	**na**
Exports	**-0.09**	**-1.0**
Imports	**-1.21**	**8.8**
Government Spending	**1.59**	**8.5**
(- National Defense	*1.74*	*45.8)*
All Other Factors	0.0	na
Real GDP	**3.3%**	**na**

As with virtually all quarters this decade, our trade deficit (or, more broadly, our current account deficit) reduced the quarter's growth rate – this time by 1.3%. Chart 1 reflects we have been running higher and higher deficits for over a decade. Unlike during the 1990-91 recession, net demand for imported goods during the most recent recession fell very little, and the current account deficit has since ballooned out to over 5% of GDP.

Chart 1. U.S. Deficits – Fiscal & Trade



At the same time, we can also see from this chart that the country has rapidly moved back to a significant fiscal deficit position, after a brief few years in the black. The aggressive shift to a fical deficit was why government spending contributed so positively to GDP growth during the latest quarter. As long as the federal government spends more than it takes in, this will be a boost to GDP growth.

Employment

The September labor report indicated a decline in the unemployment rate, to 6.1%. This was seen as a good thing, and when combined with the many signs of improving economic growth, it seemed to quell the media's single-note emphasis on the jobs picture. In true contrarian fashion, we were moderately concerned by the 3rd quarter's labor picture, because total **em**ployment actually declined by 165,000 persons. The only reason our unemployment rate went down in September was an unusual 500,000 persons drop in the labor force number since June. This figure almost always is rising, and only drops because a lot of people "give up" on being in the labor force. So, our take is that the overall **em**ployment picture remains mixed, with over 1 million more persons employed since this year's start, but some unexpected weakness recently.

Inflation

Domestic consumer prices (CPI) have been very volatile quarter vs. quarter this year, with the most recent one no exception. The CPI rose at an annualized rate of 3.1% during the 3rd quarter, after falling at an annual rate of 0.7% in the second quarter and rising at a 5.2% rate in the first three months of 2003. The year-over-year increase of 2.3%, compared to a 10-year rate of 2.4% per annum, masks considerable short-term price volatility.

Of course, energy costs have been the prime culprit. They rose at a 28% rate during the 3rd quarter, after falling in the second quarter, and are up 14.7% for the year. The other areas of concern are transportation costs (increased at an annual rate of 9.0% during the quarter) and medical costs (up 4.7%).

The Bond Market

(As we go to print, the 10-year Treasury yields 4.47%. This compares to 3.95% at quarter's end)

The benchmark ten-year Treasury bond dipped to a 45-year low of 3.11% on June 11th, then rose sharply to begin the 3rd quarter with a still-low yield of 3.52%. In fact, as the quarter began all Treasury bonds with 3 years or less to maturity were trading at yields ***less than*** forecasted inflation. Something had to give, and it did. Despite the Federal Reserve's "promise" to keep short-term rates anchored at 1.0%, long-term interest rates were exceedingly volatile during the 3rd quarter, as the following graph indicates.

Chart 2. Long Term Interest Rates in 2003

The result of this sharp sell-off in Treasury bond prices was easily predictable – the domestic bond market posted its worst quarter of performance since June 1999. As Table 4 indicates, Treasury bonds, especially long-term ones, led the way down. On the other hand, high yield (i.e., lower grade) corporate bonds generally retained their value during the quarter. Mortgages also outperformed, but this was from a base of sharp underpermance earlier in the year. In general, overweighting credit bonds has clearly been the winning strategy over the past twelve months, including high yield bonds. What a different result that was from last year's expectations.

Table 4. Fixed Income Sector Returns

Periods ended Sept. 30, 2003; indices are cap-weighted

Index (% of Aggregate)	3Q03	1 Yr.	3 Yrs.
Aggregate Bonds *(100%)*	**(0.2)**	**5.4**	**8.9**
US Gov't, all *(34%)*	(0.8)	3.6	8.9
- US Treas, long *(7%)*	(2.7)	3.6	10.6
Mortgages *(35%)*	0.5	3.5	7.7
Inv. Grade Credit *(27%)*	(0.1)	10.5	10.6
- "BBB" Bonds *(11%)*	0.3	15.5	10.6

High Yield Bonds	2.8	30.0	6.2
- "CCC" Bonds	4.9	68.4	2.9
Global Bonds, Unhedged	2.0	14.4	10.5
Global Bonds, Hedged	(0.8)	3.4	6.8

However, the superior relative performance of credit bonds is not sustainable. One year ago, the Treasury component of the market was yielding only 2.99%, and the Corporate sector 5.55%, for a spread over 2.5%. Then, the BBB index yielded a very rich 6.9%, a spread of 3.3% above the 10-year Treasury. Today, the overall Treasury/Credit spread is down to 1.4%, and the BBB/Treasury spread is down to only 1.0%.

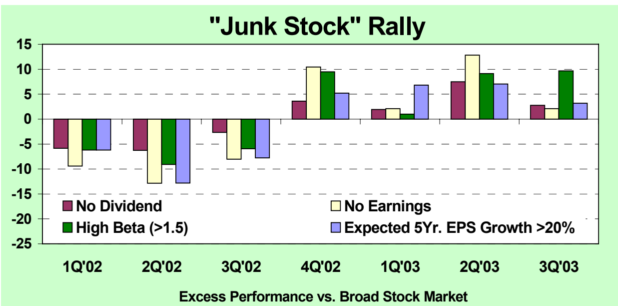
Domestic Equities

(As we go to print, the S&P 500 index stands at 1039. This compares to 995 at quarter's end)

The longest and most severe bear market since the 1930's ended just about one year ago (10/9/02). Over the past year, the S&P 500 has advanced 24.4%, including 2.7% in the quarter just ended. Small cap stocks fared even better, gaining 36.6% in one year, including 9.1% during the third quarter.

We believe the 10/9/02 trough also marked an inflection point for investor psychology. During the latter stages of the bear market, investors aggressively sold risk. Companies with strong balance sheets, low-betas, and a healthy dividend yield fared best. Technology stocks lost 48.9% during the first nine months of 2002, while defensive Consumer Staples stocks lost "only" 6.8%. In 2003, investors regained their appetite for risk taking. Year to date, the riskiest stocks (with betas greater than 1.5) have gained 42% while defensive names (with betas lower than 1) are up "only" 10%.

Chart 3. Equity Investors Are Now "Buying Risk"



Many observers have characterized the current bull market as a "junk stock" rally. Companies with no current earnings or dividends, micro cap stocks, and stocks priced below $10 have posted the strongest gains. Companies with *forecasted* annual EPS growth rates of greater than 20% *over the next five years* have done exceedingly well (+45% Y-T-D).

In terms of investment styles, Table 5 clearly reflects the 3rd quarter results of this continuing rotation toward "smaller and growthier".

Table 5. Equity Returns by Style/Market Cap

Periods ended Sept. 30, 2003; indices are cap-weighted	3Q03	1 Year	3 Years
Growth			
Large Cap	3.1	22.8	-19.5
Mid Cap	7.2	38.9	-17.3
Small Cap	10.5	41.8	-12.6
Value			
Large Cap	0.4	22.7	-5.6
Mid Cap	5.9	28.3	6.7
Small Cap	7.7	31.7	11.1

Betting on future earnings isn't de-facto irrational. A stock's intrinsic value isn't a function of *current* earnings; it's *future* cash flows that count. It's just a riskier strategy. In fact, consistently buying stocks with the highest analyst estimates of long-term earnings growth would not have outperformed the market over the long run. The reason is that focusing only on expected earnings growth ignores two pitfalls:-

1. Overly optimistic forecasts
2. Paying too much

Given expectations for a more modest economic recovery than past recoveries, and the run-up in valuations of low-quality assets, both potential pitfalls should loom large in investor's minds.

From an economic sector perspective (Table 6), large-cap stocks in those areas highly sensitive to the business cycle (technology, capital goods, and consumer durables) led the 3rd quarter advance, although the large financial services and retailing sectors also outperformed. Conversely, health care, utilities, and consumer staples (aka, non-durables) stocks have been relative underperformers throughout 2003. The smaller cap companies (non-S&P) have benefited across the board from intense buying pressure this year, with tech stocks most positively impacted.

Table 6. U.S. Equities - Sector Performance

(Cap-weighted data; Vestek)	S&P 500		Non S&P
Sector (*% of S&P*)	**3Q03**	**1-Yr.**	**1-Yr.**
Financial Services (20%)	4.1	25.9	21.6
Technology (18%)	11.0	52.3	76.7
Health Care (14%)	(4.7)	6.2	44.8
Consumer Non-Durables (9%)	0.2	7.7	16.4
Retail (8%)	4.4	17.8	37.6
Utilities *(6%)*	(5.3)	27.7	36.2
Energy (6%)	1.0	16.6	21.1
Consumer Services (5%)	(1.8)	21.6	27.6
Multi-Industry (4%)	4.8	24.6	96.0
Business Equip. & Serv. (3%)	2.7	19.6	53.2
Capital Goods (2%)	9.2	36.5	29.3
Raw Materials (2%)	5.2	23.9	7.8
Transportation (2%)	0.9	9.8	53.9
Shelter (1%)	8.5	33.3	29.9
Consumer Durables (*1*%)	10.5	14.4	21.8
Universe	**2.7**	**24.4**	**35.3**

We've updated our research on the domestic equity market's valuation relative to "risk-free" bonds, and conclude that moderate appreciation (7-10%) from current levels is a reasonable assumption for 2004. But, we are concerned that the *anatomy* of the current market is unsustainable (not the bull market itself). At some point the market will need to be driven by fundamentals, rather than hope. We feel that a rotation towards higher quality companies (ones with earnings) is inevitable.

International Equities Extend Gains

The performance of international equities appears to be reflecting investors' growing optimism for a global economic recovery. International equities once again outpaced domestic equities during the third quarter, and MSCI EAFE's 18.8% year to date return is well ahead of the S&P 500's 14.7% result. Gains were led by cyclical sectors (technology, industrials and materials), while more defensive sectors (healthcare and utilities) lagged. Similar to the US, lower quality and small company stocks have been the strongest performers on the international front. But, the MSCI EAFE Growth and Value indices tell a different story, with the Value index outpacing the Growth index by 8.9% on a year to date basis (23.2% versus 14.5%). Emerging markets continue to outperform developed markets, returning 32.7% in 2003, and 46% over the past one-year period.

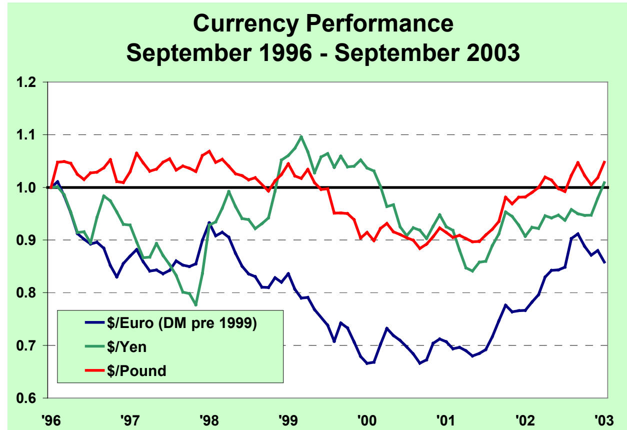
Table 7. International Equity Markets

Cumulative % returns for the periods ended Sept. 30, 2003

	3Q03		One Year	
	Return In US$	Currency Return	Return In US$	Currency Return
MSCI EAFE	**8.2**	**2.6**	**26.5**	**12.0**
EAFE Growth	6.7	-	21.7	-
EAFE Value	9.7	-	31.5	-
MSCI Europe	3.9	1.3	28.2	12.3
MSCI Pacific	18.9	5.8	22.6	11.2
- Japan	21.9	7.5	18.5	9.0
MSCI EMF	**14.2**	**1.8**	**46.0**	**11.2**

Data Source: Capital Guardian

Chart 4. The Dollar Continues to Weaken



The strongest performing region year to date continues to be the Pacific Rim, led by Japanese stocks which returned 21.9% in the third quarter. The Japanese economy posted an annualized growth rate of 3.9% in the second quarter, and confidence in the government's willingness to continue banking reforms is growing.

Some fear that currency management actions by the Bank of Japan, keeping exchange rates low to support an export-driven recovery, have gone too far. The Bank of Japan has conducted $40B of currency intervention this year, and the Yen has weakened 30% against the Euro in the past year.

European markets continue to lag, hampered by sluggish economic growth. Germany, the region's largest economy, remains in recession. Sweden and Denmark were the best performing markets in Europe. There is cause for optimism, as a number of structural changes are in process, but it may take time for the effects to show. Interest rates are low, tax cuts are being implemented, pension reforms are underway and ten new countries are expected to join the EU in 2004. Even so, U.S. investors have done very well in these markets over the past year, after currency gains are factored in.

Perspectives

Stock funds took in an estimated $26 billion of new investments in September, topping the $23bn of equity inflows in August. Through the first nine months, $106 billion has been added to stock mutual funds, compared to a net outflow in 2002. There is evidence the mutual funds implicated in the NY Attorney General's investigation have experienced net outflows in the past month. This is as it needs to be, but a better outcome will be the rehabilitation of the industry's business practices and governance structure (mutual fund boards are notorious for being packed with ineffective cronies of the fund's manager). Institutional investors should now be on notice of the need for unconflicted due diligence when it comes to mutual fund investing.

The country's twin deficits (fiscal and current account) are large and only projected to grow larger during the upcoming months. These are both unsustainable trends, and something will need to give. Normally, the situation can be expected to put continuing downward pressure on the Dollar's exchange value, and upward pressure on long-term interest rates. But, the current market view is that it suits the central banks of our trading partners for the Dollar to remain overvalued, because their export industries benefit. Provided central bankers are willing to prop up our dollar with consistently increasing purchases, and then invest these dollars in our nation's increasing pool of Treasury bonds, both deficits can be sustained. We think that is fine for now, but the *future* strategic implications for investors are –

- Bond yields will be flat to rising, and when they rise is apt to be quite independent of domestic issues;
- While the major currencies have appreciated against the Dollar since the middle of 2001 (see Chart 4), there is much more room to the upside;
- If we take steps to adopt trade restrictions, perhaps to protect certain affected manufacturing industries, Watch Out!

One year ago, we made four very clear recommendations to clients –

1. *"Rebuild Overall Equity positions"*
2. *"Overweight Foreign Equity"*
3. *"Underweight Interest Rate Risk"*
4. *"Emphasize higher coupon credit bonds"*

As a tactical matter, we continue to recommend investors keep at, or modestly above, their overall equity allocation targets.

As a tactical matter, we continue to recommend investors keep moderately above their international equity allocation targets. We also recommend giving your managers the freedom to invest in emerging markets, if they have the expertise, or shifting your assets to managers with that expertise;

Our "long credit risk, short interest rate risk" fixed income recommendation has proved to be quite prescient in a much shorter timeframe than we ever foresaw. But now, credit spreads for all except very low grade and distressed corporate bonds have become fairly tight by historical standards. We've managed enough fixed income portfolios over the past 15 years to know the current trend can't be sustained much longer. Right now, nothing much in "traditional core" bond land is appealing from an institutional investor's perspective. But, emerging markets debt, non-Dollar foreign bonds, and very diversified junk bond portfolios, are attractive.

It's a low expected return, high volatility, investing environment. You either need to dial ***down*** your expectations, or (gulp!) dial up your risk taking.

See you next quarter!

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