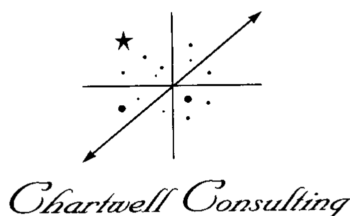

CHARTWELL REVIEW

October 2005 | **THIRD QUARTER 2005** | Volume XII, Issue No.3

IN THE HOME STRETCH

We like metaphors, as even an occasional reader of _Chartwell Review_ knows. Our title this quarter might be alluding to the phase of our country's current economic expansion, which began four years ago and is showing modest signs of slowing. Or, we could be referring to the current bull market for stocks, which began three years ago and has quietly provided super returns (see tables at right) to risk-taking investors who were willing to re-allocate back into stocks when the fundamentals looked right (but the sentiment was horrible), and then stayed the course.

Perhaps we're suggesting the Federal Reserve is finally nearing the final stages of what has been a sixteen month period of tightening, to what beneficial effect is still being hotly debated by economists and bond managers. Or, maybe we're referring to the upcoming end next January to Alan Greenspan's 18½ year tenure as Fed chairman.

We could be vainly trying to make a clever comment on the plight of the U.S. consumer, who own increasingly unaffordable homes, which they will be heating this winter with incredibly expensive natural gas, and in whose garages sit cars that cost the other arm and leg to fuel up. With wages and personal earnings declining in real terms this year, home spending budgets look to be stretched very tightly in the months ahead.

We wish we were talking about our continued military presence in Iraq, but it doesn't as yet look to be the case.

Or, we could just mean it's the last quarter of the year.

Table 1. Index Benchmarks

Market Index	Q3 2005	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	3.6	12.3	16.7	-1.5	9.5
U.S. Large-cap Stocks	3.2	10.2	14.7	-4.0	8.8
U.S. Mid-cap Stocks	5.9	25.1	26.0	7.2	12.6
U.S. Small-cap Stocks	4.7	18.0	24.1	6.5	9.4
International Stocks	10.4	26.3	25.1	3.5	6.1
T-bills (3 month)	0.8	2.5	1.6	2.4	3.8
1-3 Year Treasuries	0.1	1.1	1.6	4.1	5.0
Aggregate Bonds	-0.7	2.8	4.0	6.6	6.6
High Yield Bonds	0.9	6.5	15.7	7.6	7.0
Global Bonds, ½ hedged	-0.5	4.5	6.1	7.1	6.4
CPI, **annualized**	9.4	4.7	3.3	2.8	2.6
DJ Commodity Index	17.6	19.6	20.8	13.3	10.2

* Annualized trailing returns for periods ending 9/30/05.

Table 2. Average Mutual Fund Returns

Fund Category	Q3 2005	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	4.2	13.8	16.5	-0.9	8.7
U.S. Mid-cap	5.9	21.2	21.8	2.6	10.7
U.S. Small-cap	5.3	19.5	23.5	7.3	11.3
International Lg. Cap	11.0	25.9	23.9	3.8	7.7
International Sm. Cap	12.4	35.0	33.8	9.5	12.6
Emerg. Mkt. Equity	16.0	42.9	36.6	13.7	6.7
Balanced/Hybrid	2.9	10.3	11.9	3.1	7.9
General Bond	-0.6	2.8	4.4	6.4	6.2
Government Bond	-0.7	3.2	3.3	6.2	5.9
High Yield Bond	1.3	6.1	13.8	6.1	5.9
Hedge Funds Universe	*5.0*	*12.5*	*12.8*	*7.1*	*11.1*

* Annualized trailing returns for periods ending 9/30/05.

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Developments in the Economy

The government released its final estimate of 2nd quarter GDP during the quarter just ended, and its advance estimate of 3rd quarter activity as this Review went to press. Real GDP advanced at an annual rate of 3.3% in the 2nd quarter, which was weaker than expected. The biggest negative contributor to 2nd quarter GDP growth was domestic inventories. Businesses reduced them $2bn in the second quarter, after an increase of $58bn in the first. The swing reduced GDP by over 2%. The most positive contributing factor in the 2nd quarter was a *reduction* in net exports, which added to GDP for only the second quarter in the past sixteen.

Third quarter GDP is estimated to have grown at a 3.8% annual rate, which was a pleasant surprise to investors and economists. On July 1st, the consensus estimate had been 3.5%. Table 3 reflects the major factors in the quarter. Fixed investment growth, especially by business, has noticeably slowed this year. Overall, it is estimated that GDP has increased by 6.5% in current dollar terms, and 3.5% in inflation-adjusted terms, from the same time last year. This compares to a peak year-over-year real increase of 5.0% during this economic expansion, realized in the first quarter of 2004.

The final tally of 3rd quarter GDP is going to be subject to greater revision than normal, as the impact on inventories and imports/exports due to hurricanes Katrina and Rita is sorted out. Past natural disasters have not had a lasting impact on our economy.

Table 3. Contributions to Third Quarter GDP

Factor	**Contributed …**	**…By Rising**
Personal Consumption	**2.73%**	**3.9%**
Fixed Investment	**0.93**	**5.7**
(- by Businesses	*0.65*	*6.2)*
(- by Consumers	*0.28*	*4.8)*
Chg. in Inventories	**(0.55)**	**na**
Exports	**0.08**	**0.8**
Imports	**0.00**	**0.0**
Government Spending	**0.61**	**3.2**
Real GDP Growth	**3.8%**	
Gross Domestic Purchases Price Deflator		***4.0%***

- ***Personal income/outlays*** – current-dollar disposable personal income increased by only $62bn in the third quarter (+2.8% annual rate), down from $107bn in the second. Prices paid for domestic purchases increased at a 4% annual rate, which means that real disposable income fell in the quarter. Personal savings (disposable income less personal outlays) was >$100bn *negative*, the largest such "dissavings" in any quarter ever. Disposable income growth has been very low this year, and personal spending has exceeded income for most months in 2005.
- ***Private investment*** *(business spending* on property, plant, equipment and inventory, plus *residential investment* for housing) accounts for about 17% of nominal economic activity. Business spending growth in 2005 has been positive, but slower than in 2004. Still, real spending on equipment and software has advanced at an annual rate over 6% for ten straight quarters. Domestic investment in plants and office buildings has declined this year. Taking up the slack has been robust real growth in residential investment, which advanced 5% in the 3rd quarter.
- ***Employment levels*** in the third quarter increased moderately. Based on household survey data, 790,000 more people were employed at the end of September versus June. The unemployment rate rose to 5.1% because labor force growth was faster than jobs growth. Based on payroll data, 450,000 more people were employed during the 3rd quarter. Payroll employment has increased by 2.2 million persons since September '04.
- ***International trade*** is currently not estimated to have had much impact on Q3 GDP growth, but that is likely to change for the worse. The quarterly trade deficit was $176bn through August, up almost $10bn from the prior quarter. Net petroleum imports totaled $154bn during the first eight months of 2005, up from $115bn during the same period last year.
- ***The Inflation picture*** –was the quarter's biggest economic surprise. Including all items, the Consumer Price Index rose 2.3% in just three months, which works out to a compound annual rate of 9.4% for the quarter. This was after rising at just a 1.9% annual rate in the second quarter. The first nine months of 2005 have seen consumer prices rise at a 5.1% annual rate, compared with 3.3% for all of 2004. The energy index increased at a 122% annual rate in the third quarter, and a 43% rate for the first nine months of 2005, after increasing 17% in all of 2004. Excepting energy, consumer prices have increased at just a 2.0% rate this year.
- ***Monetary policy*** - The Federal Reserve Governors twice raised the target Fed Funds interest rate by 25bps during the quarter, to 3.75%. They again gave every indication increases would continue, dashing hopes by some market participants that the hurricanes' impact would cause them to pause. Indeed, *market expectations are now for a year-end Fed Funds rate of 4.25%, plus additional 25bps/meeting increases as we move through 2006.*

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Is the Bond Market "Spitting the bit"?

The only parts of the US$ bond market which advanced during the 3rd quarter were the high yield (aka, "junk") and emerging markets sectors. Yields last quarter on bonds rose across the board (and prices fell), following short-term rates higher for the first time since the Fed started raising rates 15 months ago. Even so, the 10-year Treasury bond yielded only 4.32% at quarter's end.

Table 4. Fixed Income Returns

periods ended September 30, 2005; indices are cap-weighted

Bond Index	3Q '05	YTD	1 Year	3 Years
		Trailing Returns		
Aggregate Bonds	**(0.7)%**	**1.8%**	**2.8%**	**4.0%**
US Gov't, all	(0.9)	2.0	2.5	2.9
US Treas, long	*(2.7)*	*5.4*	*6.9*	*5.2*
Mortgages	(0.2)	2.0	3.3	3.7
Inv. Grade Credit	(1.0)	1.5	2.7	5.8
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High Yield Credit	0.9	2.1	6.7	**15.7**
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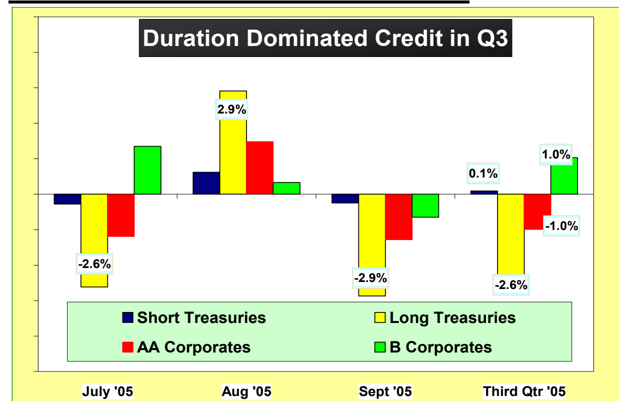
Global, Unhedged	(1.1)	(5.1)	3.0	**8.0**
Global, Hedged	0.0	4.2	6.1	4.1
Emerging Markets	3.8	9.6	15.2	**21.8**

What had been the best performing sector during the past year, long-term Treasury bonds, turned in by far the worst quarterly loss (see Table 4). This was due simply to the much higher duration (or sensitivity to rate shifts) of the long bond. In terms of absolute yields, the flattening trend of the yield curve continued, as Fed policy makers implied that more interest rate hikes would be forthcoming to prevent further overheating in both the housing and bond markets. In response, short-term rates again rose more than long-term rates. The spread between the 2-year and 30-year Treasury yield declined to just 40 basis points, with short-term rates up 1.1% in 2005, and long-term rates down 0.25%.

Chart 1. Credit Risk vs. Interest Rate Risk



Credit spreads were a mixed picture during the quarter. High yield (higher credit risk) bonds outperformed high quality A-rated paper (see Chart 1), but investment grade "BBB" bonds underperformed both. The explanation given by many bond managers is leveraged buyout risk. This is the concern that investment grade companies will be taken over by financial buyers, who will finance the acquisition with lots of borrowed money. Such an event inevitably reduces the credit rating of the acquired firm's existing bonds. Thus, many managers are reluctant to pay up for BBB bonds, preferring instead the already leveraged (thus, "LBO-proof") high yield sector.

Foreign bonds *without* the currency exposure (that is, either $-denominated or currency-hedged) have been better investments over the past year, and the latest quarter was no exception. Developed market rates have not been under pressure by their central banks, keeping prices up. But, the real action this year has been in emerging markets. Rising commodity prices and robust export-led economies have helped resource-rich countries sharply upgrade their creditworthiness (as we've noted previously, over 50% of emerging market countries are investment grade). Investor demand has pushed up prices in most EM countries (China being the notable exception, but it is only the 10th largest EM bond issuer).

The bond markets in 2005 has been challenging for "core" bond managers. Many have kept duration shorter than their Lehman Aggregate index benchmark, anticipating rising interest rates. Unfortunately, those that did so by simply reducing long-term Treasury positions were eliminating the top performing investment grade sector! In the credit area, managers often gravitate to the higher current yields of "BBB" bonds, but these have been under pressure most of the year. Domestic bond managers with the capability (and permission) to invest outside the pure U.S. investment grade market (aka, "core plus strategies") have enjoyed a considerable advantage the past three years.

U.S. Equities – Seabiscuit or Dogbiscuit?

The current bull market started on October 9, 2002, when the S&P hit 776. So, except for a few trading days at the start, the close of the latest quarter marked the 3rd anniversary of the bull market. Further, the broad domestic stock indices (e.g., S&P 500, Russell 1000) peaked in early September 2000. The five-years ended 9/30/05 encompass something of a market cycle (although the upcycle may not be over).

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Table 5. U.S. Equity Returns

periods ended September 30, 2005; indices are cap-weighted

	3Q '05	Trailing Returns YTD	1-Year	3-Years
Growth				
Largest Cap	3.1%	0.1%	7.8%	11.9%
Mid Cap	6.6	8.4	23.5	24.9
Small Cap	6.3	2.5	17.9	23.2
All-cap / All style	*3.6*	*3.4*	*14.1*	*14.6*
Value				
Largest Cap	3.2	3.3	12.6	17.8
Mid Cap	5.4	11.2	26.1	26.7
Small Cap	3.1	4.0	17.7	24.9

Unlike the 2nd quarter, the broad market's solid 3rd quarter returns (see above) were achieved without much intra-quarter volatility. For example, the S&P 500 climbed 3.7% in July, then lost and gained about 1% in each of August and September, respectively. As you'd expect, monthly swings were more pronounced in the small-cap sector, where July's 6.3% gain gave way to August's nearly 2% loss. Final results were superior returns for mid-cap stocks compared to their larger counterparts, with growth-biased indices generally performing better than value-biased ones.

Investment style played its role in 3rd quarter results, but differences have been more muted in 2005 than recent years. It has been possible to gain more excess return from "capitalization management" than it has by simply overweighting value versus growth. Many observers attribute the reduced returns from style bias to the market's overall valuation compression, with growth sectors comprised of increasingly "cheap" stocks and value benchmarks holding more high expectation stocks than ever. Table 6 summarizes the broad characteristics of style indices today, versus three years ago.

Table 6. U.S. Style Sectors – Portfolio Characteristics

periods ended 9/30/02 and 9/30/05; indices are cap-weighted

	Large/Mid Caps Value	Large/Mid Caps Growth	Small Caps Value	Small Caps Growth
Price/Earnings - 2002	15.9	21.6	15.4	18.4
Price/Earnings - 2005	14.7	21.9	17.7	23.0
Price/Sales - 2002	1.0	1.9	0.7	1.3
Price/Sales - 2005	1.4	2.0	1.1	1.8
Price/Book - 2002	1.8	4.2	1.2	2.4
Price/Book - 2005	2.4	4.3	1.8	3.5
Avg. Mkt. Cap - 2002	$45.8B	$80.8B	$0.6B	$0.6B
Avg. Mkt. Cap - 2005	$84.6B	$75.5B	$1.0B	$1.1B

Large-cap growth stocks reflect much the same fundamental values as they did at the absolute bottom of the bear market. All other cap/style sectors have seen their valuations rebound from 2002 lows, although not unreasonably so in light of strong earnings growth. The S&P 500 index is up 51% over the past three years (with dividends, investors have gained 59%). But, in that time the trailing 1-year earnings/share of the S&P companies has advanced either 69% (operating earnings), 120% (as reported earnings), or 156% (core earnings), depending on the line of the income statement you look at.

Table 7. U.S. Industry Sector Performance

GICS Sector *(S&P weight)*	**Large-cap (S&P 500)** Return %	Contribution %	**Small-cap (Russell 2000)** Return %	Contribution %
Energy *(10)*	18.3%	1.73%	29.1%	2.01%
Utilities *(4)*	7.3	0.26	1.2	0.04
Info Tech *(15)*	6.0	0.92	6.6	1.12
Cons. Staples *(10)*	3.1	0.31	(2.3)	(0.07)
Industrials *(11)*	2.4	0.27	9.3	1.33
Materials *(3)*	1.9	0.06	10.3	0.52
Health Care *(13)*	1.4	0.19	7.3	0.91
Financials *(20)*	0.7	0.14	0.8	0.17
Cons. Disc. *(11)*	(0.8)	(0.09)	(5.5)	(0.85)
Telecomm *(3)*	(1.1)	(0.03)	3.6	0.04
S&P 500	3.6%	3.6%		
Russell 2000			4.7%	4.7%

Table 7 looks at industry sector performance for the 3rd quarter, broken down by size factor. In order to gauge the impact of sector allocations on actual portfolio returns, we look at this on two dimensions. The first dimension is how well the stocks in a sector performed. The second dimension is how "important", in terms of total market cap, the stocks of that industry sector are compared to those of all the other sectors. Thus, we see the energy and information technology sectors drove large-cap returns for the quarter, through a combination of strong stock performance and important weight. In small-caps, the same two sectors were very important, even though energy stocks make up only 7% of the small-cap universe. Because of strong returns and important weighting, the industrials and health care sectors contributed significantly to small-cap portfolios.

International Stocks - Ahead in the Backstretch

The domestic trifecta of rising oil prices, higher interest rates and devastating hurricanes did not restrain international equity markets during the quarter. Developed and emerging markets both posted double-digit returns (10.4% for MSCI EAFE and 18% for MSCI Emerging Markets index).

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International growth stocks finally matched the return of value stocks (10.5%). The size factor continued, as small cap stocks outperformed large caps (12% for the EAFE Small Cap Index). Attractive returns were achieved despite a strong currency headwind, as the US$ continued to strengthen versus most major currencies.

Table 8. International Equity Markets

	Local Currency Return %		U.S. Dollar Return %	
	3rd Qtr 2005	Y-T-D 2005	3rd Qtr 2005	Y-T-D 2005
MSCI EAFE	**10.9%**	**17.9%**	**10.4%**	**9.5%**
- EAFE Growth			*10.5*	*8.9*
- EAFE Value			*10.4*	*10.1*
- Europe	8.5	20.0	7.8	7.8
- Pacific, ex-Japan	8.1	14.1	8.2	11.7
- Japan	21.9	24.2	19.2	12.3
- Germany	10.2	19.3	9.7	5.8
- Canada	12.3	22.1	18.5	26.1
EAFE Small Cap			**12.0**	**17.4**
Emerging Mkts	**17.7**	**26.9**	**18.1**	**25.5**
- EM Asia	10.5	16.2	8.5	13.8
- EM Europe	34.4	49.5	34.8	42.9
- EM Latin America	25.1	30.6	30.3	45.3

The large Japanese stock market drove developed country returns, advancing 19.2% during the quarter in Dollar terms, due to an extremely strong local market offset modestly by negative currency effects. The same dynamic is evident for the year-to-date, although negative currency returns were even larger. The resounding victory of reform-oriented Prime Minister Koisumi's LDP party has attracted significant overseas inflows as foreign investors grow more confident that the latest economic upswing will be more sustainable than others in the past decade. The banking sector was the primary beneficiary during the quarter.

Compared to the United States, developed European markets provided attractive absolute returns in the quarter, but this has been the weakest international area. Concerns about the European Union's precarious political situation were ultimately pushed aside by strong corporate profitability and a modest improvement in the region's economic condition. Returns in the region ranged from 3.1% in the Netherlands to 15.6% in Norway, which was once again propelled by soaring energy stocks. German stocks climbed by 10.2%, driven by world-leading exports and the UK market gained 6.2% as record commodity prices helped drive materials stock prices higher.

Emerging markets surged ahead during the quarter. Latin America claimed the winning position, benefiting from rising energy and other hard commodity prices despite the Venezuelan market's (11.4)% loss. Argentina(+49%) and Brazil(+38%) led the way. Eastern Europe's developing markets ran a strong second, with Russia's +48% energy-driven result, followed by the Czech Republic(+31%), Poland(+25%) and Hungary(+22%). The very large Asian emerging markets actually held back overall returns in the quarter, even though absolute returns were excellent, led by South Korea(+22%), India(+16%) and China(+14%).

Not surprisingly, energy and materials were the best performing sectors during the quarter. The only other sectors to post double-digit returns across developed markets were industrial and financial services firm (an odd combo). Conversely, info technology and telecomm services firms have struggled this year.

Table 9. International Sector Performance ($ terms)

	Emerging Markets		Developed Markets	
GICS Sector	3rd Qtr 2005	Y-T-D 2005	3rd Qtr 2005	Y-T-D 2005
Energy	35.7%	64.8%	13.6%	28.2%
Materials	24.5	25.1	19.4	20.0
Industrials	14.5	17.6	13.3	15.4
Health Care	9.9	14.8	8.5	10.5
Utilities	19.1	33.5	6.1	10.1
INDEX RETURN	**18.1**	**25.5**	**10.4**	**9.5**
Financial Services	17.6	19.8	10.9	7.7
Cons. Staples	16.0	30.1	8.0	7.1
Cons. Discretionary	17.2	18.1	9.5	4.9
Info Technology	6.6	15.9	6.1	0.0
Telecomm Services	16.3	21.2	4.8	(4.6)

The above figures are disconcerting to us, especially the EM data. Not because they're poor. But, after three years of a bull market, during which returns have already been exceptional, the stocks of nearly every industry sector had a blowout quarter. We're guessing fundamentals had little to do with the past three months, and October's weakness in international markets bears this out. Rather, money has been sloshing into international equities, much of it coming from U.S.-based funds. Emerging and developed foreign markets do remain cheaper than the U.S. in terms of Price/Earnings, Price/Cashflow, Price/Book, and dividend yields. Nevertheless, we expect near-term volatility will be quite high because of flows.

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Back Page Perspectives

In the space of 5 years, we've been through a super bear stock market (third worst in 100 years) and a rather super recovery. The recovery phase hasn't seemed to capture the imagination of many investors, whether institutional or retail. Given the perversity of investment markets, weak investor conviction and lack of hype has probably added to returns for those true believers.

One thing which strikes us is how closely cumulative investment results over the past 3 years have followed the naively simple "more risk = more return" script. Investing in those notorious emerging market and developed market international stocks (especially small-caps) has produced the best cumulative returns, closely followed by smaller U.S. stocks, commodities, emerging market bonds (not really risky, but perceived that way), large-cap domestic stocks, and high yield bonds. At the end of the parade (and we mean end), are those nice, safe, investment grade U.S. bond portfolios. Not bad returns, given how low interest rates were three years ago, but a long way from actuarial assumptions.

So, we're worried. We can't imagine that all this success hasn't softened up investors just a bit. We find it much easier to give good strategic advice when select asset classes are cheap and look like terrible investments from a backward-looking perspective. It's easier to separate the wheat from the chaff in that environment.

For example, demand for high yield and emerging market bonds must be nearing a peak of sorts. Emerging market debt interest rate differentials versus U.S. Treasuries have fallen to just over +230 basis points, or lower than at any time during the last 12 years. Average high yield differentials are down in the 350bps range. They've been lower (9/97 and 9/04), but not by much. So, are these sectors of the bond market done? Should investors be pulling their core-plus bond manager assignments, and replace them with very conservative investment grade-only mandates? We continue to say no, but not with the same fervor of three years ago.

Another case in point is the entire international equity complex. We've suggested our clients more aggressively weight this area for some time, and have been particularly strident the past two years (our apologies). Relative returns have been great, with the past 12 months nothing short of phenomenal. But, all investment strategies have shelf lives. Should investors now be underweighting international equity exposure? Again, we're inclined to say no, because valuations still favor international stocks, but there is clearly alot of hot money speculating on the greater fool theory – especially in emerging markets.

Also, the currency factor is a concern. U.S. interest rates are already higher, and expected to rise faster, than in other developed countries. As long as we remain the world's primary reserve currency, rising short-term rates may keep the Dollar strong. We're inclined to the flip-side of the currency argument, so this year has surely been a surprise.

And so it goes. Many of the recent slam dunks appear to be gone, with no clear replacements. Differential expected returns are not especially wide across asset classes, and certainly not wide enough to adequately compensate a concentrated investor. Further, our "favorable fundamentals, negative sentiment" metric is not readily observable.

Except with regard to U.S. large-cap growth stocks. Relative valuations now favor growth stocks over value for all tiers of the market. This holds true whether one uses valuations based on earnings, book values, or sales. And the difference is most magnified when we look at the most expensive sector (small/midcap value), compared to the least expensive: large-cap growth.

We expect these stretched relationships will revert toward their means over the next two years. So, we're removing our prior recommendation to overweight small-cap stocks. We believe U.S. small-cap allocations should now be less than market-weight (i.e., less than 14% of an investor's *domestic* equity exposure). If investors decide to keep their total equity allocation unchanged, then all of the small-cap reduction should be flowed to large-cap growth manager(s).

We aren't reversing our basic "conservative allocation, aggressive global diversification" perspective at all. Plans which are presently overweight total equity versus targets should think through this position very carefully. We believe being overweight total equities at this stage presents downside risks that may not be adequately compensated. Traditional equity markets face increased prospects for a global economic slowdown. This could be precipitated by higher global energy/commodity input costs, and/or the unwinding of excessive U.S. leverage (which includes higher interest rates). After three very good years, cautious is the word.

See you next quarter!

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

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