



## **Second Quarter 2004 Review & Commentary**

### **Overview**

The second quarter of 2004, threw a curveball to investors who had become used to the outsized returns of the past year. Less traditional asset classes outside of US stocks suffered along with bonds as the long awaited bond bear market awoke.

### **Equities (Stocks)**

The average US stock fund was narrowly positive with a gain of .84% for the quarter. Value outperformed growth across the US equity market caps. That said, returns for all of the US equity markets hovered around 1% for the quarter.

As noted above, asset classes that are not as widely popular experienced a difficult quarter, giving back what in some cases were enormous returns in the 1<sup>st</sup> quarter. Real estate funds lost nearly 6% after gaining nearly 12% in the first quarter. Gold funds were especially hard hit, losing over 18%. Natural resources funds, which represent the commodities and hard assets found in your portfolio and which were discussed at length in last quarter's commentary, continued to perform well, however, returning nearly 5% for the quarter.

Internationally, investors who were diversified away from US large cap stocks experience a slight decline. The average international fund lost .8% for the quarter. Investors in emerging markets were particularly hard hit with losses of 9% for the quarter, wiping out the 1<sup>st</sup> quarter's gain of 9%. The one year return of 33% shows why an emerging markets allocation makes sense over time despite the short term volatility.

### **Fixed Income (Bonds)**

As noted above and discussed in past commentaries, the party in long term bonds came to a very abrupt and sobering end. The average Long Term US bond fund lost nearly 3% for the quarter. High yield bond funds fared somewhat better losing .63% for the quarter.



## Commentary

*Do not expect to arrive at certainty in every subject which you pursue. There are a hundred things wherein we mortals. . . must be content with probability, where our best light and reasoning will reach no farther.*

Isaac Watts

I generally like to use the commentary space to remind clients of the long term nature of investing and how short term events are mere blips on the radar screen of life and investing. This process often involves evoking theory from some discipline that most people find arcane and normally uninteresting.

This quarter will be slightly different. Not to worry, however, we'll still cover some arcane and uninteresting theory. In fact, to some it may be the mother of all uninteresting theory, namely probability and statistics. The difference is a decidedly short term focus.

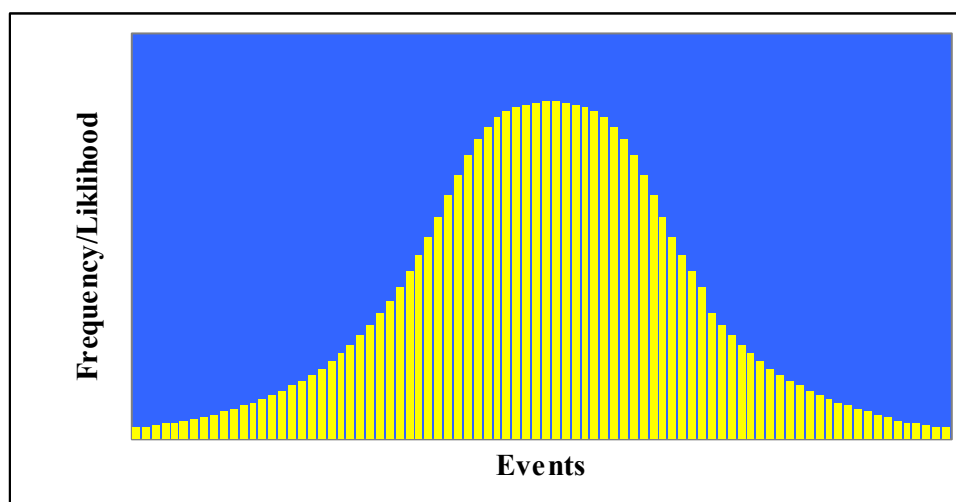
As we near the presidential election, we may see some unprecedented events unfold. Specifically a terrorist event on the scale of, or exceeding those, of September 11, 2001. Al Qaeda learned a valuable lesson with the Madrid train bombings immediately preceding the Spanish elections. Namely, that they can influence sovereign policy and direction with well timed and placed terrorist actions. They will certainly not let this lesson go unheeded as the US presidential election nears. Federal officials are deeply concerned about security for both the democratic and republican conventions, which are both in densely populated, high traffic urban centers (Boston and New York) that are all but impossible to secure.

Given the terrorist group's history however, a political convention strike is not a foregone conclusion. They typically favor "softer," less secure targets, the element of surprise, maximum casualties, visibility and now, direct policy impact. The odds bet would seem to be on an event closer to the election (the Madrid bombing was only three days before the election). It is also reasonable to expect high profile targets and multiple coordinated attacks.

Our job here is to examine the likelihood of such an event and its impact on your portfolio. In terms of the portfolio impact we can look back to September 11<sup>th</sup>. Much of the negative capital market performance post September 11, 2001 was a function of two factors. The first, and largely overlooked or now forgotten, was the already rapidly decelerating economy. The second factor was the increased risk premium across capital markets as the world adjusted to a new perception of greater likelihood of random acts of devastation.

## For Us, The Bell Curve's Toll

The perception of higher risk due to terrorist events is where statistics meet psychology. A very unlikely event is statistically known as an “outlier.” Possible outcomes for most activities tend to form a relatively narrow cluster on a chart in the shape of a bell. In other words, more events with a higher frequency of occurrence (likelihood) are lumped together in the middle. Less frequent events are on the left and right sides which taper off to form the edges of the bell.



In the context of day-to-day life, the bell curve concept becomes more intuitive. For example, we brush our teeth or tie our shoes more often than we go on vacation or get married (except, perhaps, in the case of certain movie stars). In this example, teeth brushing/shoe tying would be in the middle of the graph and vacation and marriage would be toward the outer edges. Thus, the term “outlier”.

The distance from the center to the edges (from frequent occurrences to outliers) is measured by “standard deviations.” The more standard deviations, the more unusual an event is. Put into the perspective of day to day life, going to the dentist might, for example, be a one standard deviation event, while getting into an auto accident or winning the lottery might be a five or ten standard deviation event.

While we acknowledge outlier events as possible, we generally don't base our daily routines on them. When we do experience an outlier event, however, it can change our intuitive view of probability. Someone who gets into an auto accident is likely to be more cautious about driving immediately afterwards as their perception of the likelihood of an accident increases.

The point of this exercise is not simply to bore you endlessly with probability and statistics (which you were likely able to successfully avoid in school). Rather the goal is to provide a necessary basis for understanding current world events as they relate to markets and, ultimately, your portfolio.

Prior to September 11, 2001 the probability of a widespread terrorist attack in the US had been viewed by the markets as perhaps a ten or more standard deviation event. Very much an outlier. Since then the markets have considered a similar or worse attack as more likely or, perhaps better stated, less unlikely. Using the chart above, a large scale terrorist attack has moved from one of the far edges in closer toward the middle.

Lest you be left with the impression that statistics is all about dismal news (in which case you would be confusing it with economics) we can measure the likelihood of some pleasant events as well. For example, a year of unusually large market returns, such as occurred last year.

All of this brings us, finally, to our point. That point being *current market and geopolitical conditions currently represent an unusual probability distribution or, at least perceived probability distribution*. The likelihood of a dramatic, large scale terrorist event preceding the November election is at least perceived to be much greater than had been the case in the past. If on the graph above we say that events to the left of center are bad, a terrorist strike is thought to have shifted from the far left, at least a little right toward the center. Alternatively by virtue of the facts that the economy has strengthened considerably, and it is an election year (which is traditionally good for stocks), unusually high stock markets returns are perceived as being more likely (a shift from the right edge toward the center). These two outcomes are, somewhat obviously, mutually exclusive.

To distill the above paragraphs, there is a very good chance something very good (high returns) or very bad (large scale terrorist attack) is going to happen within the next several months. There's an outlier coming our way, but is on the left or the right?

As you can imagine, this presents an interesting portfolio structure challenge. So let's examine some of the possible outcomes.

Let's start with the best possible scenario or the right side outlier. A major terrorist plot is uncovered and foiled on the same day Osama Bin Laden is captured. The economy and corporate earnings continue to do very well and returns are very good.

Alternatively there is the bad scenario. There is a major plot that is carried out and stock markets react negatively. In the weeks after September 11<sup>th</sup>, the S&P 500 lost 12% which can be directly attributed to the event. Over the course of the next year the index lost 29% arguably due to very poor earnings, fraudulent corporate acts, a declining economy and adjustment to an increase in the risk premium brought on the decline in global security.

A similar event this time wouldn't be as wholly unexpected. The economy and earnings are much stronger and corporate fraud has been reigned in significantly. In other words, the effects on markets would likely not be nearly as severe in effect or duration.

The net effect, however, is that large terrorist events are at a minimum somewhat bad for markets at least in the very short run, but in the longer run markets respond to earnings and interest rates more than they do to events. So there is no reason to panic or put all of your money under the mattress, because you will certainly end up costing yourself far more in the long run in terms of forgone returns than you will save in the short run by trying to avoid some brief unpleasantness.

The above explanations and scenarios are presented not as a predictive exercise or an effort to deny you a good night's sleep. The objective is to provide a framework for what you may be seeing in the media and to provide you with reasonable and realistic expectations. Forewarned is forearmed. If this were a plane flight the pilot would be coming on about now to say "folks, we just received a call from the tower saying there might be some turbulence up ahead, so please buckle your seatbelts."

Your portfolio is well positioned to weather any short-term volatility *relatively* well and still benefit from long term performance. It is worth noting all client portfolios are well diversified to include asset classes such as cash, bonds, real estate and hard assets that can actually perform well in difficult periods. Your portfolio seatbelt is buckled, but we're going to keep flying.