



Second Quarter 2006 Review & Commentary

Overview

The second quarter of 2006 was one of the most volatile in recent memory. The quarter was off to a strong start, losses were widespread across nearly every asset class by the end of May. A late June rebound helped to mitigate the worst of the damage, allowing a (very) few asset classes to finish ahead for the quarter.

Equities (Stocks)

The more aggressive asset classes sustained the biggest losses in the second quarter, as evidenced by stocks around the world. More aggressive Growth stocks underperformed Value across market capitalizations with Large, Mid and Small Cap Growth funds all losing more than 5% for the quarter on average. Small Cap Growth was the worst of the domestic US stock fund lot losing an average of 7.3% for the quarter. This is particularly attention getting in light of the fact that this performance actually represents a significant improvement over the low points achieved during the quarter. The relative domestic stock winners for the quarter were Large Cap Value funds, breaking even with a loss of just .04% for the quarter.

International funds were also caught in the downdraft. The average Pacific Region fund lost 3.3%. Japan and the Emerging Markets took the biggest overseas hits with the average Japanese fund losing nearly 8% and the average Emerging Markets fund losing just under 5% for the quarter. This represented a relatively good performance for Emerging Markets, however, as they had cratered more than 10% in just a few days at one point in May. European funds were the international bright spot, actually returning a slightly positive .8%

Natural Resources provided a rare bright spot in the quarterly investment scene. The average Natural Resources fund returned nearly 3% for the quarter.

Fixed Income (Bonds)

Bonds were more notable for their lack of losses than large returns. The average Long Term US Bond fund lost just .2% for the quarter, losing a nearly flat 1% for one year. High Yield bond funds were also flat, losing just .1% for the quarter.

All indices cited above are Lipper Mutual Fund Indices as reported in The Wall Street Journal Online, July 6, 2006.



Second Quarter 2006 Commentary

No party is any fun unless seasoned with folly.

Desiderius Erasmus

When it comes to reviewing the last quarter, the foremost question would seem to be, what happened? We can divide the answer into two parts. The first is the mechanics of what happened, and the second is to identify some of the causes.

What happened can perhaps be best likened to a roller coaster ride. We got on the ride very excited from the great rides we've been on recently, including the first quarter of this year, which was one of the best of them all. In their rush to get on the ride some investors ignored the "you must be this tall to ride this rollercoaster" sign because they got considerably more than they bargained for. The ride started off to be quite fun for the month of April and into May with many markets continuing their rise from the first quarter by a few percent. Around the middle of May, however, the rollercoaster had reached its crest and began to descend into a very steep and fast decline.

At the end of May we started to make the ascent up another hill with relief. At the beginning of June, however, another fast, steep decline was underway, accompanied by some pretty loud screams. Just before the middle of June, a number of funds and asset classes were off by as much as 20% from their highs. In the middle of June things began a rocket-like recovery with even the hardest hit asset classes and funds paring the losses to "just" several percentage points for the quarter, providing a wild ride indeed. When the ride ended there certainly didn't seem to be any investors yelling "let's do it again!, let's do it again!"

Blame It On The New Guy

So we are left with question, what caused all of this? The quick answer is that it was the new guy's fault. Ben Bernanke, the new Chairman of the Federal Reserve began making comments in the beginning of May that were considerably less than well received. Prior to this, everyone assumed that the Federal Reserve was just about done raising interest rates, inflation was well contained and all was right with the world in general. Furthermore, everyone had been used to years of Alan Greenspan's speaking style, which usually elicited a polite (if not confused) smile and nod from most market participants.

In contrast, Chairman Bernanke actually says what he means, which became very unsettling to those used to years of the old way. In this new speaking style he clearly laid out how he thought perhaps the economy and inflation were a bit more bubbly than everyone perceived and that a few (or several) more rate hikes might just be the thing to cool down all of this economic and market excitement.

Well this changed everything and the cascading effect was underway. If inflation and interest costs are higher, borrowing will be more expensive, which means people and companies can't buy/build as much, and bonds are worth less and companies won't make as much profit, so stocks go down and people won't be buying as many materials to build things, so commodities go down, and mortgages cost more so real estate goes down and on and on. At this point the overleveraged hedge funds had to start dumping positions to meet margin calls, exacerbating all of the downward cycles even more.

After realizing he was the new wizard at the controls and maybe he should be a little more aware of the effects of the things he says, Chairman Bernanke began to back peddle a bit. He made some "things aren't really so bad" speeches, which everyone seemed to mostly buy into.

So that was the cause, but not necessarily the reason. After all, Ben Bernanke didn't build the roller coaster, he just had the controls. The roller coaster was built by, as I pointed out in last quarter's commentary, some markets that had come very far and very fast and were certainly due for a little backtracking.

Perhaps most interesting and unusual was the fact that there was virtually no place to hide, save for cash. As has been pointed out a great many times in this space, one of the great tenets of investing is diversification. According to the principles of diversification, when one asset class goes down, another should go up. In reality, this does in fact hold for longer time periods which has worked quite nicely for us, especially over the last several years. There are cases, however, over much shorter periods, when correlations simply don't hold and everything goes up or down together, and that is exactly what just happened in the last quarter. Luckily, these are rare (perhaps once or twice a decade) and generally very short lived.

Welcome to the Party

Given the new Fed Chairmen's recent speeches and actions, I thought I'd take some time to explore an old analogy that has resurfaced quite frequently in the media, or at least the financial media, of using a party as a metaphor for managing money for clients. This analogy has been around on Wall Street for a number of years, perhaps because it's so effective.

Now, we should establish early on that this isn't to imply that managing money is all fun and games. Rather it tries to capture some of the decision making and complexities of the interactions that can lead to a successful, memorable evening (successful retirement or whatever your goal may be) or a wholly forgettable one where you're left offended, bored or otherwise disappointed (experiencing undue volatility and losses).

In this analogy, the money manager is seen taking his client to a party, or series of parties. The first challenge is to deciding which party or parties to attend. You don't want anything too boring, of course. On the other hand, a raucous frat party in which fights break out and everyone leaves in a paddy wagon would quite never do either.

The Federal Reserve is seen as being the host and has control over the bar or, more specifically in most references, the punchbowl. So they want everyone to have some punch, loosen up, relax, converse, etc. What they really don't want is a drunken brawl. Too little punch and everyone stands around staring at each other, too much and pandemonium ensues. In other words, they're trying to keep economic growth consistent and predictable.

Managers also have some real challenges managing their client's good time at the parties. Get to the party too early and guests are bored (no or low returns). Arrive or stay too late (suffer losses) and you certainly won't be very popular the next day when the hangover arrives.

Of course, all of the guests will compare notes the next day. Was the party I went to the best one? Did someone else get taken to a better one?

So let's bring this analogy back to our situation. After September 11th the Fed not only provided plenty of punch in the form of low interest rates, but practically forced everyone to drink it. Two years ago when the current rate hikes began, they stopped handing out drinks, but still left the punchbowl on the table.

With the additional rate hikes through the beginning of this year, people reaching for punch were beginning to get their hands slapped. This culminated with Ben Bernanke's actions last quarter, which were the investing equivalent of threatening to call the paddy wagon. By the reactions of the markets in May and June, the guests took the new host's threats very seriously.

So now what?

Inflation is clearly the current cause of market angst. This is particularly ironic because it wasn't very long ago at all that the masses were convinced that deflation was going to be the undoing of us all.

The concern is not just inflation in and of itself, but that it makes the Fed do bad things such as raise interest rates too high and plunge the economy into recession. All of this causes a great deal of uncertainty which puts investors (and party goers) in a very foul humor.

Label me an optimist, but I don't see that scenario as the most likely. While inflation has, in fact, picked up (largely as discussed here in the 1st Quarter 2004 Commentary, available at Soundportfolios.com), the current level is simply more of a return to normalcy we haven't experienced for a while than any great historic high.

Much the same can be said for interest rates. I hear comments from people dismayed that interest rates are so high. They are not actually very high at all, they've simply risen back to historical averages.

I believe the reality is that most of the past rate hikes have only begun to tame inflation and the real effects will begin to be felt in the coming months. Exactly how many more interest rate increases the Fed undertakes is anyone's guess. But they are clearly much closer to the end of the rate increase process than the beginning. Once in place, these two factors should serve to assuage uncertainty considerably and provide a much more accommodating investment environment. Punch anyone?