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HOW GOOD WAS IT?

Strong market performance

A year ago, I offered a comment entitled, "How bad *was* it?" covering the markets of 2002. 2002 was a bad year: the S&P 500 index had its third consecutive year of decline (-22.1% in 2002), and international equities also performed poorly, returning (in the MSCI EAFE index) -26.1% in local currencies and -15.9% in US dollars.

2003, of course, was a much better year. Risky assets performed well for the year – the riskier the better, it seemed. The S&P 500 returned a handsome +28.69%, reversing the previous year's decline (the two-year return was +1.54%). International equities were also strong. The MSCI EAFE index returned +17.13% in local currencies. US investors holding foreign stocks also enjoyed the benefit of a sharp decline in the US dollar. EAFE returned +35.82% in US dollars. Germany, which had been the worst of the EAFE markets in 2002 (-43.3% in Euros; -26.1% in dollars), was nearly the best in 2003 (+33.23% in Euros, +60.14% in dollars, a narrow second place finish after Greece). The results in dollars reflect a sharp decline in the US currency. It fell from 119 to 107 yen, while the cost to buy one pound Sterling rose from \$1.59 to \$1.78, and the Euro rose from \$1.03 to \$1.25.

Bonds had a modest year. The Lehman US Aggregate Bond Index returned +4.10%. The market rewarded credit risk in line with equities; the Lehman Credit Index returned +7.70%, and the Lehman High-Yield Index +28.97%. The yield on the 10-year Treasury note, which had fallen from 5.06% to 3.82% during 2002, fell as far as 3.16%, backed up beyond 4.60%, and ended the year at 4.26%.

The returns of the last two years illustrate well the benefits of disciplined investing. An investor earning index returns for one common balanced allocation, 60% stocks and 40% bonds and cash, could have earned +19.82% for 2003. The same allocation could have incurred a modest loss of -9.05% in 2002.¹ The two-year total would have been +9.02%, a strong result compared to +1.54% for the S&P 500.

¹ Calculations by author. Based on monthly returns of a portfolio allocated 48% US equity (S&P 1500 Supercomposite index, source Standard & Poors), 12% international equity (MSCI EAFE Index, source Morgan

Pundit peril

The year's actual results stand in stark contrast to the claims of some investment managers that equity returns are doomed to be low for the foreseeable future, and that we are now in a "stock-pickers' market," in which good managers will easily outperform their benchmark indices. As good an example as any is an interview with Will Muggia, manager of the Touchstone Emerging Growth Fund, on BusinessWire in January 2003. Quoting from the article:

"The bear market is largely over," said Muggia. "We're seeing a muted recovery of the economy because the recession was barely a recession." Muggia is watching leading indicators such as the price of copper, the price of linerboard and Baltic freight rates. "These things are telling us the economy is getting better," said Muggia. . . .

According to Muggia, the leading sector for 2003 is a tough call. "We are going to be in a stock-pickers' market and good, active managers should beat their index this year," said Muggia. He believes the average annual rate of return over the next five years for stocks will be between five and seven percent. Since index funds own every sector, investors in these funds will be pushed toward this mean. "Disciplined stock-picking will be the key to beating that five to seven percent return," said Muggia. Muggia believes active managers will need to find those companies that have a strong new product cycle and accelerated earnings growth, and that good, active managers should be able to find those companies that will lead in a particular sector.²

Mr. Muggia was correct in one respect. It would have been difficult to guess which sector was to perform best in 2003. Standard & Poors publishes sub-index returns within the S&P 500 for ten major sectors identified in the Global Industrial Classification System (GICS). Seven of these ten sectors returned more than +20% for the year. The other three had smaller, but positive, returns.

Calling sectors may have been difficult last year, but how did stock-pickers do? To get some idea, let's look at Morningstar's universe of Large Cap Blend funds, the category most comparable to the S&P 500. According to Morningstar, the Vanguard 500 Index fund returned +28.5% for the year, below the S&P 500 by an amount just about equal to its 0.18% expense ratio. Morningstar places the fund at the 27th percentile among Large Cap Blend funds. In other words, just over one in four US Large Cap Blend mutual funds outperformed the Vanguard 500 Index fund. The following table gives performance results for a number of popular funds in the category, plus the funds' percentile ranks in both 2003 and 2002.

Stanley Capital International), 35% US fixed income (Lehman US Aggregate Index, source Lehman Brothers), 5% cash (author calculation based on 1-month US T-bill yields). Index results may not be available in actual portfolios, and actual results of portfolios managed with objectives represented by this composite benchmark may differ.

² "Touchstone Fund Manager is Bullish on Stocks, Bearish on Sectors; Muggia Says Good Stock-Pickers Should Beat Index Funds," BusinessWire, January 15, 2003.

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Selected US Large Cap Blend Mutual Funds			
Fund	Return 2003	Percentile 2003	Percentile 2002
State Street Research Investment	+30.2%	15	89
Evergreen Large Cap Growth	+29.8%	18	49
S&P 500 Index	+28.7%		
Vanguard 500 Index Fund	+28.5%	27	39
Franklin Growth	+28.0%	35	72
Putnam Investors	+27.6%	42	69
Nations Strategic Growth	+27.3%	46	47
AIM Premium Equity	+24.9%	68	97
Fidelity Magellan Fund	+24.8%	69	68
Strong Growth & Income	+24.4%	72	36
INVESCO Core Equity	+23.6%	78	78

Source: Morningstar. Percentile is Morningstar's percentile rank in performance among its Large Blend category. Performance is for A shares where fund has multiple classes, and does not reflect sales loads. Past performance does not predict future results. In particular, there are years in which more than 27% of Large Blend funds outperform an index fund.

Mr. Muggia's Touchstone Fund itself had a good year, returning +43.4%. Fund shareholders aren't likely to complain about such results. But they probably didn't come from stock-picking – Morningstar classifies the Touchstone Fund as a Small-Cap Growth fund, and the Russell 2000 Growth index, (a broad index of small-cap growth stocks) returned +48.56% for the year, five percentage points better than the fund.

Historical perspective

Opinions on the year's results cover a broad range. Some observers, like the perpetually bearish Alan Abelson of *Barron's*, suggest that we are seeing a reinflation of the 1990s bubble, which will bring investors to grief. More moderate pessimists consider the last nine months' performance a garden-variety bear-market rally (a sharp upward movement in the midst of a long, downward trend). On the brighter side, a moderately optimistic view sees last year's returns as the result of full-blast economic stimulus – low interest rates, high government spending, tax cuts, and yes, a falling dollar. These observers are hopeful, but not sure, that the stimulus will yield a sustained recovery. The most optimistic simply take the market rally as an indication that the worst is over – some even indicate that a new bull market has begun.

The long-term history of the markets may shed further light on last year's returns. If we go back seventy years, to the Great Depression, we can see market action that may, by now, seem eerily familiar. The Depression was truly terrible. Gross Domestic Product, which had been \$103.6 billion in 1929, fell to \$56.4 billion in 1933, before it began to recover. That's a decline of –45% in the overall economic activity of the United States. The consequences for employment, consumption, and business must have been devastating.

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The effect on the markets was catastrophic. From the end of September 1929 (just before the Great Crash) to December 1932, the market, as measured by Alfred Cowles's long-term stock market data series (the precursor to the S&P 500), fell by -71.8%. It must have appeared as though no end was in sight. But what about 1933? The market *rose* by +54.0%, and in 1934 GDP increased for the first time in five years. The table below gives figures for GDP (from 1929) and US large-cap stocks (from 1927) through 1945, just after the end of World War II. From the end of 1932 to the end of 1941 (just after Pearl Harbor, and including the runup to the war), the market more than doubled, returning +105%. From the end of 1941 to the end of 1945, the market rose another +147%.

Market and Economy Depression to World War II		
Year	Market Return	GDP (billions)
1927	+37.5%	
1928	+43.6%	
1929	-8.4%	\$103.6
1930	-24.9%	91.2
1931	-43.3%	76.5
1932	-8.2%	58.7
1933	+54.0%	56.4
1934	-1.4%	66.0
1935	+47.7%	73.3
1936	+33.9%	83.8
1937	-35.0%	91.1
1938	+31.1%	86.1
1939	-0.4%	92.2
1940	-9.8%	101.4
1941	-11.6%	126.7
1942	+20.3%	161.9
1943	+25.9%	198.6
1944	+19.8%	219.8
1945	+36.4%	223.1

Source: GDP figures, US Department of Commerce, Bureau of Economic Analysis. See <http://www.bea.doc.gov/bea/dn/nipaweb>. Stock market: Ibbotson, Roger, (with R.A. Sinquefeld), Stocks, Bonds, Bills, and Inflation, Dow Jones-Irwin/Institute for Chartered Financial Analysts, 1989.

Make no mistake, the 1930s were a volatile time – look at the -35% decline in 1937, ahead of a renewed recession in 1938. But as the figures for 1933 suggest, a significant rally as the economy sets itself up for recovery need not be a surprise.

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What's a long-term investor to do?

We don't know whether 2003 was the start of a long recovery, the worst type of suckers' rally, or something in between. But 2002 and 2003, taken together, demonstrate the enduring power of well-structured portfolios to weather storms while maintaining the positioning necessary to capture market advances when they occur. Investors seeking long-term gains are likeliest to obtain the results they seek if they establish and maintain the equity market exposure they need, while building into their portfolios the allocation and diversification disciplines necessary to moderate and control their risk. The goal is to keep losses in years like 2002 in check, while capturing a solid share of the gains the markets offer in years like 2003. We don't know what 2004 will hold. That is precisely the reason that asset allocation and diversification are as much the policies of the future as of the past.

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Source for performance data: S&P 500 and 1500 index, plus GICS sector, returns: Standard & Poors; Russell 2000 Growth: Frank Russell Company; EAFE: Morgan Stanley Capital International; fixed income index returns from Lehman Brothers; bond yield data and currency rates from Yahoo! Finance.

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