FINANCIAL ADVANTAGE, Inc.®

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The *Blue Sheets®*

Our quarterly commentary on the economy and securities markets

December 2004

I LOVE SUGAR!

I have tasted it, and it is yummy!

Aided by a dip in oil prices and a reasonably smooth conclusion to the presidential election, the stock market (S&P 500) zipped 8% to the upside in just four weeks, bailing out a heretofore uninspiring year for stocks. This surge from late October almost immediately rekindled enthusiasm among investors previously worried about deficits, rising interest rates, global terrorism, the falling dollar, high valuations, slow jobs growth, consumer debt burdens… well, you probably know the litany by heart. But all it took was a couple of "up days" and all of a sudden the sky is blue and the future is sunny!? What happened to the problems and the risks? I was feeling confused.

But, I experienced a flash of understanding about this sudden turn-around in investor sentiment while Mary Liz and I were having dinner at Señor Tucan's Mexican Restaurant with our 4 year-old grandson, Max (a contraction of Martin Xavier!). As Max was finishing the last crumbs of his chicken fingers and fries (a children's menu staple in restaurants of every cultural persuasion) he asked politely, "Are we having sedert?" It took a minute to realize that sedert is easier to say than dessert; then I asked what he would like. "Something with sugar," Max said forthrightly. "I LOVE sugar! I have tasted it, and it is YUMMY!"

Max is not the only small person addicted to sugar. And like the rest of his peer group, he could care less about the data suggesting that too much sugar may not be good for him in the long run. He has tasted it, found it yummy, and hopes to repeat the sensation soon and often.

In an "aha!" moment, as Max dug into his chocolate cake, I realized that his craving for pure carbs actually explains why U.S. investors have reacted so enthusiastically to a few delicious days of rising stock prices. We have tasted this before. It was yummy and we want more! Don't bore us about valuations and risks; bring on the desert!

JMM

The ~~Bull~~ Bubble is Back!

Borne upon the pleasant breeze of a 13-year bull market (1982-1994 gains averaged 15%) the mother of all bull market binges visited planet Earth from 1995-1999, scattering internet sugarplums across the landscape like so many apple seeds. Naive American shareholders greedily feasted on her proffered delights. They became delirious with visions of a New Economy in which productivity would surge by double digits every year into infinity. Any fool could see that real work was no longer necessary for the cognoscenti, appropriate only as punishment for those drudges who didn't "get it." All a thinking person needed was an on-line brokerage account to tap into unlimited wealth. So, heretofore ordinary people emptied their bank accounts, hocked their homes and plunged their IRAs into the sea of prosperity. Literally tens of billions of dollars a month were pumped into the technology stocks, fueling gravity-defying gains averaging 29% a year for five irresponsible, I mean remarkable years!

Shortly after the dawn of the millennium, party-goers awoke to the inevitable hangover and two years of cold-turkey withdrawal as the market plunged 50% from its September 2000 peak to the October 2002 trough. Ouch! Ooof! But a painful lesson in the timeless virtue of moderation was learned, right? I don't think so!

As personal bankruptcies increased to record levels and retirements were postponed across the once-fruited plain, the stock market quietly began to recover, rising 50% in the two years to this month (remember that following a 50% decline, a 50% recovery only bring us back to 75% of the former high). The 8% rally of this latest month has been especially effective in rekindling the blue-sky enthusiasm of the late 1990s. With the enthusiasm of donut addicts tasting their first hot Krispy Kreme after a long abstinence, financial writers whispered at first and then more boldly proclaimed, "The Bull is back!"

On-line brokerage activity has surged suddenly and dramatically, as have cash flows into mutual funds. Believe it or not, Mary Meeker and other 1999 internet bubble celebrities are back in the news, crowding out sober economic and global realities with their familiar message: "Value is relative in a world being ransomed and transformed by astounding new technologies." The market is at a 3-year recovery high. The rocket is taking off again! Don't miss it this time!

Think we are exaggerating? Last week a 73-page Goldman Sachs report initiated coverage of recent hot IPO, Google. GOOG, offered at $85 in August, began trading at $100. Here three months later it is proclaimed undervalued at $167. Goldie's report set a "price target" (language reminiscent of the first internet bubble) of $215, and the stock immediately vaulted to $178 on the pronouncement. In support of the undervaluation thesis, the analyst pointed out that based on 2005 estimated earnings, Google's P/E stood 23% below that of a package of EBay (104 X trailing earnings), Amazon (51X) and Yahoo (96X). The bubble *is* back!

Secular Market Trends

For more than 200 years, American stock market activity has been continuously recorded in exquisite detail and analyzed from every imaginable point of view. Yet most investors, caught up in the daily battle for investment survival, ignore this treasure trove of information. For readers interested in developing their understanding of market history and investor behavior, we strongly recommend "*Bull's Eye Investing; Targeting Real Returns in a Smoke and Mirrors Market*" by John Mauldin (2004, John Wiley & Sons, Inc.). In this important work, Mauldin makes a convincing case, supported by reams of hard data, that there are long-term trends in the stock market, the understanding of which will give an investor a huge advantage over other hopeful buyers and sellers of securities.

In its briefest terms, long-term or "secular" bull and bear markets have tended to last about 10- to 20 years. A secular bull market begins with stocks selling at a low, usually single-digit multiple of corporate earnings, which we call a Price/Earnings ratio or P/E. Over a bull cycle, the P/E ratio gradually rises as investor confidence in the future increases, so that stock prices rise faster than the earnings of the companies issuing the stocks. Typically, in the last stages of a secular bull market, stock prices advance at an accelerating pace, resulting in a very high aggregate P/E ratio for the market.

But trees don't grow to the sky. All good things must come to an end. There's no such thing as a free lunch. Choose your favorite cliché to describe the cold reality that Bull markets always end; and they end badly for shareholders ignorant of this reality.

Mauldin points out two interesting and important characteristics of secular market trends:

First: Corporate earnings tend to grow quite normally throughout the secular market cycle, whether the trend in P/E ratios is rising or falling. U.S. corporate earnings have grown 3% or 4% a year, on average, *plus* the rate of inflation. Naturally, earnings growth is not a straight line, but is interrupted by business cycles. Since the Great Depression, the normal earnings growth trend has been about 7% a year, including 3% inflation; yet over those 75 years the stock market has still experienced, alternately, long bull and bear market trends. So, even the ability to accurately predict corporate earnings for the year ahead will not necessarily provide an investment advantage in the short-term. Wall Street, which specializes in making earnings forecasts (though not always accurate ones), may be disappointed to learn this!

Second: Over a long secular market cycle, whether bull or bear, in any single year the market is as likely to go up as down! So, alas, understanding whether we are in a secular bull or bear market does not provide any advantage in forecasting next year's market.

> **Since Bull's Eye Investing is a 400-page book, of course we cannot do justice to its valuable insights in these few pages. So, Financial Advantage will be happy to provide a copy for any *retainer client* who would like to read it. Just call Charrée Nash at our office and tell her that if we send it you will read it! (Offer good to December 31, 2004.)**

So what *is* the big advantage of identifying secular bull and bear market trends? For one thing, by seeing where P/Es are trending and how they are situated relative to their historic extremes, we are better able to gauge the risk and return potential of the broad market. Understanding that shifts in investor attitude are reinforced by experience and take a long time to run their course gives us the conviction to go against the tide. Secular market trends are not about corporate earnings or the business cycle; they are about P/E compression or P/E expansion. This is the overwhelming reality. Understanding this should help investors avoid getting swept up in periods of either runaway optimism or abject fear, and free them to run outside the herd and to actually make money when others are losing theirs. We think that is a significant advantage!

The Current Situation

Where are we today in terms of these long, secular trends?

Virtually all observers now agree that a classic 17-year bull market topped out in 2000 when the S&P hit 1527, an astounding *11 times* the index value at its 1983 low! During that time, stock prices gained over 16% a year while underlying earnings compounded at an above-average 11%, a patently unsustainable divergence. Now, in November 2004, despite a nasty multi-year correction, the index is still at 1182, and selling at 20 X the latest 12-month reported earnings versus a P/E of approximately 8X when the bull market trend got under way 22 years ago.

Steve Leuthold, of The Leuthold Group, and other market historians believe the best way to measure P/E activity is to divide the index by the average "normalized" earnings of the latest ten years in order to eliminate the distortions of peaks and valleys in corporate profits. Using this approach, the 2000 market peaked at more than 40X normalized earnings compared with a peak P/E in the low 20s in 1929 and 1964; those earlier market tops were followed by secular bear markets of 20 years and 17 years, respectively.

Today the market's normalized multiple is in the *high 20s*, well above any time in history except the 1998-2000 top! Mauldin notes that, "There has never been a time in history when P/E ratios have been in the range they were in 1999 or the end of 2003 that 10 years later investors in the broad stock market have outperformed a money market fund. None." We think investors should find this fact sobering. We find it *motivational*!

John Mauldin, Jeremy Grantham (of investment manager GMO) and many other experienced investment professionals (including your advisers at FAI) believe we are currently just four years into what promises to become a prolonged, secular bear market with years of P/E compression ahead of us, unless the compression should occur more suddenly. In this context, the rally of the last two years is most correctly understood as a "cyclical bull market rally" within a secular bear market trend.

We believe that the broad U.S. market indexes represent limited return potential over the next five years.

Morphing from Bull to Bear

You may ask, "What causes this P/E compression that characterizes secular bear markets?" Or asked another way, why do investors exhibit boundless enthusiasm for stocks late in a bull market cycle and then somehow become less enthusiastic, even skeptical about future business developments and expected future investment returns?

For every cycle the answer is different, but what typically triggers the shift from bullishness to bearishness is *unexpected bad news*, cold water, rain on the parade, some sort of disappointment relative to expectations. For individual stocks, it may be a negative earnings surprise or a news development that portends *future* earnings disappointment, such as an accounting scandal, an unforeseen competitive threat or a significant product failure. For the broad market, the catalyst can be an accumulation of corporate earnings disappointments, or an economic or societal development of broader impact such as rising inflation, a currency crisis, a recession or a war.

Do investor attitudes change abruptly or gradually? In 1929 the change was swift and dramatic; stocks plunged for 2 years with nary a rally of any significance. There were major cyclical rallies in the mid-1930s and mid 1940s but the next secular bull market did not get under way until the Eisenhower years, lasting until 1964. The 1964 topping process was a long, dragged-out affair that didn't really get scary until the 40% market collapse in 1973-74. But the next bull market didn't launch until the early '80s.

Why does the shift in investor attitudes take so long? Contrarian investor David Dreman and Eric Lufkin produced a study in 2000 called, "Investor Overreaction: Evidence That Its Basis is Psychological." They examined for numerous consecutive fifteen-year periods the price performance of groups of the most popular stocks (high P/Es and rising prices) versus groups of stocks that were, concurrently, the least popular.

Researchers in behavioral finance will not be surprised by the study's finding that investors tend to chase price performance (helping explain how bull markets pick up speed in the late stages), and that investors are prone to expect a future similar to their recent past experience (helping explain why, after a long bull market, they tend to rationalize early disappointments as aberrations.)

The more fascinating results of the Dreman study are that once a popular stock suffered due to disappointing news, its price behavior continued negative, sometimes for years, *even when the earnings continued to grow*! They conclude with respect to popular stocks that lose their halo, "There is no reversal in fundamentals to match the reversal in returns. That is, as favored stocks go from outperforming the market (to under-performing) their fundamentals do not deteriorate significantly; in some cases they actually improve." In another paper, Dreman and Lufkin show that, "Even a small (negative) earnings surprise can initiate a reversal in returns that lasts many years, *typically four years after the initial event."* They attribute these observations to major changes in investor expectations following a surprise. "We conclude," write Dreman and Lufkin, "that the cause of the major price reversals is psychological."

> Consistent with the work of Dreman and Mauldin, we believe that some sort of fundamental development triggers a shift in investor expectations at both bull market tops (characterized by greater than usual optimism reflected in *high* Price/Earnings ratios) and bear market bottoms (characterized by greater than usual skepticism reflected in *low* P/E ratios). Stock market history has shown that once these shifts in investor expectation begin, they tend to continue in the new direction for years until another extreme is reached, setting the stage for reversal of the long secular trend.

How to Invest in a Secular Bear Market

Because we are convinced that the U.S. stock market is in the early stages of a secular bear trend or period of significant P/E compression, we think that the potential returns on a portfolio correlated to the S&P 500 or NASDAQ do not justify the risk inherent in the historically high P/E ratios of the broad market.

We suspect that Dreman is correct in his contention that once investors' highly bullish expectations are disappointed they tend to grow increasingly skeptical (which becomes reflected in shrinking P/Es) for years, *even if economic fundamentals are pretty good*. We all know that the optimistic "new economy" mindset of investors was seriously shaken by the losses of 2000-2002. That alone would seem like a serious enough event to launch the classic secular bear market trend that Mauldin so painstakingly describes.

Yet it is also clear that the recent rally, with powerful encouragement from Wall Street, has rekindled the animal spirits. All this is consistent with the historical patterns; as past bull markets have morphed into bear markets, a roughly 50% recovery from the first big decline has normally preceded the next major down leg.

But we think the current bearish case for the broad market is even stronger than Dreman's and Mauldin's theses, because we see in the present economic circumstances substantial risk of further disappointments to consensus expectations that could accelerate the P/E compression.

Specifically, we perceive that the prosperity of the U.S. economy for most of the past decade has been bolstered by an assortment of unsustainable financial stimuli which, in turn, have resulted in unprecedented debt leverage for consumers (accounting for 70% of GDP and government (20%). We think that in the nearby years, the U.S. economy must work through some potentially painful adjustments before sustainable long-term growth can be resumed. We are confident that such a transition will be successfully achieved in this, the world's freest, most transparent and most resilient economy. But we believe that to enjoy investment success *during* the adjustment period will require fresh insights with respect to global capital flows and a non-traditional approach to asset allocation.

Our long-standing goal for retirement portfolios is to achieve an average *real* or after-inflation return of 4% from "conservative" portfolios. In an environment of 3% inflation, that translates to a nominal return goal of 7% a year. We believe that for the next five or maybe ten years, unless stocks collapse suddenly, it is imprudent to

expect more than a 5% nominal annual return from the broad U.S. stock market; less is certainly possible. Furthermore, we believe that a reasonable expected return for a diversified bond portfolio is perhaps 4% to 5% at best, with greater than usual volatility.

If we are right (and we are supported in our modest return expectations by a star-studded cast of professionals including Warren Buffett, Bill Gross and Peter Bernstein) no matter how we vary the weighting of stocks and bonds in our portfolios we cannot expect to reach our return objectives. Hence, we have concluded that we must address an opportunity set different from the broad U.S. stock and bond market indexes if we are to help our clients achieve our return objectives to support their retirement goals.

For the past five years, we have already been structuring our clients' retirement portfolios very differently from traditional stock/bond mixes that were successful during the last secular bull market. This differentiation has allowed us to avoid losses during a very serious first-stage bear market. In recent months, anticipating further economic dislocations for not only the US but many of our traditional trading partners as well, we have been developing further enhancements to our strategy that we hope will allow us to continue earning consistent positive returns in a dangerous market environment.

Fresh Approach to Portfolio Design

Over the last 25 years or so, portfolio management has been increasingly influenced by the efficient market hypothesis, which posits the impossibility of "beating the market" with any sort of consistency, because the market supposedly processes every known scrap of information about each stock as soon as it is available. A manager is foolish to waste resources trying to outsmart this highly efficient market. Instead, he or she should focus on capturing "market returns" for the clients by allocating a portfolio's resources across a wide swath of the major asset classes.

We have always been uncomfortable with this theory on several levels, preferring a disciplined value approach to investment selection for both equities and bonds. This has served us well. And yet, for the 17 or 18 year duration of the latest secular bull market, broadly diversified portfolios of stocks and bonds did indeed provide very satisfactory investment returns, which appeared to validate the theory and consistently attracted new adherents. The efficient market hypothesis has been the philosophical force behind the enormous popularity of low-cost "Index Funds" and the "style box" approach to diversification.

However, now that 60/40 stock/bond portfolios neatly divided among large-, mid- and small caps, growth and value, domestic and foreign and so forth have become the norm in portfolio management land, it needs to be said that the reason for the apparent success of the efficient market theory is that for nearly 20 years both bonds and stocks had the wind at their backs in the form of falling interest rates and rising P/E ratios. Furthermore, from the beginning to the end of the secular bull market, corporate profit margins went from a cyclical low to a cyclical high, which helped reinforce investor optimism along the way; a perfect environment for virtually any asset class you could name or invent.

The next ten years will almost certainly not be so kind across the board. In fact, we are so convinced that there will be unusual volatility and extraordinary variation in returns among the different kinds of securities, that we believe the efficient market approach to asset allocation needs some serious updating. To that end, we have designed a new and practical way to describe the diversification in our client portfolios that we think will help us identify opportunities and reduce overall investment risk.

Scenario-Based Allocation

Beginning in the first half of 2005, rather than describe our portfolios by their percentage allocation to cash, stocks and bonds, and rather than using the popular style-box approach to describing asset classes (large growth, small value etc.), we will begin our portfolio design process with the overarching classifications of "Stable Investment" and "Opportunistic Investments." As you would expect, our Stable Investments category will include mostly cash equivalents and short-term and medium-term fixed income securities with low expected returns, low expected volatility and only a small opportunity for excess return or "alpha." This category will be useful for liquidity, for opportunity reserves, and for tempering overall portfolio volatility. The allocation to Stable Investments will be made separately for each client.

Our broader "Opportunistic Investments" category will be far more eclectic and will contain investments with more expected volatility. Hence, these investments will require our serious effort to see that they represent a variety of variously-correlated risks, to minimize the possibility that any one financial scenario might trigger all the risks. As a matter of fact, we expect some risks to be negatively correlated to others in the portfolio. As one example, some investments may be selected to defend against rising inflation and others to do well in a deflationary scenario.

So far we have identified <u>four major classifications</u> covering a <u>dozen sub-categories</u> of Opportunistic Investments to be considered for our portfolios. We would not expect all of them to be represented in all portfolios all of the time. Some you will recognize as "sectors" of the equity market, some as management styles, and some will not be equities at all. Some can be implemented with individual securities and some with no-load mutual funds.

What these Opportunistic Investments categories have in common is:

a) We believe they will help us identify opportunities for satisfactory investment returns during the nearby years despite the unattractive valuation of the broad markets, and

b) By using these sub-categories we can broadly diversify, and thereby minimize the investment risk in our portfolios, especially relative to future economic developments.

Following are our four major classifications and the current 12 sub-categories of our Opportunistic classification. In the future, we may add to them or we may consolidate them as our research develops.

Income-producing	**Macro-driven**	**SuperiorValue**	**Competitive Advantage**
Dividend Growth	Emerging Economies	Deep Value	Great Businesses
Interest-sensitive	Commodities	Distressed Secs.	Health Sciences
Real Estate	Short positions	Special Situations	Small Companies

The mutual funds and securities which we already own in client accounts already fit nicely within this matrix. This enhancement of our approach to portfolio design is consistent with the investment style we have employed, yet we believe it enhances our ability to identify opportunities and reduce risk by thoughtful diversification unencumbered by the constraints of traditional asset class definitions.

As we begin to implement this strategy, we expect to be reducing the positions in money market funds and short-term bonds to fund opportunities with greater return potential. It may appear to some clients that we have

stepped up the level of risk in their portfolio; and, in fact, that may be true in some cases if you think in the conventional sense that a greater percentage allocation to equities indicates greater risk (meaning, in Modern Portfolio Theory terms, greater volatility of results in the short-term.)

However, what we are trying to achieve by our new approach to portfolio design is to actually *reduce the overall risk* in our clients' portfolios during a period of P/E compression in the broad equity markets, *while increasing the potential for positive investment results*.

If we are right (and if professional managers and academics far more famous than we are right) that in the next 5-10 years broad U.S. equity markets are unlikely to provide the sort of 10% or 11% nominal return they have *averaged* the past 75 years, but rather that we may be in for a long stretch of 0% to 5% sort of returns with a serious risk of some substantial declines… and

If you are not going to be happy with sub-5% returns on your portfolio the next 5 or 10 years…

Then, we think you will welcome the idea of owning smaller positions in low-return fixed income securities and having a greater commitment to our value-based Opportunistic categories designed to provide broad diversification of risks and opportunities as we pursue positive and consistent returns in a dangerous investment world.

In subsequent editions of the Blue Sheets, we will go into more detail regarding our definitions of the new categories and about the sorts of specific investment opportunities we see in them. We are confident that you will gradually come to share our enthusiasm for the investment opportunities ahead and the way in which portfolio stability will be enhanced by our scenario-based approach to diversification.

For the Investment Committee:
J. Michael Martin, J.D., CFP

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DJIA 10,522 S&P 500 1182 NASDAQ 2101 30-yr Treasury 4.88%