

## ***FINANCIAL MARKETS COMMENTARY*** ***2nd Quarter 2003***

**July 19<sup>th</sup> 2003**

### **Summary**

The April through June period was very favorable for stocks. Investors believed the combination of very low interest rates and tax cuts would stimulate an economic recovery in the United States. They began to snap up those securities they believed would benefit the most from a rising economy; technology, telecommunications, financial services stocks, as well as machinery, industrial services and homebuilders. In the case of the first three, expectations were very low in March with the uncertainties related to the Iraq conflict, which left a great deal of room for improvement.

Federal Reserve Chairman Alan Greenspan added fuel to the rally in May when he stated that he would keep interest rates low even when the economy recovered, in order to make sure deflationary factors were wiped out. This further emboldened bond investors. In fact, interest rates hit forty year lows by June 13<sup>th</sup>. Normally bonds really shouldn't do this well if there is or during a strong economic recovery. This anomaly was resolved late in the quarter by a pullback in both bonds and stocks.

Generally, the riskier the asset class the more it made last quarter. Technology rose 24% (though it is still down an average of 34% a year over the last 3 years). Real Estate only gained 12% on the quarter, but this sector has averaged a 13% gain over the last three years. The rebound in the dollar (brought about by the belief that the economy was strengthening), helped smaller companies outperform larger ones. The Dow Jones Industrial Average advanced by 13.1%, but the Russell 2000 (small cap) bested that by 10.3%. International stock funds averaged just under 19% (offsetting a terrible first quarter during which they lost 9%). In bonds it was the same story – risk won out. Mortgage bonds rose less than 1%, Treasuries gained close to 2%, and high grade corporate bonds topped 3%. If you had ventured into international government bonds, you were rewarded with a 6% gain. High yield corporate (junk) bonds soared over 8%.

### **Strategy**

Only a very aggressive investor would or should try to attempt to catch an impressive yet temporary rally. As a result of the market actions we only adjusted our Aggressive Portfolio (all equity funds) during the quarter (replacing the Clipper Fund with the more aggressive TCW Select Equity). The

economy seems to be treading water right now, and the notion that cutting interest rates automatically solves all problems has been disproved over the last few years. We are still more concerned with preserving capital at this point than increasing it.

### Performance

Our Balanced Model Portfolio gained 9.52% last quarter. This compares with the 11.24% return for the Balanced Model Benchmark. Because we have been more conservative than the benchmark, we would expect to modestly underperform the benchmark during a strong up quarter. Year to date the balanced model is up 8.60% versus 9.12% for the benchmark. Our portfolio management focus will continue to be capital preservation for the vast majority of our clients.

The Aggressive Model Portfolio surged 17.83% during the past quarter, just a slightly less than the Aggressive Model Benchmark at 18.37%. Even though aggressive portfolio management is not an investment area that we emphasize we are pleased with these results.

### Outlook

In the short run, the stock market is ahead of itself and we don't expect a substantial pullback unless the bond market rapidly deteriorates. There is however, more than an outside chance that this could happen. While bond yields can't really go much lower, they could get substantially higher quite quickly as investors realize that the ability of the Federal Reserve to hold down *long term* interest rates is very limited. We have kept bond durations lower than average so far this year. This has held back our bond investment returns somewhat. We believe that reduced interest rate sensitivity will be a major plus for the rest of the year, if not the next several years. Expansionary monetary policy and fiscal deficits should eventually push short rates back to 3% and long rates closer to 6%.

### Commentary – Doing the Math

Technology stocks gained more than 24% last quarter, and yet are still down an annualized 34% since June 2000. Put another way, a dollar invested in technology stocks on June 30, 2000 would have been worth about 24 cents in March, before soaring to 30 cents at the end of this past quarter. If technology stocks gain 50% every year from now on, you won't have your original dollar back until May of 2006. If they gain 20% per year, you are not whole until 2010. If they average 5%, it would take 25 years to break even. The arithmetic goes like this: Lose 10% and you need to gain 11.1% to get even. Lose 20% and you need to earn 25% to get whole. Drop 50% and you need to gain a full 100% to make it up.

*The lesson here: Don't let your dollars become quarters.*

**At Capital Strategies we strive to protect our client's principal. This is primarily because our clients are already financial comfortable, and as a result don't need or want to put their assets at substantial risk. More than that, however, is the knowledge that the best investors we know and respect have all been extremely averse to giving back their gains. They would rather make less in a rising market than lose more in a falling one. The main value of holding cash is not the interest you earn, it is that cash will not decline in value and can be easily redeployed when investment opportunities next present themselves.**

**This past quarter the average stock fund rose just under 17% and the average bond fund gained near 3%, so an evenly blended portfolio would have gained 10% or so. Our Balanced Model Portfolio was up a little more than 9.5%. We are comfortable with this because we do not measure our own performance quarterly. Over the last year, two years, three years, five years, and from inception we are well ahead of the benchmarks. Why? Primarily because we have done a much better job of not giving money back during down markets. It did not escape our attention that technology stocks were having an oversold rally last quarter, or that the internet sector in particular was the strongest it had been since the fourth quarter of 1999. We just chose not to participate. Let's say we didn't like the arithmetic!**

**We believe that we are in a period where investment returns will be lower than they have been over the past twenty years or so. On the plus side, inflation is also likely to be lower, tax rates are lower, and the real return to investors after tax will likely be in line with what we saw in the 1980s. Our approach to capital preservation will be more beneficial than ever in this scenario, since in a low nominal return environment, it is that much harder to make up losses.**

## **Capital Strategies Financial Corporation**

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