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Financial Markets Commentary *2nd Quarter 2005*

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Summary

The markets shifted notably in the second quarter. First quarter fears that the economy was growing too briskly and that interest rates would rise above 4% gave way to concerns that the economy was slowing too much. As such, the winners and losers list was very different last quarter. Interest rate sensitive securities like bonds, REITs, and small company stocks roared back from steep first quarter losses. Larger companies, which held up much better during the first quarter, gained little or nothing in the second quarter. International stocks did poorly in dollar terms as European economies weakened. Emerging markets fared much better, especially Latin America. Stronger commodities markets have really helped natural resource-based economies (Canada, Australia, Russia, and Brazil) at the expense of finished goods producing economies like those in Europe and Japan.

Halfway through 2005 the Dow Jones Industrial Average was down -3.7%, the S&P 500 was down -0.8%, the Russell 2000 (small stocks) was down -1.2%, and the EAFE index (inter-national stocks) was off -1.2% in dollar terms. Despite, the declines, there is a great deal of money out there just looking for a good place to invest, thanks to very low interest rates. This has kept a floor under the stock market when the news was not good; it remains to be seen whether this will lead to a breakout now that economic news has been improving. During the last period where there was a lot of excess money sloshing around (1997-2000) technology advances drew that money into the stock market (especially into the internet sector). Today, investors looking elsewhere for outsized gains. As a result, the speculative activity has occurred mostly in the real estate and energy sectors.

The bond market also had a good quarter, rising a little over 2.3% on average. Foreign central banks are investing their trade surpluses in our government bonds. Inflation measures have been mostly benign. These and other factors have allowed long term bond yields to fall even though the Federal Reserve is raising short term rates. Moreover, some influential bond strategists abandoned long held bearish views last quarter and predicted already low bond yields would get even lower.

Strategy

There was no major change in our strategy. Relative to the first quarter, we received more return from bonds and smaller company stocks last quarter and less from large company and international stocks. Because the best performing areas of the stock market have been more volatile sectors (energy, real estate) that we want to limit exposure to, we have maintained a higher degree of diversification in our portfolios. In other words, relative to a neutral stance, our portfolios contain more funds of a smaller average size. This has enabled us to generate very good returns on more volatile positions that may represent only four or five percent of the portfolio. Since most of the market (especially the big “safe” stocks) have failed to break even so far, this has proven very effective.

Outlook

June was a good month for investors and July has also started off that way. In almost every area of the market, stocks are up against price levels that have capped previous rallies. This suggests that while there is plenty of money to push stocks higher, investors aren’t yet convinced stocks are worth higher prices. The market needs an industry to provide leadership. Energy stocks have been the big winner so far this year, but rising energy prices tend to be a negative for most of the rest of the market (so energy never leads a broad advance). Strong real estate markets tend to draw money out of, rather than into, stocks. If technology or financial services could build some momentum, we might be able to break out of the current low risk, low return environment.

Commentary – The Bigger They Are . . .

Speaking of leadership, investors tend to look for it from very large companies such as Intel, General Electric, and Microsoft. Companies with multiple product lines and well respected CEOs have influence across a variety of industries. Guidance from firms like these can move the markets. Unfortunately, the majority of these very large companies seem to be spinning their wheels lately. Size seems to have become more a hindrance than an advantage. Five years ago Wal-Mart was looked at as the retail “category-killer”– able to dominate any market it went into. Now they are being beaten in many categories by smaller, more focused firms. Other large companies – Pfizer and Merck in pharmaceuticals, AIG in insurance, Coca-Cola, Citigroup, Hewlett Packard, etc. -- seem to be mired in ditches of their own digging. They are all up against the reality of size - the bigger a company gets, the more it takes to generate the same level of sales and profits.

Ironically, at the same time the performance of all of the capitalization (size) weighted market indices are lagging, investors are increasingly being advised to buy index funds (almost all of which are cap-weighted). Many financial columnists like to point out that passive indices beat most active managers over time (largely because active management expenses are higher by around 0.8%

per year on average). Yet in a study done by Robert Arnott which was recently published in the Financial Analyst Journal, capitalization weighted indices give up about 2.0% per year in performance. Weighting a portfolio by market cap causes one to put more in big, well loved (expensive) companies versus smaller, out-of-favor (cheaper) stocks. Index funds measure market caps quarterly or yearly and buy more of what went up and sell what went down. In other words, they tend to buy high and sell low, which statistically reduces return over time.

Index investing exploits the desire we all have -- to find an investment we can buy and forget about, knowing it would do just fine over time. The truth is the real world doesn't work that way. Financial Markets are dynamic; opportunities open and close all the time. A company develops a product that revolutionizes an industry and makes it a lot of money. The money attracts competitors. Competition brings down selling prices. Profits fall. The exceptional company becomes average. This is repeated constantly in our marketplace. The best companies find ways to stay ahead of their competition as much as possible, but a certain amount of reversion to the mean is inevitable, especially due to the difficulties of size I discussed above.

The same is true of investment strategies. We believe that indexing relies on a strategy that ultimately hurts investment returns over time, but it is highly touted because it results in better performance than a lot of investors would experience if left to their own devices. We at Capital Strategies spend a lot of our time trying to determine what is happening in the financial markets and why. We stay current on the latest investment research so that we can implement changes before they are fully priced in by the market. Just the fact that a company is large or an index fund has a low expense ratio doesn't necessarily mean it is going to perform better; in fact the opposite is often true. It is important to be able to separate the knowledge that General Electric is a very influential company from the conclusion that GE is a good company to invest in; these are two completely different things.

We really don't pay much attention to the various commentators on CNBC etc. or what is written in the financial press. What we really care about is what works for our clients' investment portfolios.

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