

FINANCIAL MARKETS COMMENTARY

3rd Quarter 2004

October 21, 2004

Summary

The third quarter of 2004 was down and then up. Stocks fell almost (-7%) from the start of the quarter until August 17th, and then climbed (+5%) from that point until the end of the quarter. Technology stocks led the decline down (-10%), as capital spending in that sector proved disappointing. On the other hand, natural resources stocks did extremely well (+10%) thanks to steadily rising oil prices. Oil was the biggest reason the overall markets finished lower, because high oil prices tend to act like a tax on the economy.

If rising oil prices were hard on stocks, they should have been devastating to bonds. After all, rising energy prices are inflationary. Moreover, (as expected) the Federal Reserve raised the Federal funds rate two more times. For these and other reasons, investors went into the quarter very negative on bonds. When the economic data began to show unexpected weakness, bonds came back into favor. Rising oil prices surprisingly contributed to the bond rally. The reason; investors were more concerned that high oil prices were slowing the economy than pushing up inflation. In a slowing economy, capital appreciation takes a back seat to income because the latter is assured where the former is not. The highest yielding stocks, real estate and utilities, were the second and third best sectors respectively. On the bond side, high yield corporate and international bonds, the two best yielding sectors, provided the highest returns.

Strategy

It was our strategy last quarter to maintain positions in hard asset sectors (natural resources, commodities, real estate) in those families where such sectors are available. Another way to play rising commodity prices is international bonds, especially those of countries whose economies depend more on natural resources (Canada and Australia). We were underweighted in growth stocks and growth industries such as technology and health care. Technology is suffering from too much competition and not enough demand. Health care is facing regulatory pressure, high profile drug failures, and precious few truly new products. Like most everybody, we were caught off guard by the rally in bonds. Our bond positions which tend to be in shorter maturities did not fully participate in the quarter's gains.

Performance

We had an excellent quarter! Despite losses for the overall stock market each of our Model Portfolios posted a gain. Our Balanced Model gained (+1.21%) last quarter, compared to a (-0.06%) loss for its benchmark. Our Aggressive Model gained (+1.13%), which was much better than the (-1.72%) loss the all equity benchmark experienced. Commodities, real estate, and inflation-indexed bonds were behind the superior performance of the Balanced Model. For the Aggressive Model, it was stellar performances from an emerging markets fund and a small cap stock fund. This more than made up for modest second quarter returns.

Outlook

Financial markets hate uncertainty. Next month's election is at this writing too close to call, so a lackluster October should not surprise anyone. I don't believe the outcome of the election will materially affect the overall market, but it provides traders nervous about the economy an excuse to do nothing. The nervousness stems from the fact that the economy has been statistically strong for over a year but cannot seem to grow jobs fast enough to accommodate the growth in the work force. The numbers don't make sense when taken together – either the economy isn't as strong as reported or job growth is better than is being reported.

To some extent stocks are being held down by high energy prices. That gives us optimism for the current quarter, in that \$50+ oil is not likely to be sustained. If oil comes down, non-energy stock prices are poised to bounce back.

In any case, the post-election period promises to be better. In election years, a disproportionately large percentage of the market's return occurs after the election. (The only concern I have is that a post-election rally is so widely expected, like last summer's consensus for a plunge in the bond market that it may not happen). An environment with less uncertainty favors growth stocks over value and appreciation over income, so we may be making changes to portfolios in the next couple of weeks.

Commentary – On Market Timing, Indexing, and Beating the Market

The term “market timing” refers to the practice of buying and selling in one's portfolio in order to earn a return greater than that of the market itself. You've probably heard someone say, “You can't time the market”, as if such a thing were impossible or illegal. It is possible (millions of investors try in way or another) and legal (unless you make arrangements with fund companies similar to placing a football bet after the end of the first quarter). Market timing is rightfully discouraged because it is difficult and most who attempt it fail to achieve a return greater than that of the market.

However, the fact that beating the market is difficult and that the majority who try do not succeed does not necessarily make it not worth pursuing. Many of our greatest scientific discoveries have come about through someone's dogged determination. If the markets were perfectly efficient or perfectly random, we would agree that there is no reason to attempt to do better than the market, since doing so would either be impossible or completely dependent on luck. As you might guess, we do believe that beating the market is an attainable pursuit.

Index investing (or investing in all the stocks in an index and passively accepting the market's return) is very popular right now. Indexing is based on the premise that the market is efficient; therefore all that can be known about a stock is already known and factored into the current price. Thus it follows that there is no ability to uncover information (positive or negative) about a stock that would enable one to make excess profit. According to the efficient market hypothesis, if any stock were priced too high or too low, traders would sell or buy that stock until an equilibrium price was realized (the true value of the stock). This hypothesis has basically governed the investment world for at least the last 25 years, but it is coming under increasing skepticism. First of all, efficient market conditions do not reflect the way real traders operate. Secondly, indexing itself make the market more inefficient.

In the real world, investors have different objectives and time horizons. They also have costs to transact and taxes to factor in. For example, even if Coca-Cola is trading at \$49.60 and everybody somehow agrees it is worth \$50 (which would never happen), they still may not buy it for several reasons: The potential gain is not large enough. Other opportunities may be more attractive. The cost to buy at \$49.60 and sell at \$50 may wipe out the gain. They may manage a fund that is only allowed to buy international stocks or small companies or bonds.

Here is another example: Right now I believe Taser International and Research In Motion are highly overvalued. I am not selling these stocks short because I know that there are speculators in these companies that are looking to squeeze short sellers (force them to buy back in at a higher price) by manipulating the shares available to be borrowed. During the Internet craze five years ago many a short seller was right about the value of the company but still suffered substantial losses due to short squeezes. The point is, markets are only efficient if all investors have equal knowledge and similar objectives, for only then would they have similar incentive to trade or not trade.

I believe the more interesting statement is the second one, that indexing makes the market more inefficient. Think about it. The more people index, the fewer traders there are to take advantage of pricing inefficiencies.

For example, on October 14, 2004 New York Attorney General Eliot Spitzer called a news conference to announce an investigation into bid rigging in the insurance industry. That clearly lowered the value of the companies being investigated. If everybody indexed, there would be no way to punish the main culprit (Marsh & McLennan) without punishing all other stocks (at least, all other insurance stocks) equally. Even as it was, investors dumped insurance stock funds all day and created an opportunity to buy those insurance companies not named in the complaint. Put simply: If everybody is a potential buyer or seller of a stock, there is less of a chance it gets wildly mis-priced. The more we invest passively in baskets of stocks, the fewer investors there are to accurately disseminate information into the prices of specific company stocks.

Famed investor Warren Buffett once said something to the effect that the game of trying to outperform the market was made considerably easier by that fact that so much of his competition didn't think the game was winnable and as a consequence, weren't even trying. I have no problem with writers such as the Wall Street Journal's Jonathan Clements who advocate indexing on the premise that most investors forays into investing cost more and deliver less than the indexes do. I just don't believe the logical extension to that premise is to give up and accept what the market is going to give you (especially when that might be (-48%), as was the U.S. stock market's return between March 10, 2000 and October 7, 2002).

Most investors do fail to achieve superior returns, usually because they invest emotionally (buying into strong markets and selling into weak ones). If that is true, however, then there must be at least some investors who have been able to sell into strength and buy weakness and thereby do better than the market (for if many are below average, at least some must be above average). For this group (and I can think of many who qualify), active investing has been very rewarding.

Therefore, rather than accept the argument that investors by and large do not make good decisions and therefore ought to adopt a strategy that takes all decision-making away from them, I would rather conclude that the volume of investors making both bad decisions and no decisions creates opportunity for skilled managers to make good decisions. Individuals make markets, and markets always create opportunity (even when it tries not to). It is our goal to continue to invest (in mutual funds) alongside those managers that have been able to take advantage of the opportunities the market presents.

Capital Strategies Financial Corporation

Mark A. Carlton, CFA

**Eric C. Graber
President**