

Asset Class Performance Comparison

The returns for the quarter ending September 30th were surprisingly positive given the sharp decline in July and August. Only two asset classes fell into negative territory, US Small Co's (-4.0%) and International Small Co's (-4.5%), reflecting the shift in favor of larger companies both in the US and abroad. Part of the theory now favoring Large Co's is their potential ability to withstand the effects of an economic slowdown due to their financial strength and global customer base. On the other hand, Large Company stocks have been performance laggards for the past ten years and the simple law of averages, or reversion to the mean theory, suggests that they might outperform. Speaking of larger companies, US Large gained 2.0% for the quarter while International Large gained 2.2%; roughly a 6% advantage for the quarter over Small Cap stocks. The high grade bond market performed very well during the recent "flight to quality" movement with US Bonds gaining 2.9% for the quarter; US Treasury Bills gained 1.2%. US Real Estate gained 1.4%; however, that modest gain masks the real story as REITs (i.e., stocks which own commercial properties) have declined by about 20% from their all-time high in February of 2007. For several years, I have been commenting that REITs were defying gravity and likely due for a correction following a long period of extraordinary performance. Some suggest that REITs may correct even further, although according to Ted Bigman, chief of Morgan Stanley's Global Real Estate division, the fundamentals in the real estate market remain strong and may help to limit further losses. Finally, the best performing asset classes this quarter were Emerging Markets (+13.7%) and Natural Resources (+8.9%) which reflect the continuing global economic expansion and seemingly endless demand for resources (as well as growing scarcity). A natural question, of course, is whether or not the financial slowdown in the US will ripple through to the emerging economies and cause their stock prices to pullback.

Performance for the latest twelve months was positive across the board. Leading the way, once again, were stocks of Emerging Markets (+54.8%) and Natural Resources (+48.7%). While we don't expect such returns to continue, we're still positive about the long-term prospects for these asset classes. Next in line were International Large Co's (+24.9%) and International Small Co's (+19.1%) which were well above historic norm (10% to 12% is the expected average annual gain). A significant portion of the international stock gain was due to the US dollar falling in value relative to foreign currencies. Being denominated in foreign currency, the value of international stocks will benefit should the US dollar decline (and vice versa, of course). For example, of the 24.9% gain in International Large Co's over the past year, more than half of that return was the result of the gain in foreign currency relative to the US dollar. (Note: if you're planning a trip to Europe, make sure to take some of the profit from your foreign funds to buy euros.) Next, US Large Co's gained 16.4% for the trailing twelve months with US Small Co's gaining 11.6%. Fixed Assets provided healthy returns with US Bonds up 5.4% and US Treasuries up 5.1% (it wasn't long ago when interest rates were in the 1% to 2% range). In last place, for the first time in many years, was US Real Estate with a twelve month return of 3.8% (foreign real estate fared better).

Volatility is Back

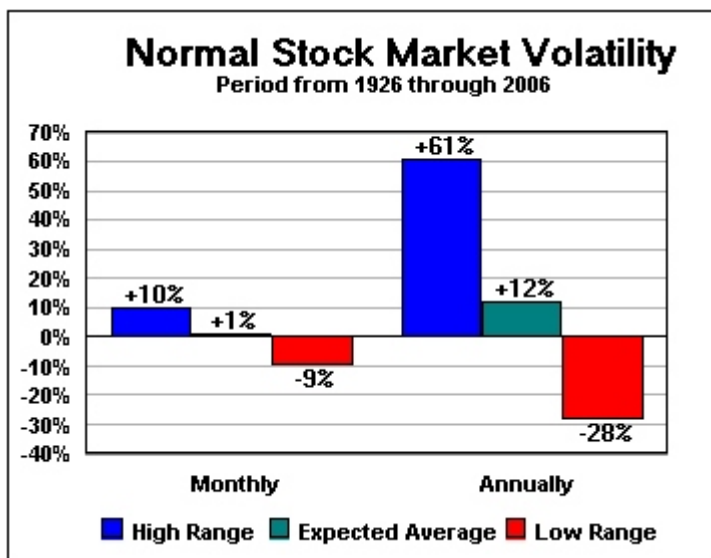
"It's baaaack", or reminiscent of an old Poltergeist movie line in which the little girl announces that ghosts have come back to haunt her parent's house, investors were once again reminded in July and August that volatility is an ever-present risk with the stock market. For those who might have been on vacation and only compared their June 30th statement with their September 30th statement, the 12% stock market nosedive might have gone unnoticed. For those who did notice, it might have felt like the stock market was exhibiting unusually high volatility; or perhaps it's the sensationalistic financial press which would have us believe that's the case. Nonetheless, the graph above illustrates the volatile path of global stock prices over the



past nine months. After a drop of 6% at the end of March and early April, the Dow Jones World Stock Index climbed by 16% through the middle of July only to plummet by 12% following the sub-prime loan scare. Thereafter, the market seemed to shrug off the bad news and regain lost ground with a surge of 13% by early October. Was this recent volatility particularly unusual? Actually, this year's stock market behavior has been just about average - it just seems more volatile given the magnitude of the Dow at 14,000 and multiple hundred point swings becoming the norm.

Are there any lessons to (re)learn about stock market volatility and what should we expect going forward? Without a crystal ball to make predictions, the best assumption for future stock market performance is to expect that it will behave pretty much as it has in the past (I realize that this "prediction" isn't the kind of sensationalistic stuff one might find on the cover of Money magazine). The chart below includes two measurement time frames of performance over the past 80+ years for a portfolio consisting of all stocks (50% invested in US Large Co's and 50% in US Small Co's).

In one month periods since 1926, stocks rose by an average of 1% (i.e., 12% per year), although the monthly range was between a loss of 9% and a gain of 10% as measured by two standard deviations (a risk measure which excludes only the most extreme periods going back to 1926). How do these long-term volatility figures compare to the recent results? Over the past twelve months, the actual high gain for stocks was 6% (October of 2006) and the biggest loss was 7% (July of 2007), with a monthly average of a little under 1%;



just about what one would expect given historic volatility. In looking at annual time frames over the past 80 years, the all stock portfolio provided an average compound annual return of 12% with the range of returns falling between minus 28% and a gain of 61%. In looking at the latest trailing ten years (a period which includes the Tech Wreck), stocks provided a lower than average return of 10%; however, the range of returns were just about what would be expected with the biggest loss being 23% in 2002 and the highest twelve month gain being 59% in 2003 (note how the biggest gain came immediately after the biggest loss which is a good lesson on why it's hard to time the stock market).

With expected monthly swings in portfolio value of plus 10% or minus 9%, we find that most investors would prefer to dampen the risk of an all stock portfolio. Of course, one proven method of reducing short-term risk is to balance the volatility of stocks against the stability of high quality bonds. For example, over the past ten years, an investor who placed 50% of his or her portfolio in high quality government bonds and 50% in stocks achieved an average annual return of 8% versus the 10% for all stocks. A 2% lower annual return would be very meaningful over a long-term investment horizon. On the other hand, not everyone requires 10% to achieve their financial goals and a more reliable 8% return might be just fine; plus, the trade-off for accepting a lower return was a much lower level of risk. Instead of experiencing a 22% loss in 2002 as did the all stock investor, the 50% bond investor limited his or her loss to just 5%; a much more tolerable level of risk. Since there are no guarantees with investing and no magic answers as far as portfolio risk balancing is concerned, our commitment is to work closely with each client of the firm to help determine his or her long-term financial goals and recommend a portfolio allocation which appropriately balances future needs against a tolerable level of risk.

In Closing, a Reflection from the Archives

In searching the Aequitas archives recently, I ran across the quarterly letter I wrote to clients exactly ten years ago following the death of my mother in which I discussed some lessons learned in looking back over her lifetime and that of her parents. While this was written in October of 1997, I think that the lessons learned are still valid today and I offer them as my closing thoughts.

Last month [in 1997] we lost three great women -- two of whom you know about. First, Princess Diana's sudden death shocked the world, then Mother Theresa's lifelong mission of helping the most downtrodden ended, and finally, my mother passed away after suffering through one of life's cruelest diseases, Alzheimer's. I hope you will forgive me for taking this opportunity to tell you a little about her life. Sometimes experiencing the death of a loved one presents an opportunity to reflect upon some of the more important lessons in life. And, as you might guess, there is an important message to this story regarding the management of investments.

My mother, Margaret, was born in 1919 during an extremely prosperous time in America. Her father was a successful young businessman in the steel industry in Youngstown, Ohio, and made a great deal of money during the 1920's, but lost much of what he owned as his business failed during the Great Depression. Thankfully, he had saved enough to provide college educations for his two children. As the Depression ended he once again started a new business and reestablished financial security. All went well until, once again, he experienced business failure at a time just prior to his retirement in the early 1950's. Were it not for his savings and investments, retirement would have been a financial disaster.

Soon after retiring, my grandfather died leaving my grandmother with a modest estate, including a stock portfolio and a house on Buzzards Bay. She lived for the next 25 years on the income from her stocks and Social Security. She didn't worry about the stock market or the gyrations of the Dow Jones very much, she was only concerned about the dividends which never missed a beat and which managed to keep pace with inflation. At her death, my mother inherited those stocks and, through continued professional management of the portfolio, they provided income throughout both bull and bear markets, recessions and hyperinflation. With this modest portfolio, plus with the assets left to her by my father, my mother had sufficient assets to be able to live in her house on Buzzard's Bay and eventually pay for six round-the-clock care givers until her death last month (those high costs consumed a large portion of her portfolio in her later years).

The lesson I learned at an early age from my grandparents was that while financial risk is an ever present reality, through hard work, saving and investing in a diversified portfolio, one can ride through economic depressions, wars, and personal business failures. I know first hand that had my grandfather only invested in bonds and safe treasury securities, he and his wife would not have been able to enjoy a secure retirement. I also know that had my grandmother shifted too much of her portfolio to bonds during the final 25 years of her life, her financial security would have been in question and, certainly, my mother would probably have been forced to sell her home and live in a nursing home instead of being able to spend her final days in the home that she loved so much.

While my mother's financial security was dependent upon having a portfolio consisting mostly of stocks, each of us must find a combination of stocks and bonds to balance risk at a level we can live with -- and still provide sufficient returns so that we won't outlive our investments.

I hope that you had an enjoyable summer and that autumn brings well being.

Sincerely,

Warner A. Henderson