
LETTER FROM THE PORTFOLIO MANAGERS

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Year End Planning



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Heading into December, many investors start planning for the year-end and prepping their investment portfolio for the year ahead. Most of the time investors are primarily focused on the outlook for the Market in the coming year, and while that is obviously important, investors should also be thinking about re-balancing and taxes. Let's address these three issues in reverse order.



Rusty Vanneman

Taxes Do Matter, And Not Just In December

We have spilled a lot of ink talking about taxes in recent commentaries (and expect more ink to be spilled in the years ahead) and for good reason. Investors generally don't realize that "tax cost" is the largest "expense" for taxable investors in mutual funds. That is, the average annual tax cost (the difference between pre-tax and after-tax returns) for domestic equity funds over the last 15 years is actually higher than the average equity fund expense ratio.

Yet, typically, many investors don't start to think about taxes on their investment portfolios until December. We think this is a mistake. One should think about taxes all year long. For instance, if a position in a taxable account is trading at a loss in January, there may be an economic value in taking that loss ("harvesting a tax credit") and/or executing a tax swap. In short, tax planning should be a year-round exercise, not something just for the closing weeks of the year.

This all said, worrying too much about taxes can be a problem, as well. Many investors can't bring themselves to sell a position with a big capital gain — even if the primary investment considerations (such as valuations, fundamentals or risk characteristics) suggest that they should. In short, "don't let the tax tail wag the dog."

For more on taxes, please refer to our past Research Perspective, "Debunking Mutual Fund Tax Myths": http://www.kobreninsightmanagement.com/research_perspectives/res_perspectives_may_2005.html

Rebalancing Your Portfolio

An important task is to periodically re-balance your investment portfolio, bringing it back into alignment with its target portfolio weights to keep it headed in the right direction. This is accomplished by buying assets or market exposures that have underperformed and selling those assets or market exposures that have outperformed. Typical re-balancing programs are based off the calendar (annual or quarterly rebalancing for instance) or off market movements (for example when an asset class moves more than x% from its target weight).

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Over time, due to market movement, portfolio weights can start to deviate significantly from targeted levels. And, if you don't rebalance, that can cause your portfolio to earn less than it should.

Let's take a simplified example where an investor begins the year with a weight of 75% in stocks and 25% in high-quality government bonds which is consistent with their long-term goals and risk profile. It's a tough year for stocks because the economy is weak and corporate profits suffer and the stock portion of the investor's portfolio declines by 30%. But the Fed cuts interest rates to help get the economy going again and so bond yields fall and the high-quality Treasuries the investor owns rise by 13%.

At the end of the year then, the investor's portfolio has 65% in stocks and 35% in bonds. This is well off his target asset allocation, but the investor does not rebalance. The next year, as often happens, the stock market rebounds nicely, rising 30% as the economy starts to improve. Bonds on the other hand are flat.

I'll spare you the math, but an investor who started with a \$1 million portfolio and did not rebalance after the first year, would have earned about \$24,000 less in that second year than an investor who did rebalance back to the 75/25 target mix at the beginning of the second year.

Yet, few investors rebalance even annually, and most don't re-balance at all! Of people who invest in 401(k) plans, according to the Employee Benefit Research Institute, 86 percent don't rebalance. Also, according to Yale's chief investment officer David Swensen, even highly educated and extremely well informed people with a significant degree of financial sophistication don't re-balance enough. In Swensen's book, "Unconventional Success", he studied investors in TIAA-CREF. He found that nearly nine out of 10 investors made minimal, if any, changes to their new money allocations over a 10-year period.

How much does re-balancing "cost"? There are a variety of studies on this point, and there are various time frames that were examined. The answer is, as it is with many questions: "it depends". Nonetheless, one paper we looked at suggested the annual cost of not re-balancing (depending on the time frame) was 0.5 to 1.3% a year. In short, an advisor that re-balances a portfolio can pay for its management fee just by the simple act of re-balancing.

At Kobren Insight Management, we re-balance accounts at least once a year. For non-taxable accounts we look to re-balance in December. For taxable accounts, we look to re-balance in January. We will, however look to re-balance at any time during the year depending on market conditions.

Early 2007 Outlook Suggests Diversification Remains Key

In the broad strokes, our over-all market outlook has not significantly changed that much in recent months. We remain cautious as many factors that we look at in the economy and markets suggest that caution is in order. Let's just look at a couple factors – earnings and valuations.

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We have seen incredible earnings growth in recent years. Using reported earnings from Standard & Poors on the S&P Index, year-over-year earnings growth in 2003 was 77%. In 2004, the earnings growth was 20%. In 2005, it was 19%. It is estimated to be 15% in 2006. For a frame of reference, the long-term earnings growth for the stock market is approximately 6%. Next year, the early call is for 4% year-over-year growth.

As with many market factors, it is just not the absolute level that is important, it is oftentimes the trend of the factor that is even more important. While we have seen stock prices rise in recent years, partially thanks to earnings growth being at least twice long-term averages, the trend of earnings growth is for slower growth – and for below average growth at that. All else being equal, this is not a positive for the market.

It should also be noted that only a few economic sectors expect to have better year-over-year earnings growth in 2007 than they did in 2006: consumer staples, health care, information technology, and telecommunications. What is interesting about these sectors is that each of them has above-average representation in larger-cap securities. While the rough rule of thumb is that the over-all stock market is roughly 70% large cap securities in terms of market capitalization, these sectors range from approximately 75% large caps (information technology) to about 90% (telecom). These sectors tend to have growth tilts as well (though consumer goods and especially telecom have value tilts).

At present, our investment portfolios tend to be tilted towards larger cap companies as well as toward growth stocks.

Regarding valuations, it is often stated that the stock market is “fairly valued” since the price/earnings ratio for the S&P is back near long-term averages. From where we sit, however, it just isn’t this simple. There are a variety of valuation metrics to use, and again the trend of the data is often as important as the absolute level.

The S&P 500 price/earnings ratio, using operating earnings, at the end of 2003 was 20.3. At the end of 2004, it was 17.9. It dropped to 16.3 by the end of 2005. It is expected to be 16.0 at the end of this year based off expected earnings for 2006. Using earnings expectations for next year, the P/E is expected to be 14.6. Looking at individual sectors, each major sector is expected to see their price/earnings ratio contract next year. Yes, P/Es are not as expensive as they were, but they are still trending lower. And, as we have mentioned in the past, they don’t usually stop at average, but well below. Valuations cycle from high to low to high to low to high and low — like nearly all things in the markets.

Three Components to Stock Returns

In summary, when it comes to forecasting the stock market’s returns, there are three components to focus on. First, is the dividend yield (currently about 1.8% for the S&P 500). Second, there is

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the growth in corporate earnings. Third, there is the speculative component that comes from changes in valuations on earnings (P/Es).

As mentioned above, while the long-term earnings growth for the stock market is about 6%, the expected earnings growth for the S&P 500 next year (using reported earnings) is 4%. Also, as note above, when P/Es begin to decline they usually continue to do so until they are well below fair value so lets assume a further contraction of P/Es in 2007.

What does this leave for an expected return for the stock market? Adding the dividend yield of nearly 2% to the earnings growth of about 4% and factoring in a small negative bias due to valuation (P/E) compression, that leaves an expected return of less than 6% for equities. Given that the yield for the Lehman Aggregate Bond Index is just above 5%, this suggests two important things.

First, the value of diversification (i.e. holding bonds and other securities as well as stocks) is as important as ever, especially given that the expected return differential between stocks and bonds is less than in years past.


Second, given that equities still have the higher long-term return potential, growth-oriented portfolios should maintain healthy exposure to the stock market for potentially higher returns.

Next month we will review how our annual list of potential surprises (2006 version) fared, and boldly lay out our list of surprises for 2007.

Sincerely,



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Portfolio Manager



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