KOBREN INSIGHT MANAGEMENT
An E*TRADE Wealth Management Company

Letter From The Portfolio Managers

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Hot Topics

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In the course of our regular discussions with clients we answer a wide array of questions. However, as the markets here, and indeed around the world, have been surging into record territory, several common themes to your questions have emerged so we thought we would discuss some of those in this month's letter.

(Note: we prepared this letter before the big market sell-off that began on June 5.)

Rusty Vanneman

With the stock market at new highs, shouldn't we increase equity exposure?

Certainly the financial media seems to be making a big deal about the various stock market indices reaching new records, finally exceeding the old highs set some seven years ago. Of course, what that means is that the last seven years have not been that impressive for the stock market. With the S&P 500 now just above where it was on March 24, 2000, there has essentially been zero capital appreciation and with dividend yields of less than 2%, the annualized total return for the S&P 500 from then to the end of May this year has only been 1.7%. Over that same time, bonds (as measured by the Lehman Aggregate Bond Index) have an annualized return of 6.2% and cash has returned 3.0% per year.

On the other hand, the market is indeed displaying positive momentum; steadily moving higher. While we recognize and appreciate the stock market's upward momentum, and acknowledge that some investors like to utilize momentum-based trading strategies, we tend to emphasize value-based and even mildly contrarian strategies. This fits with our philosophy of building well-diversified portfolios.

Our preference is to buy on price weakness and sell on price strength. We like the idea of buying things on sale, rather than buying something because its price is higher than it was yesterday. In other words, it doesn't make sense to us to increase our equity exposure just because some stock market indices finally crossed price levels from years before.

When we assess the outlook for the market today, we are roughly neutral, with positive factors such as momentum and liquidity balanced against concerns about valuations, earnings and interest rates. So despite the siren song of the market's gains, we are sticking with our disciplined, unemotional process and neither adding to or decreasing our allocation to stocks.

Why stick with your process, even when it seems to be "out-of-step" with the market?

We believe that a steady, disciplined approach to saving and investing is the best course to building and maintaining financial wealth. The urge to buy what's been hot is understandable and very human – but it must be fought as it can lead to sub-par returns.

To that point, at a recent Morningstar Institutional Forum where one of our senior analysts, Ben King, was a speaker, Morningstar presented some interesting data on the actual investor experience in mutual funds.

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What they found was that because investors typically buy funds that have already had strong performance, the average investor in mutual funds typically earns a lower return than the average return of the funds themselves.

Let's take a simplified example. Assume that Fund x has a return of 20% in Year 1 with an asset base of $1,000,000. That attracts of lot of investor interest and assets swell to 9,000,000 in Year 2, but the fund's return drops to 0%. The average annual return of the fund over the two years is just under 10%. However, with so much more money invested in the fund in Year 2 compared to Year 1, the typical investor in this fund has had an average annual return of just 2%.

Over the past 10 years, Morningstar's data revealed that the average diversified actively-managed equity fund earned 9.18% per year, but the average investor in those funds earned only 7.53%, or 1.65% less.

Ironically, the performance for diversified index funds was even worse. While index funds averaged 9.11% per year, their investors only averaged 7.09% or 2.02% less. While many individual investors have flocked to index funds because they believe that active-managers can't beat the market – apparently these same individuals are more likely to try to time the market than those who buy actively-managed funds!

While those differences may seem small, compounded over a lifetime of investing, they would likely be significant. At 9.11% per year, in 35 years, a portfolio of $100,000 would grow to $2,114,752, but at 7.09% per year you would have only about half that amount or $1,099,543!

But the stock market is cheap. Why be so cautious?

Compared to bonds, stocks are indeed relatively cheap. This is a major reason why stocks have moved higher in recent years. Low interest rates have encouraged all sorts of market-friendly behavior, including the surge in mergers and acquisitions activity. This is currently a big plus for the market.

On an absolute basis, however, it is a different story. Based on 12-month trailing reported earnings, the S&P 500's price/earnings ratio is at 18.4. This compares to the long-term average going back to the 1920s of 15.9. On that basis, the market is not cheap, though not necessarily outrageously expensive. However, while the level of the market's P/E is not terrible, the trend of price/earning multiples is not so constructive. The market's P/E has been steadily moving lower since 2002. Despite some slight valuation expansion this year, the general trend is still lower. Overall, the net read on S&P valuations, in an absolute sense, is not positive.

Why don't you have more in small cap funds?

Speaking of relative valuations, large-cap stocks are currently cheaper on a relative basis than small-cap stocks. As a result, we are currently modestly overweight large-cap securities. Being believers in diversified portfolios, we do maintain some exposure to small caps, but currently are underweight

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relative to the broad market in our client accounts.

There are a number of ways to demonstrate this relative valuation advantage for large caps but a good example comes from a recent report from Fidelity Investments. It showed that the recent capitalization-weighted price/earnings ratio (which gives more emphasis to larger companies) for the broad U.S. stock market was just slightly above its average since 1962. But the P/E of the median company (which puts small companies on an equal-footing with larger companies), was "almost as expensive as it has ever been [since 1962]."

International Markets Continue To Beat The U.S. Why Not Add More Foreign Exposure?

Because valuations overseas were considerably cheaper than here at home, and the dollar looked like it would weaken (which boosts the value of foreign holdings when translated back into dollars), five years ago we began increasing our allocation to international stocks to 20% of our equity exposure.

Since then, international stocks have had a very strong run versus the U.S. market. As a result, the relative valuations are not as attractive as they once were. It is also becoming a crowded trade. Monthly asset flows from U.S. investors into international securities remain at extremely high levels. A spot-check on U.S. equity mutual fund assets show that approximately 30% of equity exposure is now in international securities. This is a big jump in international security ownership in just the last several years. (Remember the study on why investors tend to earn less than the funds themselves?)

Currently, our client portfolios in general still have 20-25% of their equities in international stocks. As we see it, we are slightly overweight and not eager to add to those positions. In fact, we have modestly trimmed international exposure in recent months.

Another cause for concern is the dollar. It almost seems like universal "knowledge" that the dollar will weaken further. Admittedly, it's hard to argue against that given the large and persistent U.S. deficits. However, the interest rate environment has changed considerably over the last year. A year ago, most long-term U.S. interest rates were lower than most other major countries (with the notable exception of Japan). But today, U.S. long-term rates tend to be higher than the rest of the world. All else being equal, higher interest rates usually invite currency strength. While we are not "dollar bulls," at least in the short-term, we are not as negative on the dollar as we have been.
Today, we see many recommendations to have larger allocations to international. To be honest, we are truly skeptical of this advice. Where were these recommendations after international underperformed the U.S. market from 1995-2001?

What about more exposure to China?

Over the last 12 months (through May 25th), China has had the best return out of the 29 world markets and benchmarks that Morgan Stanley regularly tracks. While China ranks only 23rd among this same list for 2007 year to date, there still seems to be demand for specific dedicated exposure to China.

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It's hard to argue against the amazing growth story of China. A money manager we respect just returned from a trip to Southeast Asia, incredibly enthusiastic about the regions growth prospects (but actually more about other countries in that region). In short, this is a story to follow, from an investment and cultural standpoint.

Still, markets can get way, way ahead of themselves and future growth. For an example, take the case of Amazon. Their stock price is still approximately 40% below its highs from 1999. How many books have you bought from Amazon since then?

At this point, our preference is to gain exposure to China through diversified emerging market managers. It's easy to forget that China is only 1% of the world's over-all stock market and only a bit over 10% of the over-all emerging market equity exposure. While these numbers will surely grow over time, they do not suggest a large dedicated position now.

It's also easy to forget that the Chinese stock market isn't quite like the U.S. market. It is disconnected from the economy as most companies are financed by banks, which in turn are financed by the state. In a rapidly inflated market financed by the government in a society where property rights are less developed, the risk/reward ratio doesn't feel right. Besides, China is currently acting to let some air out of its equity bubble as it has raised benchmark deposit and lending rates and has widened the trading band around its currency.

Again, China is a great story, and one that demands to be followed, but we think the best course is to go slow and steady and let experienced diversified emerging market money managers make the country and security selections.

Keep the questions coming!

Lastly, we encourage you to keep the questions coming. We take pride in fostering open and honest client communications (through good times and bad). Your questions keep us alert to our own assumptions and, I hope, our answers give you a better understanding of how our investment philosophy plays out in managing your portfolios.

Sincerely,

Eric

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