

Perspectives

on investing and other observations

CLEAR GULL

➤ TABLE I - TOTAL RETURN RESULTS FOR VARIOUS PERIODS ENDING JUNE 30, 2008

	2 nd Qtr 2008	1 st Qtr 2008	4 th Qtr 2007	3 rd Qtr 2007	One Year	10-Years Annualized	20-Years Annualized
Domestic Equity							
Lipper Diversified Equity Funds Average	0.14%	-10.56%	-3.21%	0.98%	-11.92%	4.47%	9.86%
Dow Jones Industrials Daily Reinvested	-6.85	-7.00	-3.91	4.19	-13.27	4.50	11.39
Lipper S&P 500 Funds Index	-2.75	-9.51	-3.39	1.99	-13.29	2.61	N.A.
Lipper Large-Cap Core Funds Index	-1.44	-9.49	-2.46	1.85	-11.38	2.32	9.44
Russell [®] 1000 Growth Index	1.25	-10.18	-0.77	4.21	-5.96	0.96	9.68
Russell [®] 1000 Value Index	-5.31	-8.72	-5.80	-0.24	-18.78	4.91	10.99
Lipper Mid-Cap Core Funds Index	2.66	-9.38	-3.44	-0.87	-10.95	7.49	N.A.
Lipper Small-Cap Core Funds Index	2.37	-9.19	-4.23	-2.84	-13.50	6.95	N.A.
Russell [®] 2000 Growth Index	4.47	-12.83	-2.10	0.02	-10.83	2.80	7.11
Russell [®] 2000 Value Index	-3.55	-6.53	-7.28	-6.26	-21.63	7.47	11.29
International Equity							
MSCI EAFE + Canada IX ND	-1.17	-8.69	-1.62	2.71	-8.81	6.33	6.59
Lipper International Funds Index	-1.90	-9.42	-1.00	3.52	-8.94	6.60	8.48
Fixed Income							
Lipper Inter-Investment Grade Funds Index	-1.09	0.11	2.08	2.54	3.65	5.04	N.A.
Lipper Sh-Investment Grade Funds Index	-0.27	0.15	1.17	1.57	2.65	3.99	N.A.
Lehman Intermediate Govt/Credit	-1.53	3.00	2.90	2.87	7.37	5.55	6.89

SOURCE: LIPPER, INC., FRANK RUSSELL COMPANY, LEHMAN BROTHERS INC.

MORE ANXIETY

The average diversified equity fund, propelled by growth strategies and mid- and small-cap stocks, posted a profit in the quarter in contrast to the prior two quarters. During the first two months of the period, stocks generally rose, spreads (the difference between interest rates on U.S. Treasury securities and other types of bonds) narrowed, but prices of U.S. Treasury bonds declined. In June, everything reversed. Investors became very discouraged as indications that financial system problems persist and earnings expectations for most sectors are too optimistic. Share prices declined across the board. June was dismal, the poorest month for stocks since September 2002. U.S. investors that owned foreign shares were not spared; MSCI-World ex U.S. declined -7.9% in June and -2.4% for the quarter. Most foreign markets declined more than the U.S. market in local currency terms.

Within the equity market, performance varied both in terms of sectors and when compared to the first quarter. Mid- and small-cap stocks generally rose, while large-cap stocks were mixed. As you can see in Table I, large-cap growth funds advanced, while large-cap value funds continued their decline. Mid-cap stocks appear to be a sweet spot. The relative out-performance of multi-cap funds (when compared to large-cap funds) can be partially explained by the penchant for dipping into the mid-cap area. A look at the returns of selected sectors contained in Table II on the next page provides some insight into these different results.

Value managers and funds usually have meaningful commitments to financials and energy, the worst and best sectors. While these might offset each other, the different weightings explain some of the results, accompanied

by the fact that value managers have begun to reduce their allocation to energy and increase the allocation to financials based upon the relative valuations of energy to historical valuations (at or above average) and financials (significantly below average). The health care sector has been mixed. Companies that address aging (medical devices such as hip replacements), dental care and cost containment have been performing relatively well. The major pharmaceutical companies, which have the largest market caps and dominate the results, have been poor performers as patents expire and possible new drugs fail to meet expectations.

TABLE II

Looking at index results has always been fraught with the dangers associated with generalizations. Most stock market index data is weighted by the market capitalization of stocks. (The exceptions are the Dow Jones Averages.) This can alter perceptions. The S&P 500 Index narrowly surpassed its 2000 peak last October, but the average stock in the S&P 500 has gained 76% since 2000. A portfolio manager that is heavily invested in metals and fertilizer stocks, but does not own paper and forest product stocks, may have fared relatively well this year. Those managers that have invested in oil service companies, not in the major oil producers or the refiners, have performed quite well. This can be seen by comparing the performance of the S&P 500 (large-cap) energy sector to its sector in the 400 (mid-cap) and 600 (small-cap) indexes. While harder to identify, within the materials sector forest products and paper companies' stocks have declined, but agricultural chemicals and steel stocks have increased. Nothing in the financial sector has escaped the problems associated with the current illiquidity in the bond market and mortgage credit problems; however, the large-cap financials have declined relatively more than the mid- and small-cap financials. The financial sector has not been this cheap on most valuation measures in almost 20 years, but whether all of the problems have been identified and disclosed is unknown, eliminating confidence in the valuation measures. That said, there are real financial franchises with great earnings potential if one can look beyond the current crisis.

	Weighting		Returns	
	12/31/2007	6/30/2008	2nd Qtr	YTD
S&P 500			-3.23%	-12.83%
Energy	13%	16%	16.92%	8.12%
Materials	3%	4%	3.88%	0.19%
Industrials	12%	11%	-10.59%	-14.59%
Health Care	12%	12%	-1.73%	-13.47%
Financials	18%	14%	-19.01%	-30.89%
Telecom. Services	4%	3%	-5.09%	-18.90%
S&P 400			5.07%	-4.57%
Energy	10%	11%	36.06%	39.48%
Materials	7%	9%	17.51%	8.50%
Industrials	16%	17%	6.59%	-2.34%
Health Care	13%	10%	2.46%	-9.44%
Financials	15%	15%	-9.34%	-14.86%
Telecom. Services	1%	1%	14.91%	-23.25%
S&P 600			0.10%	-7.64%
Energy	8%	11%	46.02%	47.95%
Materials	4%	4%	-10.21%	-14.34%
Industrials	17%	18%	0.32%	-5.85%
Health Care	14%	12%	-0.99%	-13.91%
Financials	16%	16%	-15.40%	-19.88%
Telecom. Services	0%	0%	-11.88%	-38.17%

CONTROVERSY AND OPPORTUNITY RESULTING FROM COMMODITIES

The soaring price of crude oil coupled with the falling dollar, which is the currency used to price oil, have propelled inflation fears, induced political consternation, inflicted real pain on consumers' pocketbooks and contributed to strong investor demand for energy related investments.

The price of crude oil has spiked to over \$140 per barrel, a 40% increase since the first of the year. In 2000 the price was about \$27 per barrel. The volume of oil traded on the New York Mercantile Exchange (NYMEX) has nearly tripled in less than three years. The headlines have tended to focus on oil, but food is also a growing issue, particularly among emerging markets where increasing prices for basic foodstuffs have contributed to political unrest in some emerging countries. Over the last several years institutional investors such as pensions and foundations have added an allocation to commodities and done so primarily through index futures tied to commodity indexes. As a result, they are being blamed by some for part of the increase in volume and price. However, there is also evidence that some price increases are the result of growing demand and constrained supply.

Many commodities trade on the exchanges, but not all; there is also private market trading. In assessing the arguments about the influence of institutional investors on commodities, the introduction of ETFs and speculators, one must consider two important facts: (1) eventually the cash price for each commodity is determined by supply and demand and is the price at which economic decisions are made; and, (2) there have been significant increases in the price for a variety of commodities that do not trade in the futures markets. For example, China just agreed to increases of 80-97% over last year's price for iron ore used to make steel. On the other hand, the volume of nickel, which is traded in the futures market, has increased over the last year, but the price has fallen by almost 50%. There is no futures contract for iron ore, but there is for nickel; so the argument surrounding speculation and institutional investors does not stand up to all commodities. In the end, the purpose of commodities trading is to provide risk management for producers, distributors, and users (while the exchanges on which commodities trade allow all parties price discovery).

Although some excess liquidity that has been pumped into the financial markets may be seeping into commodities trading, the long term fundamentals that drive supply and demand determine prices. Investors in energy companies do not appear to believe that current prices are sustainable as evidenced by the fact that major oil companies' stocks are trading on the NYSE at values that appear to anticipate crude oil prices declining to around \$75 per barrel. Given the growing demand from emerging economies for better diets, the need for materials used to build infrastructure, the increase in transportation demands as cars and motor scooters replace walking and animal drawn carts, and the limits to production and distribution of commodities, there is likely to continue to be upward pressure on prices for many commodities. At the same time, prices often overshoot and rising prices do curtail demand in time. The increase in the price of gasoline has contributed to the inventory of unsold SUVs and pick-up trucks as well as the introduction of mini-cars and hybrid vehicles. Ultimately, there will be innovation and changes in consumption in response to higher prices.

What does this mean for long term investors? Fundamental supply constraints and global demand factors indicate that there is likely to be continued pressure on many commodity prices, but probably also swings in prices. In the 1970's, oil prices vacillated between \$5.60 and \$28.71 per barrel. According to T. Rowe Price's analysis, there were two long cycles for commodities in the last century; one lasted 30 years and the other 27 years. Companies that own, produce, extract, and distribute commodities may be in a period of strong demand and pricing power, while companies that use many of these same commodities may experience cost pressures. We continuously question managers about the effects of global supply and demand on revenues and costs of companies they invest in, as well as carefully monitoring clients' positions in funds that are investing in companies in areas such as oil, service and fertilizer that may benefit from these trends and avoiding those that are being penalized. However, some fund managers are accumulating positions in companies whose share prices seem to reflect all of the bad news and then some. The financial press has pointed out that General Motors is now selling at the same price it did in 1954. If GM eliminated the entire North American operation, its international sales at \$77.3 billion are 13 times the company's entire market capitalization of \$5.9 billion. Granted, international pre-tax margins are a meager 2%. This is not a recommendation for GM but an example of what a few value managers are analyzing.

HOW MIGHT THE BEAR MARKET END?

Bear markets end in one of two ways: capitulation or exhaustion. Capitulation is short, severe and dramatic, like 1987 and 1998. Exhaustion is long and drawn-out with an end that is difficult to discern, such as 1973-1974, 1989-1990 and 2000-2002 when bear markets ended because selling gradually ceased. The bear markets of the last 50 years have been as short as 4 months, as long as 31 months, and included declines of as little as -19.4% to as much as -49.2% from peak to trough when measured by the S&P 500. This bear market began "officially" on October 10th, the day after the last high on the S&P 500 and has produced a decline of 20% as of this writing. The average small cap value stock fund has declined more than 25% since their peak in June 2007, after having been the leading diversified equity fund category for most of the prior six and one-half years.

Because the process of de-leveraging takes time, just as building the leverage took years, this bear market could continue for some time or the financial markets could trade in an extended range for a number of years. In fact, the S&P 500 barely surpassed its 2000 high in the fall of 2007, which would support the thesis that we have been in a trading range since 2000. From 1966 to 1982, the stock market traded in a range from 969 to 875 on the Dow Jones Industrials and from 92 to 123 on the S&P 500; however, there were many opportunities to profit from investing in individual companies' stocks that posted strong advances during this period. Dividends added to the return; dividend yields on average were higher in the 1966-1982 period than they are now.

STRATEGY CONSIDERATIONS

Currently, the yield on the 10-year Treasury bond is about 4.1%, resulting in the prospect of no return after considering inflation. A simplistic analysis based upon long term growth of earnings per share of 6% plus current yields of about 2% produces possible equity returns of about 8%. Individual stocks may provide higher or lower returns, but this simple analysis yields a return that is about twice the potential return from bonds. Perhaps with astute execution in a trading range bound market, the results could be enhanced.

With investor sentiment at low levels, reached only four other times in the last twenty years, there is room for a rally from current lows. Clearly little attention is being paid to the fact that Chinese demand for construction material may recede when building for the Olympics ends. A slowing economy may ripple through to countries that export large amounts to the U.S. and demand for transportation to deliver goods could soften, while higher prices is affecting gasoline consumption in the U.S. Eventually financial market and economic corrections purge the excesses of the prior expansions and recovery begins. In this environment, interest rates may increase, hurting bond returns, while earnings gains may surprise on the upside.

Managers that devote careful analysis to the potential for companies looking out three to five years are more likely to provide above average returns. Managers and funds that focus on individual companies' potential with a different lens than the majority and develop a value estimate through careful evaluation of information about products, markets, competitors and costs have proven to reward their investors over time. In 2000, for example, managers that were selling technology and buying energy, based purely on business analysis and sensible valuation, exited the sector that declined 62% from the March 2000 peak and invested in the sector that increased 262% since then. Managers make mistakes, but good managers recognize their mistakes and move forward in their analysis of companies' stocks and potential opportunities. Our focus is on the identification of those funds and managers as well as the art of combining different approaches to the management of assets so that the combination produces a total portfolio that is less volatile than any one fund/manager and fosters an environment where investors tend to stay the course during turbulent times such as these.

MAUREEN BUSBY OSTER, CFA
MBO CLEARY ADVISORS INC.
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