Roman Financial Advisors

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First Quarter 2002

SUMMARY:

The past four bear markets were followed by strong bull markets, but a look at the fundamentals shows there are notable differences in our starting point in this new economic cycle.

Today's far lower interest rates and higher price to earnings multiples suggest that price to earnings expansion, the primary driver of past bull markets, is unlikely to fuel similar level gains in coming years. Low dividend yields won't help much and it is unlikely that earnings growth alone can fuel double-digit gains.

We think returns for the traditional assets classes of large-cap domestic stocks and high-quality intermediate bonds are not likely to be much above mid-single digits. But other asset classes offer better opportunities, and with a flexible approach and hard work we think we can do better.

The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research.

Investment Review and Outlook: Seeking Good Returns—How Will We Get There?

The harsh reality of the post-bubble world is starting to hit home. We have experienced the worst bear market in a quarter century, and now, unlike other post-bear-market periods, we are faced with a low probability of achieving sustained double-digit returns from "traditional" asset classes. While the past four bear markets were followed by powerful bull markets, there are notable differences in our starting point in the coming new economic cycle. We think it is unlikely that we will see a similar bull market during the next economic cycle. Consider the following:

- In the last four bull markets, price to earning (P/E) expansion was the fuel powering most of the return. In each case, P/E expanded by at least 80%! Given that P/E ratios are now very high and interest rates very low, we are not counting on any P/E expansion and we believe P/E *contraction* is possible.
- Earnings growth was a secondary driver in prior bull markets, but based on a realistic earnings outlook we think there is a *low probability of earnings growth alone driving returns into double-digit territory*.
- Because the dividend yield is very low now, stocks (on average) also won't get as much return from dividends as in past bull markets.

So we are sticking with the idea that neither the S&P 500 nor investment-grade bonds are very likely to deliver *sustained* double-digit returns in coming years. Of course there may be exceptions in individual years. The reality goes beyond low expected returns. We believe there is more risk present today than has been the case in the early stages of past cycles. The risks now include:

Valuations: At the start of most bull markets stocks were much cheaper than they are now. Inflation and economic fundamentals may ultimately justify current price levels but frankly, we don't expect that to be the case. Earnings questions make assessing valuation more difficult and add to the uncertainty.

Debt Levels: Corporate and household debt is at an unprecedented level relative to Gross Domestic Product (GDP), which could dampen spending. It is also possible that debt levels will not be a problem, especially if interest rates remain low. But this raises the risk level if things go wrong. It is important that interest rates stay relatively low.

Current Account Deficit: The deficit exists primarily because of the spending of U.S. consumers. The balance-of-payments gap that is created by the deficit must be funded by foreign capital. Reduced demand would put pressure on interest rates, the dollar and the stock market.

Geo-Political Risk: The terrorist attacks last September and the alarming escalation of violence in the Middle East raise risks that had fallen off the radar. The possible impact is not only economic (higher defense and security costs) but also a psychological one that might reduce investors' tolerance for risk.

The net effect is that a traditional portfolio primarily focused on large-cap stocks and investment-grade bonds is, in our opinion, unlikely to earn more than mid-single digit returns in coming years. And the combination of full valuations and above-average risk means that the potential for disappointing returns below those levels is higher than it has been in the early stages of most other economic cycles.

So How Do We Deliver Better Returns?

Many investors make decisions based on buying whatever has been working the best in the recent past. But rear-view-mirror investing is a poor strategy. Periods of huge outperformance can't last forever for any asset class and investors are commonly burned in trying to chase whatever trend is in vogue without regard to fundamentals (most recently with by owning large growth as the bubble approached the bursting point). The good news is that when there are winners there are also losers and sometimes opportunities are created in the losing asset classes that are forgotten or out-of-favor. That's why it's important to stay open-minded and flexible so that new opportunities won't be missed because of bias toward what worked yesterday.

Investors who are willing to be flexible and open to investing in less-traditional asset classes are in a position to make the most of the environment we are now in. Though there is not much out there that is in screaming-buy territory there are a few good opportunities that excite us in areas that are at bargain levels. And there are other solid opportunities that are at the cheap end of a reasonably valued range. Our allocations to asset classes reflect this view. Here's a specific rundown of our thinking:

High-Yield Bonds: The absolute performance of high-yield bonds has been a disappointment, but the high-yield bond allocation has added value to equity portfolios. We continue to believe that high-yield bonds have a double-digit return run coming. Yields are still a healthy 11.5% and, with the economy strengthening, the picture should improve..

A sluggish economic recovery for an extended period would cut into the returns we expect from high-yield bonds, since defaults would decline more slowly, but most of the potential return would be delayed rather than eliminated.

Real Estate Securities: REITs have delivered excellent absolute and relative returns. But after a great run are REITs still undervalued? In our opinion REITs still sell at bargain levels, especially compared to the S&P 500. The reason is that REITs were grossly undervalued in early 2000 after two years of negative performance despite very solid economic fundamentals. Now, after two years of huge outperformance, they remain cheap relative to the S&P because their fundamentals have been much stronger than the S&P and they had lots of undervaluation to work off. They are not as cheap as they were, but they still offer higher levels of cash flow and dividends, compared to the earnings offered by the S&P, than was ever the case prior to the bubble economy.

In the near term it is entirely possible that we could have a cyclical rebound in stock prices based on expectations for a surge in corporate earnings. If that happens, REITs probably will under perform because real estate is something of an economic laggard, and earnings growth this year will probably slow down below last year's slightly positive level. But looking out three years we continue to believe REITs are well positioned to deliver 10% returns and maybe do better. The current dividend yield of about 6.5% coupled with a *below-average* growth rate gets investors to a 10% return.

Small and Mid-Caps in the U.S.: Smaller and mid-cap stocks are not in "screaming-buy" territory but they are still appealing by historical standards. And, small-caps have consistently delivered good performance in the early part of past economic cycles. Value continues to appear more attractively priced than growth based on P/E relationships, compared to historical levels.

Foreign Stocks: There are a number of compelling arguments that are hard to ignore when it comes to the opportunity outside the U.S. Europe, which makes up the majority of the exposure in most foreign stock funds, is selling at a 40% discount to the U.S. based on price-to-cash earnings (the best way to compare valuations across countries). There have been only three other instances in the last 32 years in which Europe has sold at a discount of 40% or greater (the long-term average discount is 25%). In each case European stocks soon delivered strong out performance.

While uncertain, we think there is some merit to the arguments that the relative economic out performance of the U.S. versus much of the rest of the world may narrow. Compared to Europe, the U.S. has much higher debt levels and a very high current account deficit. And there is a lot of catching up to do with respect to technology investment and restructuring, as well as potential for continued growth in the equity culture outside the U.S.

By most measures the U.S. dollar is 10% to 20% overvalued. We believe there is a good chance that currency will be a tailwind rather than a headwind for foreign stocks held by U.S. investors over the next five to ten years. And, the risk of a sell-off in the dollar and U.S. financial assets triggered by the current account deficit strongly suggests some foreign diversification is prudent. We don't really think a big sell-off of U.S. assets is likely, but it is possible.

Less Attractive Asset Classes

Investment-Grade Bonds: Because bond yields are already low, we know that over the next several years, returns will be low. Even if rates dropped 200 basis points (2%) over the next five years—a highly unlikely development given the current 5.3% yield on 10-year Treasuries—five-year average annual returns would still not exceed 8% and would probably be less, depending on how quickly yields declined. A more likely scenario is a mid-single-digit return. While this is not a terrible return, especially in what could turn out to be a very low-inflation environment, it is also not particularly exciting, especially on an after-tax basis. Still, investment-grade bonds continue to offer an important diversification benefit, protecting the portfolio in times of economic stress, as has been the case over the past couple of years. So we will continue to maintain some exposure to investment-grade bonds in balanced portfolios but we are underweighting this asset class early in this economic cycle when the diversification benefits are somewhat less likely to be needed.

Large-Cap U.S. Stocks: U.S. large-cap stocks are not cheap. Based on valuation models the S&P 500 is about 19% overvalued. This overvaluation is a function of depressed earnings, a drifting up in interest rates in recent months, and the strong fourth-quarter rebound for stocks. We view valuation models as a reality check but not an effective tool for predicting stock market performance over short time periods. And the uncertainty over how to accurately measure earnings makes valuation analysis even harder. This uncertainty is partly due to concerns about manipulation of revenues and expenses to present a more favorable but less-than-accurate earnings picture. And the uncertainty is also due to the impact of the earnings recession

Given the current valuation levels and our expectation that there is no reason to believe earnings growth rates will be far higher than they have been in the past, we come back to an expectation of returns in single digits—probably around 6% to 8%. However, just as there is some chance that returns could be higher, there is also the chance that returns could be lower. Some combination for reduced foreign demand, disenchantment on the part of U.S. investors, and lower-than-expected earnings growth could further restrain prices. We continue to underweight large-cap U.S. stocks.

From a style standpoint we have exposure to both growth and value, but in an environment where neither is clearly more attractive we believe we are better served by investing in managers who do not limit their universe based on category labels that create constraining expectations about where they should invest. Some excellent mutual fund manager examples include Selected American Shares, Artisan Mid Cap, Legg Mason Value, Westport Small Cap and Oakmark Select (and Oakmark Fund).

Closing Thoughts

Winston Churchill said "a pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty." Despite our belief that returns will be lower over the next few years than they have been, on average, over the last ten, we see opportunities and we believe decent returns can be attained. Doing better than what's generally available from large-cap U.S. stocks and investment-grade bonds—the traditional sources that dominate most investors' portfolios—will require discipline as well as an open mind to see the potential beyond these traditional options. We believe there are asset classes that are positioned to do better and deliver low double-digit returns. And as long-term investors we can expect volatility to be our friend by occasionally creating opportunities to buy asset classes at bargain prices. Finally we continue to expect the strategies we employ to add value to our clients portfolios. In short, we believe that our research and discipline will continue to be rewarded in this environment. As always, we are committed to staying focused and doing all we can to achieve investment success on your behalf.

Best Regards,

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