Angeles
INVESTMENT ADVISORS

Trials, Tribulations…& TIPS

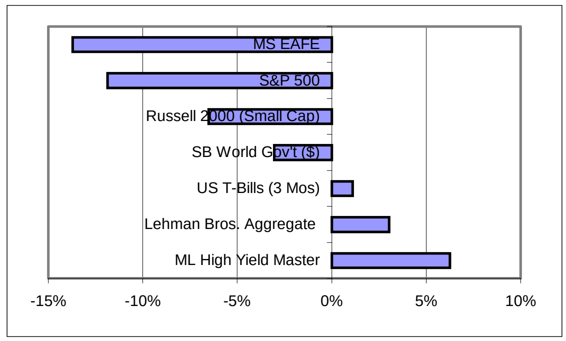
April 2001

Unless your portfolio has been stuffed with Treasury bonds, you are suffering through the worst period of portfolio returns in a generation. You probably didn't need that reminder, but I hope we can put some perspective around this current market environment and impart a little insight into what might lie ahead for investors.

As you can see in graph to the right, bonds (especially high yield, but not non-dollar) had reasonably good returns last quarter, but just about every stock index out there declined last quarter. Oh, having small-cap and value biases in your portfolio helped, but only relatively, as these, too, declined. The S&P 500 Index lost 11.8% in the quarter, the worst performance since Warren Beatty in Ishtar (well, actually just since the 3rd quarter of 1990, which saw a 14% drop following Iraq's invasion of Kuwait). It was the fourth consecutive quarterly decline in the S&P, which dipped (plunged?) into bear waters by dropping 23% over the past twelve months, the worst four-quarter period since the fall of 1984.

Technology, fresh from its beating in 2000, poked its head up just enough in January to get pummeled again. Indeed, the worst performing sector of the 94 Dow Jones industry groups last quarter was communications technology, off a whopping 56.1%. The best sector, just for the record, was coal, up an impressive 97%. It's a good thing all the smart money managers were overweight in coal. Wasn't yours?

First Quarter Returns



Technology also lost its perch as the largest S&P sector. Rising to 35% of the S&P 500 Index exactly a year ago, technology now represents just 17.3% of the index, just below financials (17.7%), the new heavyweight. The Humpty-Dumpty Award for the quarter has to go to Cisco, that Über-builder of the Internet, whose stock crumbled from 38 to 15. Cisco was the fourth largest weighting in the S&P 500 at the beginning of the quarter, and the 17th largest at the quarter's close. A year ago, Cisco represented 4.1% of the Index, but just 1.1% today. All the king's horses and all the king's men….

But being short technology was not necessarily the key to success last quarter. In fact, the best performing stock, Advanced Micro Devices (up 92%) and the worst performing issue, Applied Micro Circuits (down 78%) both came from the same group. Fortunately, those same smart money managers who were long coal also knew to be long *Advanced* Micro and short *Applied* Micro. Right?

The demise of technology leadership was inevitable. The table below shows the changes in market leadership over the past twenty-odd years. As you can see, the former leaders do not lead the subsequent rebound, so it's probably a good bet that technology stocks won't carry the market higher in the next bull phase. The table also shows that while technology's price performance was impressive, its excess earnings growth was comparatively underwhelming.

For the past fifty years, every recession (there have been ten of them) has been preceded by rising inflation. In a familiar cycle, the Fed eases monetary policy to stimulate demand, output rises, outstrips demand, the Fed tightens, inventories build, output falls, the Fed eases and we start again. Inflation-induced recession is only kind of recession we know.

But it is not the only kind of recession. Back in the 19th century, imbalances caused by excessive debt and investment produced recessions.

The pattern was different back then: lenders relaxed credit standards, borrowers assumed more debt and invested in projects with diminishing returns, defaults rose, lenders pulled back, spending fell, output crashed, and we had a recession (actually, that's a new word; back then they had depressions, crashes and panics). Recessions, or whatever we call it, were more dramatic then, both in terms of the severity and the length of the downturn (21 months on average versus 11 months in duration post-WW2).

Does this sound familiar? Could it more accurately describe today's environment? Larry Summers, Steve Roach and others think so. It's hardly an academic question. Its answer will determine the fate of the economy and the markets these next few years. If we are experiencing another cyclical recession of the type we've had since 1945, then a little more Fed easing should do the trick to pull us (that is, the economy and the stock market) back up. With the Fed aggressively easing, bulls are waving banners with that old battle cry, "Don't Fight the Fed!" (joined in the pantheon of legendary American war cries such as "Don't Tread On Me!", "Live Free or Die!" and "Nuts…").

Fallen Angels, Rising Phoenixes

		Δ Price, annualized			Δ Earnings, annualized		
	Period	Sector	Market	Diff.	Sector	Market	Diff.
Technology	1q92-1q00	36.7%	12.5%	24.2%	16.6%	7.5%	9.1%
Life Assurance	1q90-3q98	12.1%	5.1%	7.0%	15.5%	5.8%	9.7%
Retail	1q81-4q92	17.1%	10.7%	6.4%	10.2%	4.3%	5.9%
Basic Materials	3q85-1q89	49.2%	32.2%	17.0%	34.0%	15.9%	18.1%
Specialty Finance	4q82-1q87	68.4%	32.1%	36.3%	28.5%	8.9%	19.6%
Energy	3q78-4q80	37.2%	11.8%	25.4%	42.3%	13.8%	28.5%

Source: Salomon Smith Barney

Actually, “Don’t Fight the Fed!” has been pretty sage advise for the last half-century. As the table to the right shows, the stock market performed fairly well in the midst of recessions, almost regardless of their severity or duration, indicating that easier monetary policy trumps a deteriorating economy, at least as far as stock prices go. The 1973-75 slump stands out, but in most cases, stocks rose during these post-WW2 recessions, irrespective of the severity or length.

The news gets even better when you look at the impact Fed easing has had on stock returns, shown in the next table to the right. Two consecutive Fed eases (we’ve had three now) produced +20% gains a year out. Add in appealing valuations relative to bonds and the enormous damage already done (the MSCI World Index has fallen 25% in the past six months, a drop exceeded only twice before: in 1929 and 1974), and perhaps the birth of the next bull market is close at hand. Are you optimistic yet?

Stock Performance During Recessions

Recession Period	Duration (mos)	Depth of GDP Decline	S&P 500 Performance
12/48 — 10/49	11	-1.5%.	8.7%
8/53 — 5/54	10	-2.6%	17.9%
9/57 — 4/58	8	-3.7%	-3.9%
5/60 — 2/61	10	-1.6%	16.7%
1/70 — 11/70	11	-0.6%	-5.3%
12/73 — 3/75	16	-3.4%	-13.1%
2/80 — 7/80	6	-2.2%	6.6%
8/81 — 11/82	16	-2.9%.	5.8%
8/90 — 3/91	8	-1.5%	5.4%
4 mildest recessions.	10	-1.3%	6.4%
4 worst recessions, excl. 73-75	10	-2.9%	6.6%

Source: Morgan Stanley Dean Witter Research, Department of Commerce

Stock Market Gains After the Fed Eases Twice

		Average % Change in Following:	
Results Since:	**Stock Index**	**6 Months**	**12 Months**
1921	DJIA	13.6%	26.3%
1945	DJIA	11.0%	22.4%

	S&P 500		DJIA	
Date of 2nd Ease:	**6 Months**	**12 Months**	**6 Months**	**12 Months**
1/10/1975	30.6%	30.8%	32.3%	38.3%
6/13/1980	11.6%	15.3%	4.4%	14.8%
12/4/1981	-12.8%	9.8%	-9.8%	15.5%
12/24/1984	13.4%	24.2%	9.1%	25.5%
7/6/1989	9.5%	11.5%	12.6%	18.0%
10/29/90	23.8%	29.7%	18.4%	26.0%
12/19/1995	8.2%	21.9%	.10.5%	26.7%
10/15/1998	26.3%	19.1%	.26.1%	20.7%
Average Since 1975	13.8%	20.3%	13.0%	23.2%

Source: Ned Davis Research, Morgan Stanley Dean Witter Research.

Good. Now snap out of it. The Fed has already put the pedal to the metal. The Fed funds rate was cut 50 basis points three times in the first quarter, and MZM (money supply) is up 21%. They’re doing what they can, and will ease some more. But the nature of this boom and bust is such that I think this time Fed policy will be less effective in regenerating growth than in the past. That’s because the economic challenge is less one of stimulating demand, which is what lower interest rates are designed to do, than of supply. There are, still, way too many marginal dot-com businesses draining otherwise productive resources. Too many personal computer makers, too many fiber-optic producers, heck, too many automobile brands (Oldsmobile, Plymouth).

It will take time to work through all this, and we will, but Fed rate cuts will not be the elixir that they once were and that many hope they will be. But out of this rubble, and before the dust has settled, a new bull market, with new leaders, will arise.

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So, what should investors do? Two simple things: resist the temptation to follow others (usually off a cliff), and look for opportunities in places others have ignored or disdain. Simple, right?

In the four years from 1996 to 1999, diversification was synonymous with imbecility. Concentrate your portfolio, claimed the new smart money, own only US stocks, no bonds, nothing overseas. For that matter, own only large cap US stocks. Actually, just large cap technology US stocks. And that would only get you to the table. Because to outperform, you would have to own just five or ten select names (coal companies were not among them). Then, you'd qualify as an intelligent investor. But it's a funny thing about diversification: at any point in time, it never seems like the right strategy because one asset class is always outperforming the rest. The problem, of course, is that that one, shining asset class is never the same in each period. This past year has reminded us (painfully) why we even bother with asset allocation modeling in the first place. Diversification is good, and so is a disciplined rebalancing program, even if it never seems that way at the time.

Even (or perhaps, especially) amidst the rubble there are opportunities. One that is particular intriguing is TIPS. Not the horseracing kind, but the Treasury Inflation Protected Securities kind. Why investors have not backed up the truck and loaded up on these, or why their consultants have not been flogging them at every opportunity, is your guess.

TIPS were first issued by the Treasury in January 1997. Investors receive a fixed coupon, which is lower than on a regular Treasury bond, plus whatever inflation (CPI-U) has been over the period. If inflation rises, TIPS holders receive more money, and vice versa if inflation declines, whereas traditional bondholders receive a fixed coupon regardless of what happens to inflation. So the analysis between TIPS and nominal bonds is very simple: the difference in yields is the "breakeven" inflation rate.

Here's an example. In mid-April, 10-year Treasury bond yielded 5.1%. The 10-year TIPS yielded 3.4%. The difference is 1.7%. But TIPS pay 3.4% *plus* inflation. So if inflation averages more than 1.7% annually for the next ten years, TIPS will pay more than the regular Treasury.

But if we repeat the 1930s and experience deflation, won't the price of TIPS fall? Well, first, actual deflation is extremely unlikely, much less over a ten-year period. Secondly, and here's a little kicker, TIPS will not mature below par (i.e., a price of 100) because the Treasury guarantees to repay all principal at par. So here we have a US Treasury guaranteed bond that pays a minimum fixed rate of 3.4% plus whatever positive number inflation turns out to be. If inflation averages more than 1.7% per year for the next decade, TIPS will pay out more than regular Treasuries. In a world of very few sure things, an average annual inflation rate greater than 1.7% till 2011 seems pretty close.

Let's look at this security from another angle. We own assets because we have liabilities. Liabilities are things like benefits for a pension fund, claims for an insurance company, grants for a foundation. Just about everything we spend money on has an element of inflation in it. So, as inflation rises, the costs of our liabilities also rise, meaning we'll need more money from our assets in order to pay for these liabilities. One reason investors own stock (aside from the mere thrill of it) is that equities have gained value at a faster rate than inflation has eroded the value of money over time. Up until about twenty years ago, bonds barely kept pace with inflation, and cash investments lost value in real terms. But with TIPS, an investor is guaranteed to earn the rate of inflation, *plus* something. That something today is 3.4%, a *real* return with no credit risk, no inflation risk and little duration risk.

At Angeles, we believe TIPS will provide returns over the long run at least comparable to nominal bonds with much less risk (because real yields are far less volatile than nominal yields). Today, we think they offer compelling value. So for both strategic and tactical reasons, we think tax-exempt investors should consider reallocating some (or even a lot) of their fixed income portfolios, investing a portion in TIPS, and adding to equities to achieve a similar overall portfolio risk profile. There you have it. Back up the truck!

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