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FIRST QUARTER 2003

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Butterflies and Bees

Sonny Liston was not just the undisputed heavyweight champion of the world in 1964; he was the most feared fighter, possibly of all time, with an incredible 84-inch reach and a menacing glare that hinted at his violent, criminal past. One of 24 children, Liston served time in the Missouri State Penitentiary, first for armed robbery and then later for assaulting a policeman. He leveled the great champion Floyd Patterson with a single left hook in the first round to gain the heavyweight title, and again in the rematch, a left hook in the first round ended Patterson's career and nearly his life. No one wanted to fight Liston, or even talk to him; he was a scary, scary man.

On a balmy February evening in Miami Beach, Sonny Liston stepped into the ring with a 22-year old wisecracker from Louisville, Kentucky. The oddsmakers were giving 7-1 odds, but in truth no one was taking the bet. Sure, this cocky kid had won the gold medal in the 1960 Rome Olympics as an amateur, but not one of the 46 boxing experts sitting at ringside that evening thought he had a chance of surviving past the first three rounds. The medical technicians were given prime front-row seats so as to be able to respond faster with emergency care to the latest recipient of Liston's infamous left hook.

Investors may be excused if they feel as if they are on the receiving end of Sonny Liston's left hook. The mauling in the markets has been as severe as we've seen since the days when Jack Dempsey and Gene Tunney ruled the ring. The analogies to that era are eerily familiar: an ecstatic bull market led by exciting new technology collapsing in a spectacular flame; the threat of deflation, contraction in world trade and the specter of politico-military threats overseas all weighed on investors in the 1930s as they do today.

Is the current decade likewise doomed to inflict more pain and suffering? How can we escape the long reach of this bear market and avoid the crushing blows to our bodies and heads (not to mention our portfolios)? Can we even dream about positive returns in equities again, deftly counterpunching this behemoth of a bear?

In boxing, everything starts with the jab. This short, quick strike is a fighter's most important tool: offensively, it sets up every other punch; defensively, it keeps the opponent off

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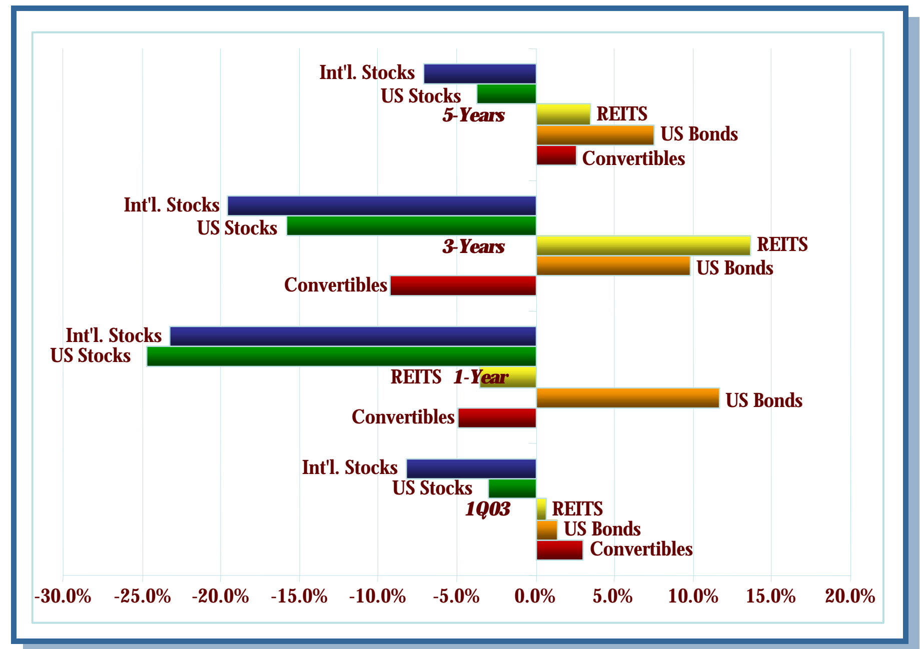
guard or slows an advance. Quick and nimble overcomes slow and powerful (almost) every time, so he who jabs best almost always wins.

Likewise with investing. Having been beaten up pretty good, we need to get back into the fight with our jab. We need to be more nimble and quick, because this decade is shaping up quite differently than any we have previously experienced. What may have worked in the past, may or may not work in the future; and what may work in the future may not work consistently.

We see two parts to being nimble investors: we need to be *intellectually* nimble, to challenge assumptions, consider alternative assets or new approaches to current asset classes. We also need to be more *operationally* nimble: be able to identify and exploit opportunities that may come and go in months rather than in years. In a world of modest nominal returns, a world we foresee for reasons that will be explained, every little jab of return will count if we hope to reach the final bell and achieve our investment goals.

Capital Market Returns



Graph Courtesy of Merrill Lynch

Misery for equity investors continued in the first quarter of 2003, as markets just about everywhere lost ground. Underneath these broad declines were some surprising (?) reversals. The best performing market in the quarter? Argentina, whose currency collapse 18 months ago led to soaring inflation, +20% unemployment, a run on the banks and a (possible) return to power of the corrupt populist that presided over all the problems in the first place. Perhaps even more surprising was that the local currency return was 5.6% in the quarter, but the US dollar return was 19%, indicating a sharp appreciation of the peso versus the dollar.

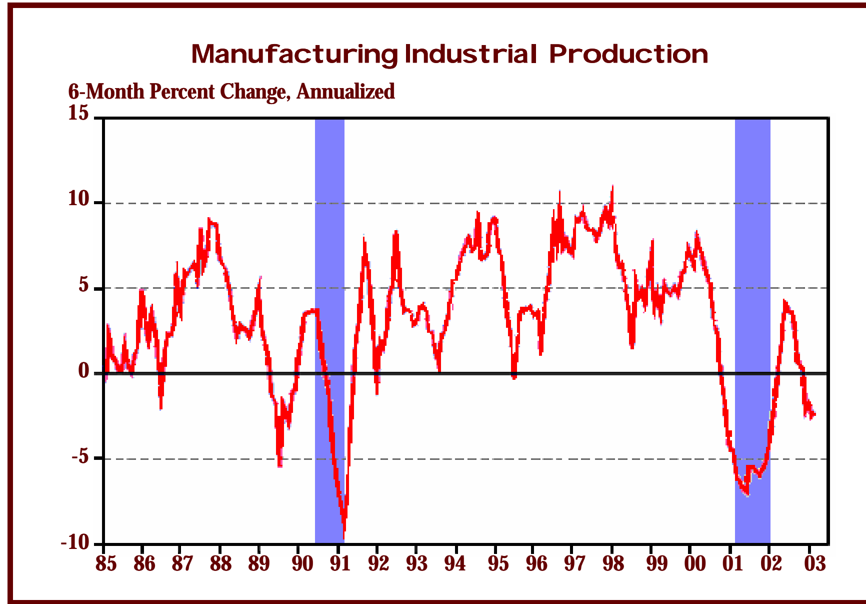
"...we need to be intellectually nimble, to challenge assumptions, consider alternative assets or new approaches to current asset classes."

Reversals abounded domestically, as the best performers in the S&P 500 Index were those that had been given up for dead. Dynergy (an aspiring Enron) more than doubled (+121%), with Corning (+76%) and Williams (+70%) right behind. AMR plunged 68% and was dropped from the Index; a controlled crash landing for American Airlines. But AMR was a very small weight in the Index. What drove the S&P 500 lower was double-digits declines in some household names, such as SBC (-25%), AIG (-14%) and Altria (-25%), the top three negative contributors.

Standing, but staggering, is the world economy. The big, knockdown blows are what make the highlight films, and the bursting of the equity bubble was the roundhouse right that sent the markets to the canvas three years ago. The September 11th disasters, the war in Afghanistan, the war in Iraq, were all supposed to make investors throw in the towel. To be sure, each one of these events had the *potential* to knock us out, as does the latest scare, SARS. Actually, SARS may be the most potent punch of them all. In less than two months, the

number of cases and deaths has grown astronomically, and while the numbers are still relatively small, we recall that the world flu epidemic of 1918-19 wasn't expected to kill 30 million people. Its impact is already being felt, and not just in Hong Kong and Toronto. China, with one-fifth of the world's population, saw its economy soar at a 10% rate last quarter. That growth rate will fall 20-30% this year due to SARS. In an interdependent world, this affects all of us.

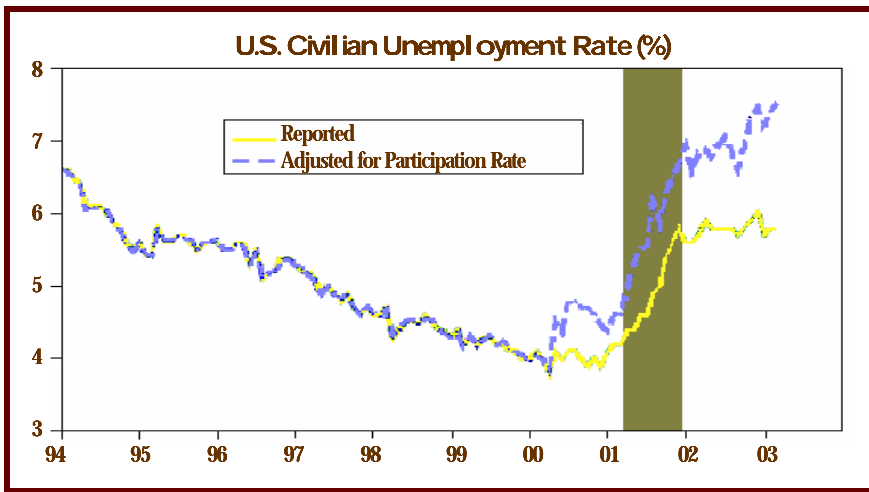
The big punch is certainly dramatic, but it's the constant jabs and body blows that tell you how a fight is going. The body blows are adding up, as illustrated in the accompanying charts. The industrial production graph shows the economy climbing off the recession floor in 2001-02, but tipping over again in the past few months.



Source: Federal Reserve Board
Graph Courtesy of Merrill Lynch

The job picture is bleak. Nearly a half million jobs have been lost in the past two months, 2.4 million jobs over the past two years. Manufacturing employment has fallen 32 consecutive months. The official unemployment rate is under 6%, but only because millions have dropped out of the work force. Adjusted for the participation rate, the unemployment rate would be closer to 7½% than 5½% (see chart).

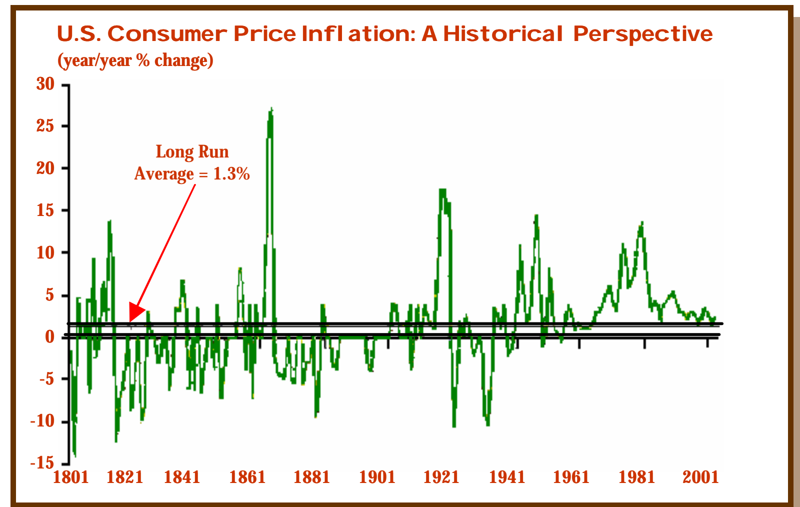
The US economy is barely growing, just 1.6% annualized in the first quarter, but the majority of this growth was accounted for by a large 7.9% drop in imports. Exports also fell, but national accounting has imports lowering GDP growth and exports raising it. Without the big decline in imports relative to exports, GDP growth would have been just 0.7% last quarter. Declining trade is hardly indicative of strength in the world economy.



Shaded area represents period of U.S. recession
Source: Bureau of Labor Statistics: Merrill Lynch

Actually, the US economy is the world's bright spot. Growth in Europe is even weaker, and Japan's decade-long depression persists. The Nikkei recently etched a 20-year low (around 7600), off a bit from the high of 39,000. It may surprise you to know that the German stock market (the DAX), is close behind the Nikkei, off about 75% from its high. Deflationary pressures abound, as core CPI in Japan recorded its 43rd consecutive month of deflation. Hong Kong has an even longer ignominious record, with 53 straight months of deflation.

Deflation has yet to reach our shores, although it seems perilously close. Despite a weaker dollar, massive fiscal and monetary stimulus and rising energy prices (up 23% year-over-year), US inflation is headed lower. Core (ex-food and energy) CPI rose 1.7% in the past year, the lowest reading in 37 years. Our inflation rate is headed lower, and we may just have to get used to it. We are accustomed of thinking about much higher inflation, partly because we remember so well the debacle of the 1970s, and partly because most references to inflation begin in 1926 (Ibottson-Sinquefield) and show a 3% long-term rate of inflation. But a longer term look (say, 200 years) shows a much lower rate (see chart).



Source: Bureau of Labor Statistics
Graph Courtesy of Merrill Lynch

Consumers are on the ropes, although after 44 consecutive quarters of rising spending, one should be cautious about betting against the American consumer's ability or willingness to spend. But household net worth has taken a beating, down $1.8 trillion last year and off $3.8 trillion from the peak in Q3:2000 (see chart; pg.5).

One reason spending has held up well is the large increase in debt. Household debt as a percentage of disposable income is now at a record 106%, and debt payments absorb 14% of income, close to a record. So the big drop in interest rates has been used as an opportunity by consumers to increase debt levels. The asset side of the balance sheet is also deteriorating. Financial assets are down $5.9 trillion from their peak two years ago. This has only been slightly cushioned by a $2.2 trillion rise in residential real estate values. Mortgage refinancing has reduced owners' equity as percentage of household real estate to a record low (see chart; pg. 5) as home owners have turned their houses into piggy banks.

The hope for consumers rests in three areas.

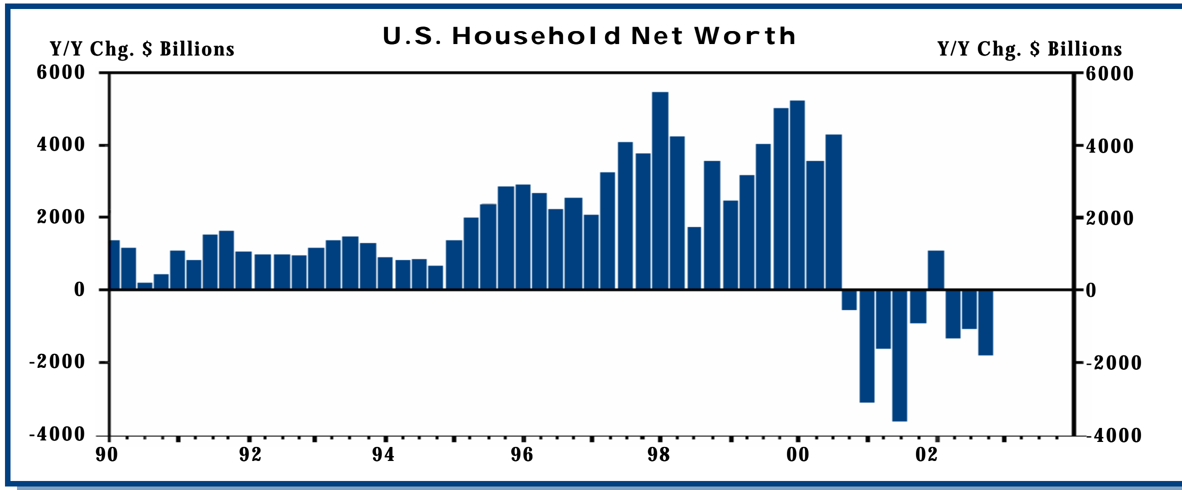
> *"...Consumers are on the ropes, although after 44 consecutive quarters of rising spending, one should be cautious about betting against the American consumer..."*

Energy prices have declined since the end of the Iraq war, and this could be worth as much as $50 billion in lower costs to consumers. Secondly, real wage growth is positive and may get more so as inflation falls (assuming unemployment doesn't accelerate). Thirdly, tax cuts of as much as $80 billion may be coming from the federal government this summer. Of course, some of these tax cuts will be offset by tax hikes at the state and local levels. Here in California, the governor has proposed billions in new taxes to try to close a $34 billion deficit.

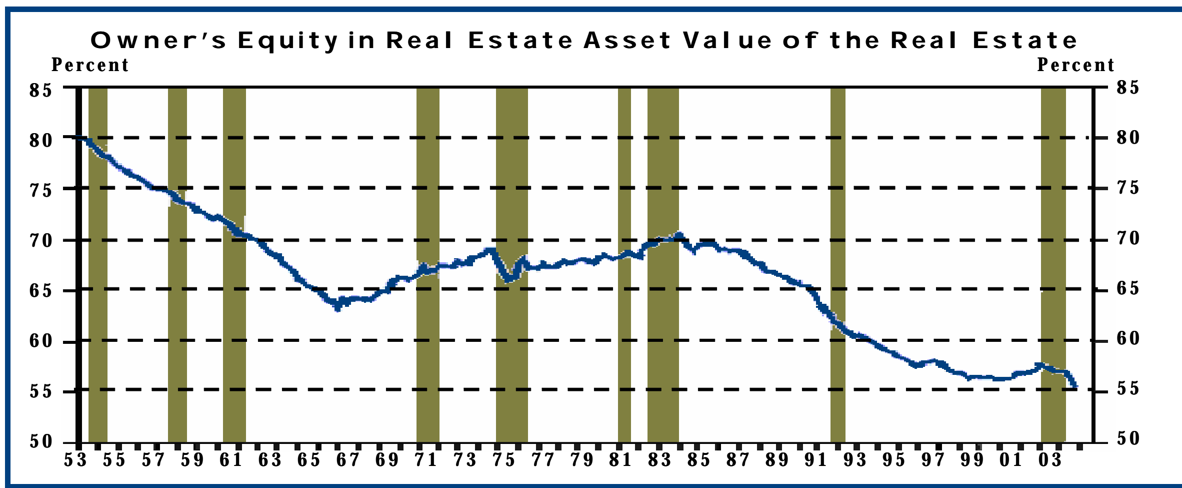
Perhaps these stimuli will keep consumer spending afloat indefinitely, but at the very least, we would expect to see consumers rebuild their balance sheets by diverting some cash flow from spending to debt reduction. If so, this would dampen the already soft economic outlook.

As in previous letters, we remain concerned about the massive current account deficit we must finance, leaving the dollar very vulnerable. The $548 billion deficit, 5.2% of GDP, continues to grow, and one (or more) of three things must occur: the dollar depreciates, we scale back our demand for imports, and/or we convince foreigners to send us their money for ever lower returns on investment. Perhaps all three will happen, but a dollar depreciation seems pretty compelling. The euro has already moved higher, but the dollar is either flat or has risen against our other major trading partners, Canada, Mexico, Japan and China. So on a trade-weighted basis, the decline has been very modest (see chart; pg. 5, especially relative to the big drop in the current account balance).

So dollar depreciation seems in the cards, trig-



Graphs Courtesy Merrill Lynch *Source: Federal Reserve*



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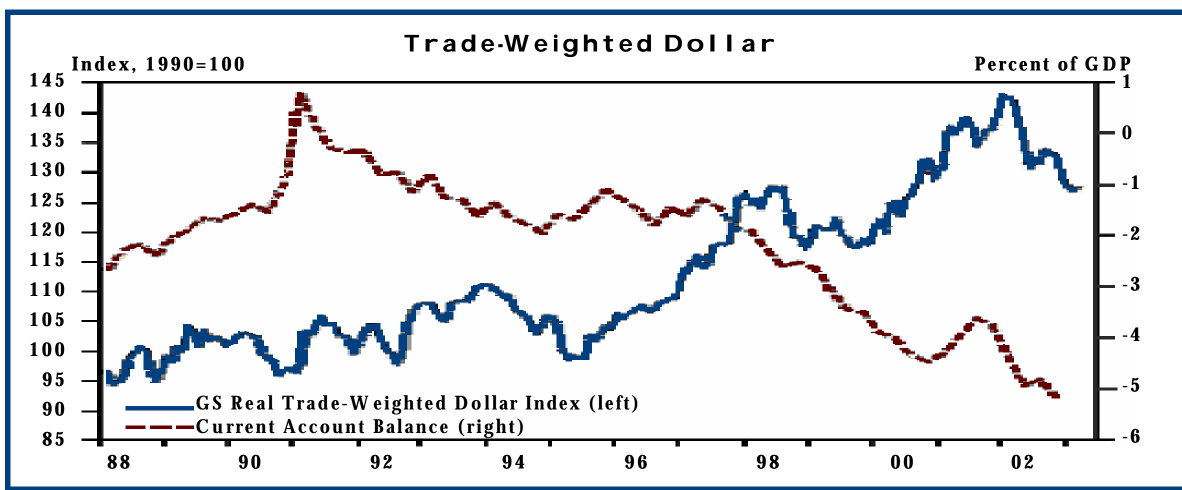


Graph Courtesy Goldman Sachs

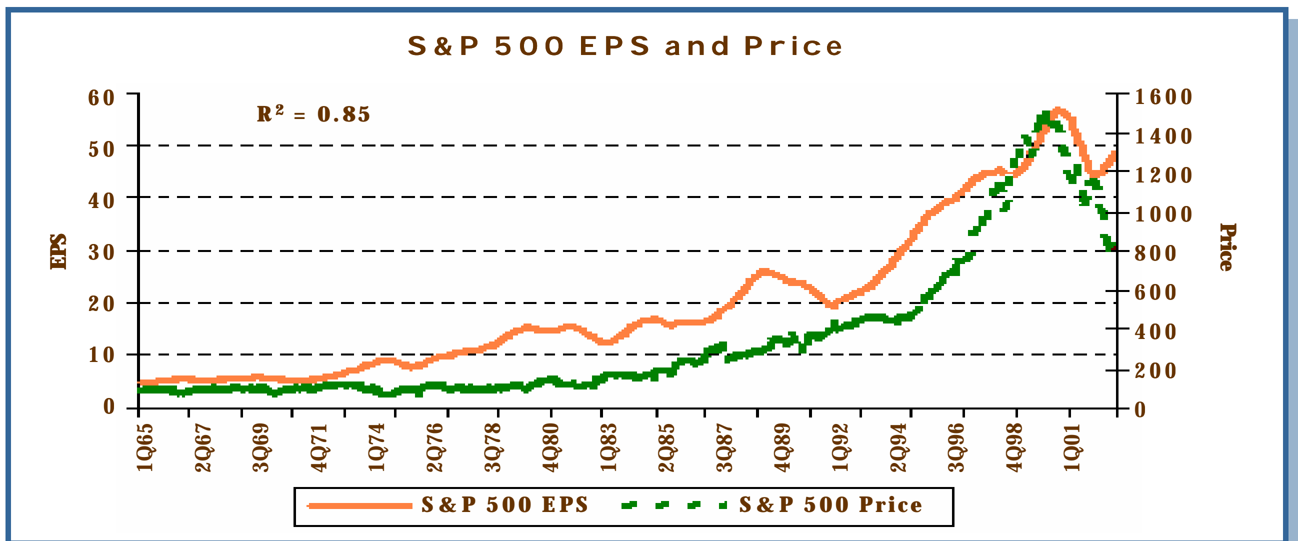
	Current Account Balance	Date of Peak	Depreciation (%)	# of Quarters
Australia (1989)	-5.3	Q4:1998	-21.9%	19
Canada (1975)	-5.2	Q1:1975	-15.6%	12
Canada (1981)	-4.0	Q1:1981	-15.5%	22
Canada (1993)	-4.2	Q3:1993	-16.7%	27
Denmark (1979)	-4.4	Q4:1979	-54.3%	21
Finland (1991)	-5.2	Q3:1989	-35.7%	15
Korea (1996)	-5.8	Q4:1996	-37.6%	13
New Zealand (1984)	-8.4	Q1:1984	-30.8%	5
New Zealand (1997)	-6.5	Q4:1997	-41.4%	8
Spain (1976)	-4.1	Q1:1976	-63.6%	36
UK (1989)	-5.1	Q4:1988	-18.5%	17
Italy (1974)	-4.4	Q1:1974	-67.9%	45
Average	**-5.2**		**-35.0%**	**20**
Median	**-5.1**		**-33.3%**	**18**
U.S. (2002)	***-5.2***	***Q4:2002***	***-2.1%***	

Table Courtesy Merrill Lynch

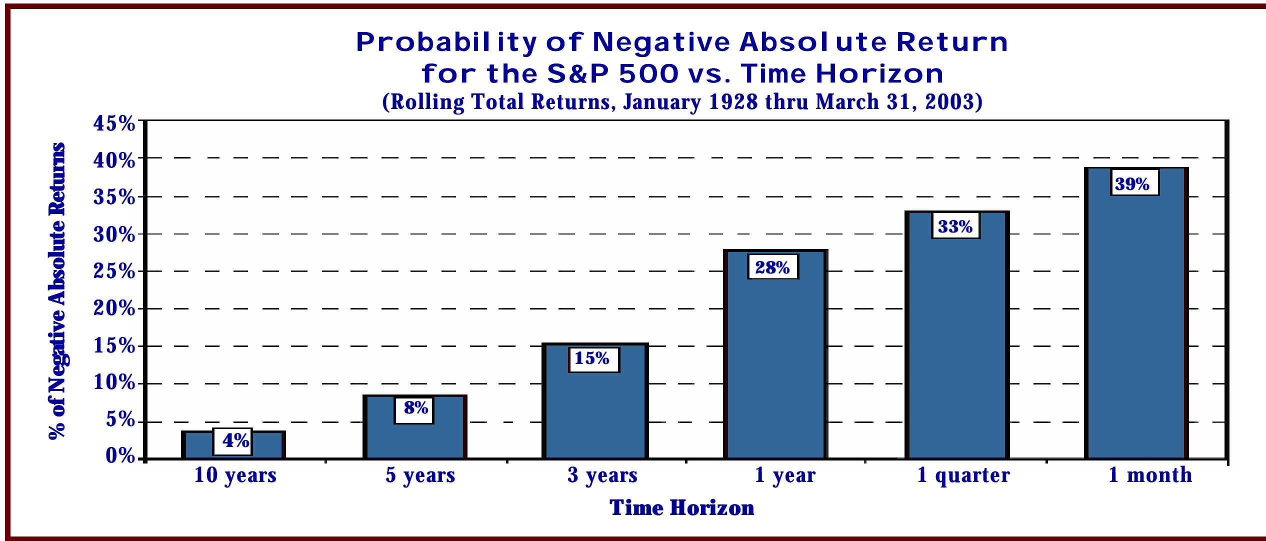
gered by the requirements of funding the current account deficit, as has been the case in prior periods of current account deficits (see table).

Throwing in the towel comes, of course, from boxing. When a fighter has been bloodied and battered and his corner thinks he can take no more, they will throw a towel in the ring, signaling that they concede the bout. With all the bleak news just relayed, it may be tempting for investors to do just that: throw in the towel, liquidate assets and stuff what little is left under the mattress. That would be a mistake, for two reasons. First, it's important to understand what drives returns in asset classes, and secondly, we think there are opportunities to achieve attractive returns, although it may require more creative thinking than we have had to do in the past.

If we think about stocks and bonds in terms of



Source: Smith Barney Institutional Equity Strategy



Source: Merrill Lynch Quantitative Strategy; Ibbotson Associates

the activity they represent, the expected return on these assets becomes clearer. Bond holders are creditors (lenders), and lenders expect to receive interest and a return of principal. Nothing more and nothing less. So the expected return for bond holders is the current yield. Certainly, if interest rates rise or fall, that will affect the total bond return, but over time, the expected return in fixed income is the current yield (today, that's around 4%).

Stock holders are owners, and as the owner of any business knows, the return on investment is a function of profits; specifically, stock ownership is a claim on all the future profits of a company. An owner's return will be calculated as the present value of all those future profits divided by the cost of the initial investment. We can hope to improve our return either by owning companies with large future profits or by paying very little up-front for those profits. In the aggregate, however, the profits of all companies will more or less (probably slightly less) track the growth of the economy (there is a 0.43 correlation over the past 110 years between GDP and earnings growth). Stock prices are closely correlated to earnings growth (with a very high R^2 of 0.85—see chart; pg. 6), so the expected return to an equity owner is dividends plus price appreciation in-line with earnings growth, which is in-line with GDP growth. Today, that expectation is probably around 7-9%.

> *"However, for those of us who live in the real world, with bills to pay and promises to keep, ignoring severe changes in our portfolio value is not viable."*

Of course, these axioms hold only over time. There can be periods where the multiples of earnings investors are willing to pay expand, resulting higher *ex-post* returns (i.e., the 1990s), as well as periods where those multiples contract, resulting in lower *ex-post* returns (the past three years). But *ex-ante*, we have laid out reasonable expectations for long-term returns.

One problem with being the owner of a business (an investor) is that we tend to extrapolate recent trends. That was a mistake in the late 1990s, and it is a mistake today, just as it has been a mistake in every prior period of time. Unfortunately, few of us have the luxury of time, because if we did, the easiest and simplest method for achieving good investment returns is patience. As the chart shows, the probability of negative returns to investors diminishes considerably over time.

Staying in the fight often requires a great deal of courage and stamina. An investor who put $1 in small cap stocks (Ibbotson-Sinquefield data) in 1929 saw that grow 6800 times by 2002. But in 1932, that dollar was worth only 10 cents, and at that point, if one managed to leave that dime in there, the investor would have seen it grow 68,000 times over the next 70 years.

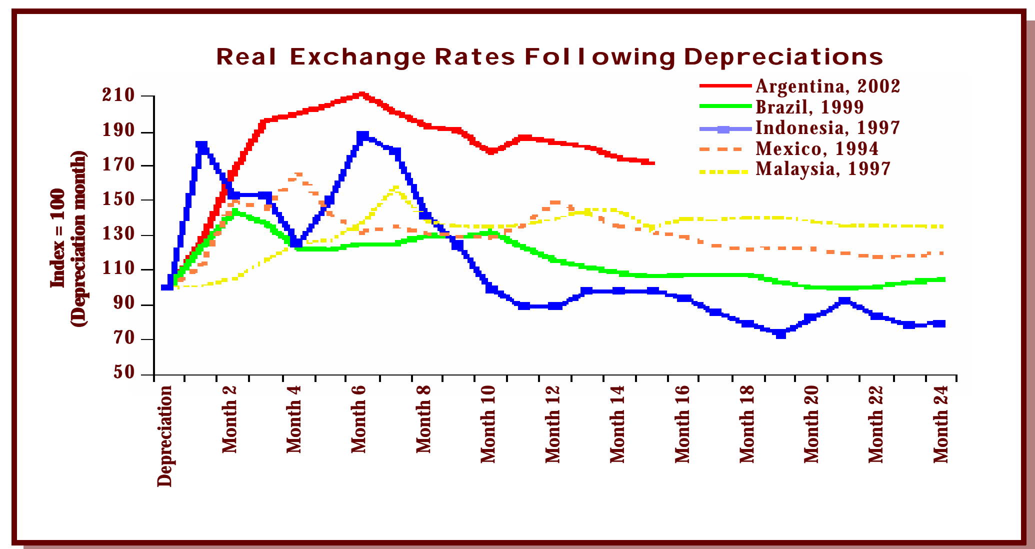
We take some comfort from this assurance that

the returns we receive as creditors and as owners are rooted in economic fundamentals. This let's us establish expectations for *long-term* returns with reasonable security. However, for those of us who live in the real world, with bills to pay and promises to keep, ignoring severe changes in our portfolio value is not viable.

In the absence of a bull market that lifts all boats, we see four approaches to investing that could provide investors with opportunities to earn attractive returns. One approach is to identify broad, multi-year themes. For example, we have suggested two such potential ideas here: the idea of balance sheet repair by consumers and corporations, and the vulnerability of the dollar to further decline. If these themes do, in fact, play out (our crystal ball can be occasionally opaque) it suggests that investors would benefit from owning credit over government bonds and non-dollar over dollar-denominated assets.

A second approach is to be opportunistic. Actual asset prices differ from equilibrium values frequently, often severely. And it is in these dispersions that opportunities arise. There are times when equities will be cheap or dear, as will bonds, although this is often seen more clearly in hindsight. Another way of thinking about relative valuation is to determine what expectations are being priced into the markets. The current environment provides an interesting opportunity in that markets are concerned about deflation and worry little about inflation. Bond investors believe that inflation will average about 2% over the next thirty years. This is well below recent actual experience, and the market may be right, but buying inflation protection today is pretty cheap because no one believes inflation is a threat. Again, investors may be right about this, but inflation protection via TIPS still looks cheap relative to conventional government debt. Certain real assets, such as real estate, for example, offers high yields plus sensitivity to inflation. Those yields are attractive in a deflationary environment, and their valuation sensitivity to inflation is attractive if inflation picks up. Of course, valuations could fall further, but we think these real assets offer attractive opportunities in the coming years.

Opportunities can also arise quickly, and then fade quickly as well. Emerging market currencies might



Source: Merrill Lynch

be a good example. It's a good bet that at some point, these currencies will collapse. Investors do not want to be on the long side of that event. But the aftermath of the collapse often provides extraordinary opportunities for the nimble (and brave) investor. As the chart shows, currencies overshoot in the panic, but the combination of high nominal yields and an appreciating currency result in extraordinary gains even allowing for inflation erosion.

A third approach for investors is to broaden their reach. Stocks and bonds and currencies are all interrelated globally, and our portfolios should be global in scope. This applies equally to asset classes that have traditionally been limited domestically. Real assets, such as real estate and timberland, come to mind. If owning an office building in Los Angeles makes sense, why not an office building in London or Lisbon or Singapore or Sao Paolo? There are global opportunities that most investors ignore.

A fourth approach for investors is to consider non-traditional, absolute return strategies. To be certain, there are myriad challenges in these products. One

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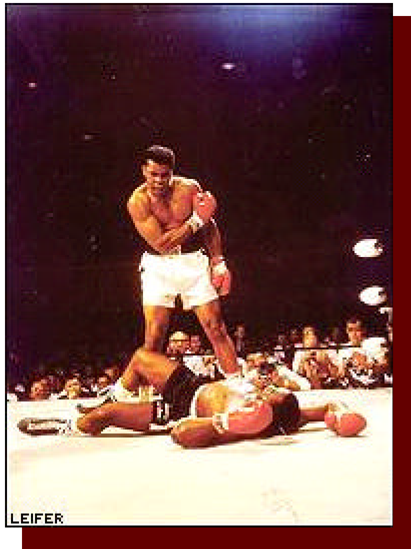
broad challenge is that they don't fit at all in the standard mean-variance framework (the asset allocation optimization model used universally) because returns are not distributed normally (the typical bell curve distribution of returns that we do see exhibited in stock prices, for example). So mean return and standard deviation are meaningless concepts in absolute return strategies, whereas the third and fourth moments of statistical analysis, skewness and kurtosis, are highly relevant. [*n.b.: skewness measures the degree of asymmetry of a distribution around its mean and kurtosis characterizes the relative peaked or flat nature of a distribution relative to the normal distribution*]. The result is that investors will find a very wide range of good and bad managers. Less than 10% of hedge funds have more than ten-year records, and even nine good years is no guarantee that year ten won't see the fund collapse. In all, it's probably a zero-sum game. Focusing on the left side of the distribution is appropriate, but we shouldn't necessarily ignore the right side, where excess returns are to be had. A properly executed absolute return program can yield large benefits in both return and risk.



Cassius Marcellus Clay entered the ring with his attention turned to the 46 experts sitting at ringside. "It won't last a round." "Nobody but a fool would wanna fight me!" "I'm too fast!" "Let me hear it: who's the greatest? I'll give you one more chance. Who's the greatest?" The experts were amused, but amused in the way we laugh at Wile E. Coyote right before he looks down at the ground a thousand feet below. It's funny, but we know he's about to be flattened.

At the opening bell, Clay turned his taunts toward Liston, daring the dangerous champion to hit him, keeping his hands at his hips instead of protecting his body and head. His mouth never stopped yapping, but his feet were dancing and his fists were flying. By the sixth round, Sonny Liston, the most feared heavyweight fighter in history, was staggering from the flurry and fury of jabs and bruises from this kid from Louisville. Liston failed to answer the bell at the seventh round, as his corner threw in the towel. A new champion was born, indeed the greatest fighter of all time. No, not Sonny Liston, but Cassius Marcellus Clay.

Charles Darwin noted in *The Origin of Species*, "It is not the strongest who survives, nor the most intelligent, but the one most responsive to change." There is a lesson for investors here, although I think Muhammad Ali (nee, Cassius Clay) put it more poetically: "Float like a butterfly, sting like a bee."

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