



Q<sup>3</sup>  
2004

# Investment *notes*

HAMRICK INVESTMENT COUNSEL

## VISION

*We envision an investment world in which markets are fair, safe, understandable, rewarding and accessible to all people.*

## MISSION

*We seek to manage investment portfolios for U.S. based foundations, nonprofit organizations and individuals, using the highest level of professional investment advice together with genuinely caring, personal service.*

## VALUES

*Utter integrity, confidentiality, honesty, and ethical conduct*

*Utmost concern and respect for clients*

*Highest level of professionalism*

*Genuine understanding of each client's individual situation and careful attention to all clients' investment needs*

## RISKY BUSINESS

For several years now, stock markets have been tumultuous. First were the wild years of the latter 1990's, when the S&P 500 index was rising 20% to 30% or more on an annual basis, with even headier gains for over-the-counter stocks.

Then came the bursting of the dot.com bubble in early 2000, which reverberated throughout the equity markets in the following two years, during which time market indices fell by 50% or more. At the same time, we witnessed the 9/11 terrorist incident, warfare in Afghanistan and Iraq, the accounting scandals and ethical violations, and serious political and economic turmoil.

In the fall of 2002, the markets bottomed out and staged a solid rebound in 2003, which carried over into the first part of 2004.

Now, however, the markets appear to have stalled out. As we head into September, average returns on the markets for the year are paltry at best. Market moves on a

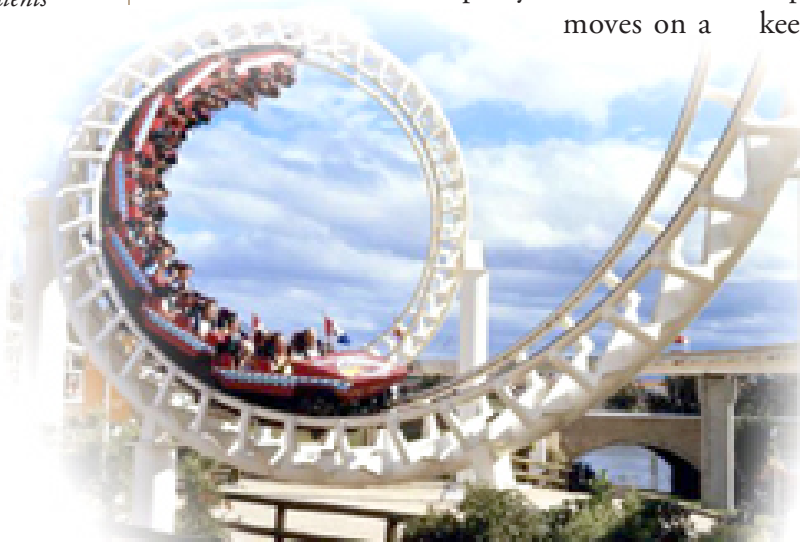
day-to-day basis are often significant, yet appear to be overall headed nowhere.

How are we to make sense out of all this? Granted – securities markets are volatile, but aren't we supposed to be rewarded for tolerating that volatility? Most of us would be satisfied with reasonable returns on our investments. As we head into the final quarter of 2004, however, is this all we have to expect – little or no return on stocks for the year? What about in the years beyond?

What follows are opinions of some of the best minds in the business about the kind of returns we might expect on stocks going forward, as well as an indication of why they think the way that they do. Then, I will note some of the strategies investors are deploying in response to that outlook, as well as factors to consider in evaluating those strategies.

At the outset, though, I want to highlight this truism: none of us knows what will happen. I believe it paramount to always keep that in mind!

The general outlook for returns on stocks is modest. When discussing equity returns, analysts usually do so using "real" return numbers; that is, after subtracting the impact of inflation. On this basis, most informed analyses provide estimates of average annual stock returns over the next decade or so in the range of 0% to 5%.

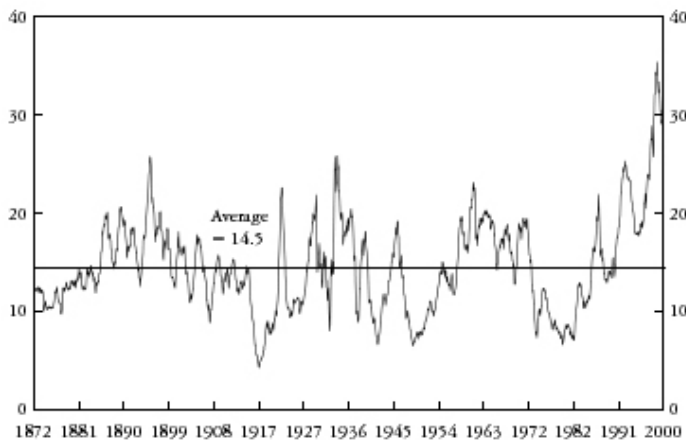


These return estimates are also below those of historical averages. Most of us have been encouraged to believe that stocks provide 10%+ over the longer term. If we reduce this figure by a 3% average annual inflation estimate, this indicates a real return of 7%. And, indeed, according to studies prepared by Professor Jeremy Siegel of the Wharton School of Business, that is quite close to the 6.8% return stocks have generated over the past two hundred years, as well as for major sub-periods within that time frame.

Given the remarkable stability of these long term returns, why shouldn't they continue into the new century – despite a lousy 2004?

There are a variety of reasons given for this. One is simply that the past two hundred years covers the period from shortly after the founding of our country, through westward migration and rise of our economic and political power, to where we now stand unrivaled in the world today. This has been a period of unprecedented growth, and it makes sense that our equity markets should reflect that. As we go forward, however, there is no West that remains to be won. The demographics in the United States have now changed radically to where we will be increasingly top-heavy, with a retiring post-war baby boom generation and population growth likely limited primarily to immigration. Major sources of historic growth will not continue into the new century.

### Long Term P/E Ratios



Source: Federal Reserve Bank of Kansas City

In addition to these changes in underlying social trends, we can see that the valuations on stocks, which have provided such remarkably steady long-term returns, have

done so by becoming increasingly expensive. For example, average price-to-earnings ratios on stocks today are around twice what they were in 1946. Another common valuation measure is dividend yields. According to Robert Arnott, Chairman of Research Affiliates and editor of the Financial Analysts Journal, stocks have been able to maintain their high growth rates only by retaining an ever-increasing amount of their earnings.

Finally, I note concerns analysts have about the accounting quality of those earnings which form the basis for stock valuations. Due to the proliferation of dilutive employee stock option programs, as well highly optimistic pension accounting assumptions, Arnott estimates currently reported earnings should be 26% lower.

Based on these demographic changes, extended stock valuations and overstated earnings, Arnott believes stocks will offer real annual returns for at least the next decade of around only 2.5%, at best.

There are a host of variables that underlie these estimates, and counter arguments to the reasoning behind them. My point here is simply to note that the projections are well-reasoned, and that they are being expounded by some of the most intelligent and experienced people in the world of investments. They must be taken seriously.

Clearly these projections are challenging. Understandably, most of us hope we can do better. What follows are various strategies that I see investors pursuing in their efforts to cope with potentially low returns, and some thoughts with regard to those strategies:

**Strategy #1: Denial.** At a recent conference for institutional investors, the treasurer of a major endowment presented investment strategies based on 8.4% real return assumptions. Since so much of the discussion at the conference concerned the prospect for much lower returns in the years ahead, I asked what was his strategy was in that event. “We don't think that will happen,” he responded.

Though his projections were based on simple extrapolation of returns over the prior 20 years – a period when the markets were generally robust, and well above the current projections of others – his estimates could easily turn out to be accurate. Furthermore, even if one's projections are overly optimistic, one has to evaluate the consequences of

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adopting a less favorable analysis. If there's nothing good to come of that, the best course may well be to "cross that bridge when we come to it." Nevertheless, we hope that by anticipating disappointing outcomes, we might be able to ameliorate them.

**Strategy #2: Active Management.** Most of us engage in this strategy. The idea is fairly simple. It's that while the markets may only generate 2.5% returns, our own investments will do better. Our stock picks will outperform, we know how to select the best mutual funds, or our tactical asset allocation methodologies demonstrate consistent above average returns. I can assure you that portfolios of Hamrick Investment Counsel's clients regularly beat their benchmarks! I suspect most other managers make similar claims. We are, of course, all intelligent and skillful investors. The question, though, is: how can we all be consistently above average?

The flip side of this, of course, is to "kick that loser out of the portfolio," back out of a disappointing asset class, or fire an underperforming manager. Actions like these always feel good – but they don't necessarily result in better investment returns. Often it's the very reverse: the worst performing stocks, sectors or managers are those poised for a generous rebound, while the investments, strategies and advisors we have come to love the most are getting set up to disappoint.

I believe it is natural for people to want to take charge of their situations and capture advantage for themselves. In the investment arena, an investor's challenge is to properly evaluate the overall picture and one's competitive position in it. Does one have the resources, information and expertise to compete effectively? What are the costs entailed, as well as the risks in doing so? In undertaking active management, one should have a solid basis for achieving above average returns.

**Strategy #3: Hedge Funds.** That's something of a mischaracterization, however, because hedge funds are not really a strategy, but rather a form of investment security, like limited partnerships, that covers a wide array of strategies. Hedge funds are currently highly popular.

The primary appeal of hedge funds is their ability to generate extraordinary returns. They have given some large, highly respected investors excellent returns over

sustained periods. Due in part to Yale University's pioneering steps into this sector, their endowment grew at an average annual rate of nearly 30% over the 25-year period from 1973 to 1998. No doubt returns like these are why we currently see an explosion in hedge fund investing.

Further, in the current environment of prospectively low stock market returns, hedge funds have additional appeal in that their returns are generally independent of those on stocks. Indeed, a common hedge fund strategy is that of "long/short," where the fund seeks to profit both by purchasing stocks as well as selling them short, so that the fund might profit on stocks moving either up or down.

Despite the broad range of their strategies, hedge funds share some common characteristics, which enhance their appeal but may also be problematic. First, since they are private partnership which may pursue proprietary strategies, they are not transparent. Another such characteristic is illiquidity. Contrary to stocks, which can be bought or sold at almost any time, hedge funds frequently have constraints on how and when investors can back out of them. Another feature of significance is hedge funds' use of "leverage" (derivative securities and/or borrowed money) to magnify profits. But leverage cuts both ways. It is also the reason why funds go through periods when they lose much of their capital, or at times fail entirely.

In evaluating use of hedge funds, I think it important to recognize that their success is based more or less wholly on active management. Therefore, hedge fund investors must consider their access to fund managers who may be able to generate superior returns, the high fees usually associated with those funds, as well as the particular investor's tolerance for risk.

Finally, hedge funds are no panacea for weak stock market returns. Looking at a list of year-to-date returns on several hedge funds style benchmarks, I note they range from -1% to +2% – essentially the same as this year's weak returns on stocks. The one outlier is a 6% return on distressed securities. This is attractive, but it takes a lot of guts to invest heavily in companies which are in bankruptcy!

**Strategy #4: Foreign Securities.** Whenever returns in domestic markets have been poor or are expected to be low, investors scramble to find more profitable areas for investment. Foreign stocks and bonds often come up. At

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times this can be a “grass is greener” approach. Often, though, valuations are more reasonable and return expectations higher for foreign securities vs. domestic. There is some evidence for this at present. There is also economic justification for foreign investment – particularly in emerging markets. Over the longer term equity markets are connected to economic growth. While real growth in the U.S. economy may be constrained to 3% or 4% per year, growth in some emerging market economies, such as China and India, is currently much higher than that.

Another argument for pursuing this strategy is diversification. By including foreign securities in an investor’s portfolio, one can maintain or enhance return expectations, while reducing the risk of a negative outcome. Despite the attraction of investing globally, however, there are some qualifications to keep in mind. First, while accounting methodologies are becoming increasingly standardized, they still differ substantially between countries. The reason foreign stocks look cheap may be because the valuation measures used are apples to oranges comparisons. Second, foreign stock investment involves extra expenses, as well as additional risks, such as fluctuation in currency values. Finally, while emerging market economies may be growing much more rapidly than that of the U.S. – those high growth rates may be already fully discounted in those markets, providing no favorable investment opportunities. Also, like hedge funds, returns on emerging market securities can be exceptionally volatile.

**Strategy #5: Live With It.** As Clifford Asness of AQR Capital Management has suggested, if in fact stock returns are to be low in the future, perhaps we need to simply accept that; stop obsessing about our investments and spend more time with our families. Similar to “denial,” I consider this another valid strategy.

In conclusion, with regard to the outlook for low stock investment returns, I give credence to the arguments put forth by Siegel, Arnott and others. At the same time, I hark back to that old adage: no one really knows what the future may hold.

As for the strategies for coping in such an environment, I think they are all valid. Despite the uncertainty of outcomes, I think it worthwhile for investors to prepare for at least the possibility of low returns. As for the particular strategies to pursue, what is most important is to evaluate the situation of the particular investor. How large is the portfolio? What are the investment goals? What is the investor’s tolerance for risk?

In all instances, though, the basic principles of investment are now more important than ever: maintain good diversification, hold down risks, minimize fees and expenses, be patient and avoid reacting emotionally.

Most of us prefer certainty – or at least some minimum guarantees. An investor might say, “Oh, the heck with it. I’ll just put my money in Treasury bonds and be done with it.” Even these solutions, though, entail low returns or even potential losses, as well as other risks. Despite all our efforts to find easy answers – I don’t think there are any. There is no way around it: investing, like life, is truly a Risky Business!



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