

SHARPER ♦ GRANITE



Optimal Portfolio Management

The first week in October marks the one year anniversary of the new bull market. We continue our intermediate and long term economic optimism, though several negative shorter term indicators keep us cautious about the market for the upcoming 4th quarter.

Most important, the stock market has the long term wind at its back in the form of low interest rates, low inflation, and a weak dollar, aided by government fiscal and monetary stimulus. These factors are discussed in the Economy Review this quarter.

Additionally, earnings reports for the third quarter were strong, led by positive earnings and expectation news from Intel, Yahoo, and Motorola through the first week of October. Our belief is that these factors will contribute to an enormous spurt in the Gross Domestic Product (GDP) for the third quarter (to be reported in November). In fact, we believe it may be the largest real (after inflation) GDP gain in years.

Finally, tremendous amounts of money remain in money market and bond funds as many investors have yet to rotate out of their defensive positions. This could provide even more benefit to the stock market in coming months as individuals move out of bonds and cash. This quarter, we illustrate research that looks at the true risk and return of stocks vs. bonds, in both the short term and the long term.

**FALL
2003**

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Financial Markets Summary



In the 3rd quarter of 2003 the S&P 500 Index edged up 2.3%, while the Lehman Aggregate Bond Index fell 1.0%. The average of all Sharper ♦ Granite client portfolios increased 4.7% and maintained a risk level 22% less than the S&P 500 Index.¹ At this risk level portfolios would expect to gain 1.8% in an efficient market. This marks the third quarter this year that the average of all Sharper ♦ Granite portfolios has outperformed the S&P 500 Index on a risk-adjusted basis. 77% of all Sharper ♦ Granite portfolios beat the S&P 500 Index on a risk-adjusted basis. Please refer to the personal letter from your portfolio manager for a report on your performance this quarter.

The S&P 500 Index has now gained 15.5% through the first three quarters of 2003. The Lehman Aggregate Bond Index is nearly flat at 0.3% on the year.

The National Bureau of Economic Research has officially fixed November 2001 as the end point of this past recession. By that definition, the stock market rebound was delayed. Stocks usually go up after a recession ends. The S&P 500 climbed higher in the year following each of the nine previous recessions since the end of World War II with an average gain of 19%. This time the market slipped 20% before beginning the current one year bull run.

The third quarter tends to be the weakest with September being the worst month, losing 1.3% on average since 1928. This year, September was true to form, finishing with a small loss. However, the first few days of October celebrated the one year bull anniversary with more strong gains.

With the help of the recent dividend tax cut, 2003 is turning out to be the best year for total dividend payments on the S&P 500 since 1999. In terms of percentage increase, it's the best year since 1996. Next year should be even better. However, dividends coming from the large established S&P 500 companies are still a relatively low, 1.9% on a weighted average basis. The average yield through the 1980's was 4.4%. 3% is the long term rule-of-thumb. ●

Portfolio Construction I: Asset Allocation of Stocks Vs. Bonds

Each Sharper ♦ Granite client holds a unique portfolio strategy, defined by life goals, and shaped by time horizon and personal risk profile. The first step in portfolio construction is determining the right percentages of stocks and bonds. Beyond that, the right types of stocks and bonds must be determined. Here, in Part I, we share some of the research that contributes to the first step: determining the optimal percentage of stocks vs. bonds.

The objective, generally, is to achieve relatively high returns while maintaining low risk. In optimizing this goal, there are two main inputs: *time horizon* and *personal risk profile*.

In analyzing the impact of time horizon, it is meaningful to describe risk by looking at the historical worst case scenario. Interestingly, the recent three year bear market tested our historical frontier for "worst case". Since 1802 the severity of that time period was surpassed only by the Great Depression.

The figure on page 3 shows the best and worst returns (after inflation) of stocks and bonds since 1871 for holding periods ranging from 1 to 30 years. Looking at the 1, 2, and 5-year holding periods, stocks are obviously riskier than bonds. But look at the 10-year holding period. The worst 10-year period on record for stocks is actually better than the worst 10-year period for bonds.

Moreover, looking at returns over all rolling 10-year periods since 1802, stocks have outperformed bonds 80% of the time. Since World War II, stocks have averaged 12.0% while long-term bonds have averaged 5.7%. Therefore, if you knew you were holding an investment for longer than ten years, you would always prefer stocks over bonds. ***Stocks are safer than bonds and produce better returns if the holding period is ten years or more.***

This trend becomes more significant the longer the holding period. For 20-year holding periods, stocks have never trailed the inflation rate, but bonds *average* a 3% annual loss over 20-year periods. A 3% annual loss over 20 years will wipe out one-half the purchasing power of the portfolio. Thus, the safest long term investment for preservation of purchasing power has clearly been stocks rather than bonds.

That said, there are at least four reasons why we may hold a small percentage of bonds in 10-year portfolios when minimizing risk. First, no one can ever be 100% sure that they may not need to tap some of their portfolio prior to ten years. Second, in times of falling interest rates, bonds tend to perform well with respect to stocks. During those periods, we may "tilt" portfolios slightly toward bonds.

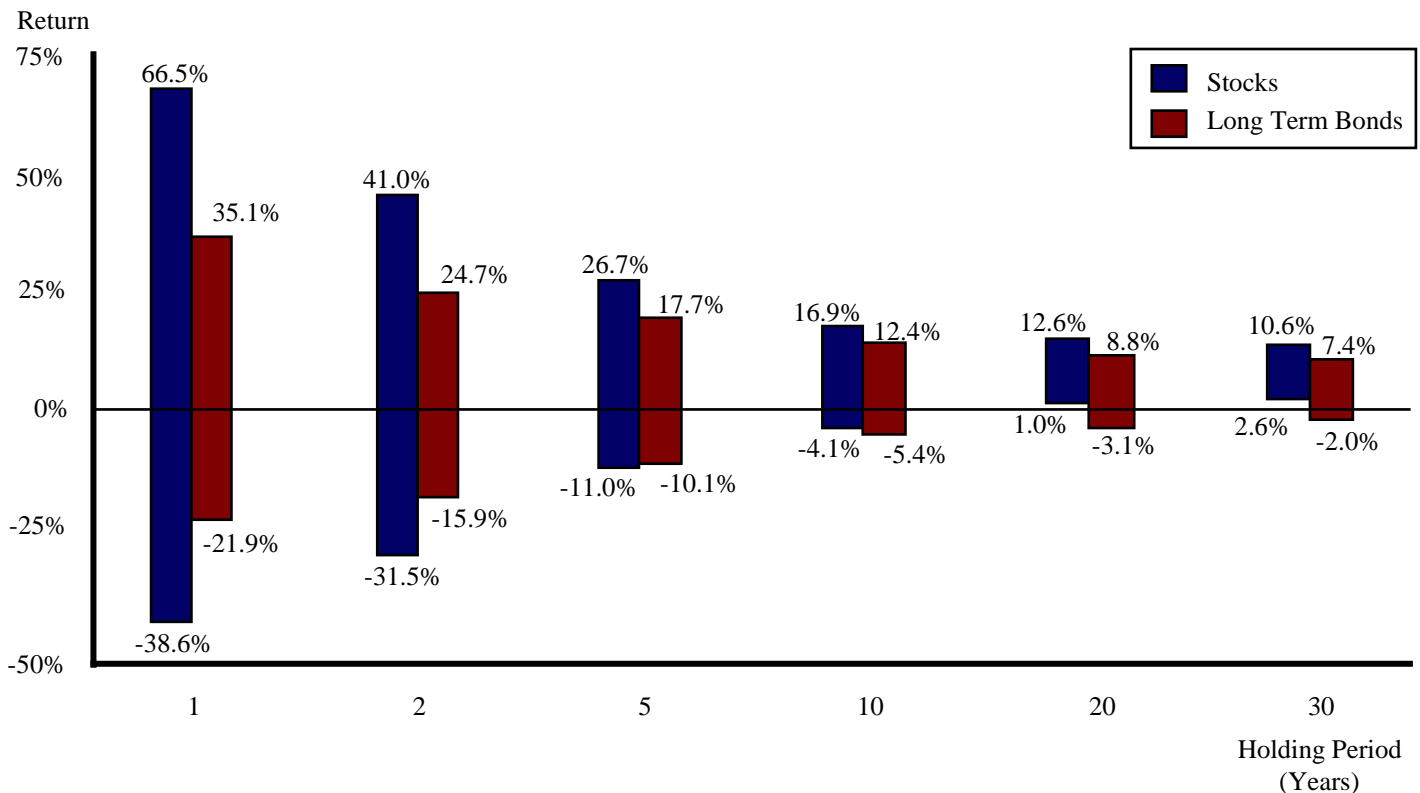
Third, and perhaps most important, bonds are somewhat uncorrelated to stocks. Based on Sharper ♦ Granite research,



20% of the time in a given month long term bonds will move in the opposite direction of stocks. Thus, they provide a natural hedging function within a portfolio. Building portfolios with components that tend to move against one another is another key to minimizing portfolio-wide risk. This process is the subject of Portfolio Construction Part II to be presented next quarter.

Finally, depending on an individual's risk tolerance, he or she may not be comfortable living with the considerable short term fluctuations that are possible with an all-stock portfolio. See the 1 and 2-year stock ranges in the chart below.

Best and Worst Stock and Bond Returns over Different Holding Periods ²



This leads to the second key in determining correct asset allocation, personal risk profile. Most people do not like risk (in this case portfolio volatility). We would rather have a sure, steady gain than a wild ride up and down on the way to that gain.

Before client portfolios are constructed, a risk interview is conducted. This allows the portfolio manager to temper the portfolio so that the client can sleep well at night in the short term while still meeting long term goals. Once a portfolio is in place, over time clients may offer feedback to their portfolio manager if the portfolio is fluctuating beyond a level of comfort or if returns are not high enough. Portfolio aggressiveness can then be adjusted.

Asset allocation across stocks and bonds is only the first step in a portfolio construction. Next quarter we will explain how the *right* stock and bond assets are selected. Stock and bond asset selection provides a second lever with which to control risk and expected return. •

Third Quarter 2003 Economy Review

The indicators we track have cooled slightly, but remain modestly positive. The government's Index of Leading Economic Indicators rose again throughout the quarter.³ We remain confident in a slow but sure economic recovery based on the intermediate term indicators discussed on the next page.

Additionally, we have the long term benefit of government help in the form of:

1. **Fiscal stimulus** in the form of the tax cuts reviewed in detail in last quarter's letter: While state taxes have increased, their rise is much more than offset by the Federal tax cuts.⁴ This year, \$150 billion less will be paid in taxes which converts to roughly 1.5% more in Gross Domestic Product (GDP).

2. **Monetary stimulus** in the form of lower interest rates: The Fed has indicated it will continue to keep interest rates low well into 2004. Consumer and business refinances have generated abundant sideline cash that may be invested.

The current weak dollar environment also helps in two ways. It makes American produced goods more attractive overseas. It also gives multinational U.S. corporations a favorable currency rate adjustment.

Concern has been expressed in the media lately about the growing government deficit. However, we don't yet see it as a significant problem. The deficit as a percentage of GDP is still quite low relative to recent historical averages

Quarterly venture capital funding showed its first sequential increase in two years, rising 7.5% (year over year) in the second quarter. Venture funds investment increased to \$4.3 billion, up from \$4.0 billion in the first quarter. While this is a positive sign, venture capital investing activity is a lagging economic indicator. It does best when the stock market is healthy and the outlook for initial public offerings is strong.

Other key leading economic indicators we track are reviewed below:

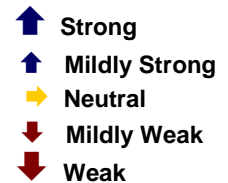
Leading Economic Indicator Summary

↑ **Market Cycle:** The first week in October marks the one year anniversary of the new bull market. The S&P 500 Index has gained 15.5% through the first three quarters of 2003.



The 4th quarter of each year tends to be the strongest. November and December have been the strongest months for the S&P 500 since World War II.²

Right around the corner is January, another very good month, but primarily for small caps and international stocks. Small caps have averaged an astounding 4.8% return in the month of January since 1925. And in foreign countries, January returns account for 30% of the total annual return on average.²



↑ Political Cycle: This is the 3rd year of President George W. Bush's term. Traditionally, the 3rd year in the presidential cycle is the strongest as elected officials, both the President and Congress, typically try to boost the economy to improve their chances of re-election. Since 1948, the 3rd year of the presidential cycle has seen the S&P 500 Index post an average gain of 23.3% (21.9% with Republican presidents), far in excess of the other years of the cycle.²

↑ GDP Growth: Gross Domestic Product (GDP) is the official economic measure of the U.S. economy. In the 2nd quarter of 2003 the economy grew at a very healthy 3.3% net of inflation.³ It was the eight consecutive quarter of expansion, or positive economic growth, since the official recession of 2001.

Early indications are that 3rd quarter growth may have been even larger.

↓ Purchasing and Manufacturing: The key economic purchasing indicator is the Chicago Purchasing Managers Index (PMI).⁵ This indicator rose nicely through July and August, then plunged in September to its largest monthly drop in eleven years.

Manufacturing output fell slightly in August. Factor utilization is still low at 75%, compared to the long term average 81%. Manufacturing represents one-sixth of the total U.S. economic output.

↑ Inflation Control: The most widely used measurement of inflation is the Consumer Price Index (CPI). The core CPI remained extremely low. August's year over year increase of 1.3% was the lowest since February, 1966, implying a continued low inflation environment. The Federal Reserve Board left interest rates unchanged this quarter.

→ Consumer Spending: Consumer spending perked up at the very end of the 3rd quarter as retailers flashed signs of strong sales performance ahead of the holiday season.

Consumer confidence is an important leading indicator of economic behavior. The Consumer Confidence Index fell to its lowest reading since before the war.⁶ The IBD/TIPP Economic Optimism Poll trended lower through the 3rd quarter, but then ticked up sharply the first week of October.⁷ The University of Michigan Consumer Confidence poll mirrored this behavior.⁸

Have a friend or family member who can use a free portfolio analysis? As a free service to clients, Sharper ♦ Granite will perform portfolio analyses for clients' friends and family. The analysis "x-rays" a current portfolio of mutual funds, stocks, and/or bonds across several accounts to review balance, risk, performance and costs.

We are happy to suggest simple adjustments that may improve return, lower risk, or reduce costs. Often times, simple changes to mutual funds in a 401(k) or an IRA can improve returns, lower risk levels, and improve alignment with specific financial goals such as college or retirement.

↑ **Capital Spending:** Business' capital spending continued its steady upward trend over the last ten quarters. Moreover, business investment should continue to get a significant lift from the accelerated write-offs allowed under the new tax cut package.

↓ **Investor Sentiment:** Investor sentiment is an important contrarian indicator. Market conditions are actually more favorable when "expert" newsletters are more bearish. This is true for two reasons. First, studies show that "experts" seeking to time the market are consistently wrong more often than they are right. Second, short term investors place their bets first, then tout their directional picks. For example, when investors are overly bullish, they have likely already employed their capital, leaving less money to be pushed into the market to generate demand.

According to *Investors Intelligence*, bullish readings sat at extreme levels going into the first week of October, suggesting investors are far more exuberant than we would like to see.⁹ However, the Hulbert Stock Sentiment Newsletter Index dropped from high bullish readings during the quarter to lower, safe readings during the last two weeks in September.¹⁰

↓ **Insider Trading:** Insider trading measures have turned drastically bearish. Insider sells outnumbered buys 36 to 1 in September. This is the largest ratio in ten years.¹¹ However, it is important to note a couple of points.

First, while insider selling is bearish if it occurs when the market's declining, it's not particularly bearish if it occurs in the wake of a market rise. This research of ours has recently been backed by Professor Nejat Seyhun at the University of Michigan.¹²

Second, historical comparisons to current insider selling may be partially impacted by the large number of options that have been granted to insiders in recent years. ●

Questions?
Contact us at:
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Notes and Acknowledgements:

1. Arithmetic average used for return measurement. Asset weighted average beta used for risk-adjustment to market risk level. Performance includes assets tracked for clients that lie outside Sharper ♦ Granite direct management, which amount to less than 10% of total assets. All client portfolios weighted equally in calculation.
2. Jeremy J. Siegel, Professor of Finance, Wharton School of Business at Penn University; and Sharper ♦ Granite Research.
3. U.S. Commerce Dept.
4. Research by Marty Feldstein, Harvard Economics Professor.
5. National Association of Purchasing Management (NAPM) – Chicago, September, 2003.
6. The Conference Board.
7. IBD/TIPP Economic Optimism Poll.
8. University of Michigan, September, 2003.
9. *Investors Intelligence*, October 1, 2003.
10. Hulbert Stock Newsletter Sentiment Index (HSNSI), October 1, 2003.
11. Thomson Financial.
12. Nejat Seyhun, Professor of Finance, University of Michigan.