

SHARPER ♦ GRANITE



Optimal Portfolio Management

The equity and bond markets continue to waffle in a narrow range, finishing near even this quarter. However, a few specific factors are acting on the market, pushing some sectors positively, others negatively, and netting the total market out near zero. These factors deserve attention as they will likely continue.

Chief among the economic factors we are watching is the price of oil. Adding to this drag on the markets is uncertainty surrounding terror and Iraq, the U.S. presidential election, and the effects of limited flu vaccine availability for the 2004 - 2005 winter.

The stock and bond markets worry just as people do. Not knowing at all is often more painful than knowing an unfavorable outcome. That is, the markets dislike uncertainty. The election is at least one uncertainty that will be resolved this quarter.

Last quarter we discussed how risks like increasing oil prices are partially buffered in Sharper ♦ Granite portfolios. This quarter we discuss how Sharper ♦ Granite "tilts" portfolios to favor certain industries, company sizes or geographies during different points in the economic cycle.

Financial Markets Summary

In the 3rd quarter of 2004 from July 1 - October 1, the S&P 500 Index finished slightly down at -0.8%, while the Lehman Aggregate Bond Index rose, finishing 1.8%.

The average of all Sharper ♦ Granite client portfolios increased 0.4% (net of fees) and maintained a risk level 19% less than the S&P 500 Index.¹ At this risk level, one would expect to finish -0.5% in a perfectly fair, cost-free efficient market over the quarter. Thus, this marks the 5th quarter in the last seven that the average of all Sharper ♦ Granite portfolios outperformed the S&P 500 Index on a risk-adjusted basis.

70% of Sharper ♦ Granite clients beat their respective risk-adjusted benchmarks. Sharper ♦ Granite performance benefited this quarter from "tilts" in favor of small value stocks, energy and Asia. These sectors tend to outperform during economic recoveries. Smaller companies tend to be more nimble in terms of meeting increasing demand. Increasing demand tends to drive higher energy needs. Asian markets especially benefit from low U.S. interest rates, which tends to be the case at the outset of U.S. economic recoveries.

IN THIS ISSUE

FALL
2004

- **Financial Markets Summary**
- **Tilting Portfolios to Improve Performance**
- **Third Quarter 2004 Economy Review**



Year to date total return (stock price change + dividend) of typical building block components representing these sectors in Sharper ♦ Granite portfolios include:

- Small Cap Index (IJR) +10.9%
- Small Cap Value Index (IJS) +11.9%
- Energy (XLE) +29.8%
- Asia ex-Japan (EPP) +14.0%
- Hong Kong Index (EWH) +13.0% ●

Tilting Portfolios to Improve Performance

As with most portfolio managers, the overall performance goal at Sharper ♦ Granite is to beat the S&P 500 Index on a risk-adjusted basis. This is no easy task as 70 - 80% of portfolio managers do not beat the index in a given timeframe.² In fact, during the past ten years the average equity mutual fund underperformed by 1.5% annually compared to the S&P 500 Index.³ In this challenging game Sharper ♦ Granite has beaten the S&P 500 Index on a risk-adjusted basis every quarter except two over the last three years.

The Sharper ♦ Granite game plan involves leveraging principles from Modern Portfolio Theory developed by Harry Markowitz and other Nobel prize winning economists. It emphasizes eliminating costs, keeping taxes efficient, and minimizing risk factors while targeting a give return.

Last quarter we discussed how minimum risk core portfolios are constructed at Sharper ♦ Granite. This quarter we explain how these core portfolios, developed for neutral economic conditions, are then "tilted" slightly to reflect Sharper ♦ Granite expectations during a particular point in the economic cycle.

Tilting is a technique used by money managers to emphasize certain sectors within a portfolio based on expectations that those sectors will outperform the general market. However, the Sharper ♦ Granite tilt process is not guesswork. We are not looking to outsmart the market with tilts; rather, we are seeking to improve the accuracy of our data analysis. We do this by factoring macro-economic factors such as where we currently are in the business cycle or interest rate cycle.



<i>Current SHARPER ♦ GRANITE Tilt Examples</i>	
Positive	Negative
Small Value Energy Utilities Asia ex-Japan Hong Kong	Telecom Real Estate Long-term Bonds

Different asset classes enjoy periods of expansion and contraction, sometimes simultaneously. Once specific economic event time periods are defined, probability analysis is used to find relationships between sectors and minimize risk.

Probability analysis is a mathematical description of the likelihood of the occurrence of a specific type of event. It tests various "what-if" scenarios and allows portfolio managers to predict a wide range of outcomes in changing market conditions.

Imagine a particular batter in today's World Series has hit for a .300 average over his lifetime. But maybe he has hit .250 in night games, .230 against left handed pitching, and only .200 over the last year. What's the appropriate batting average to assume for a particular time at bat against a left-handed pitcher at night?

By isolating more specific economic periods (e.g. rising interest rates, high oil prices, etc.) and analyzing industry sector behavior during these times, we can better determine how sectors will perform, both individually and in relation to each other, in the near future. We factor in to our estimates how the batter has behaved not just during his lifetime, but also during specific situations that he is about to encounter.

We look at not only how industry and geography components perform, but also how they correlate with each other over defined periods of time that include economic booms and recessions, different presidential administrations, high and low oil prices, war/ no war, etc.

For example, one tilt may be driven by data showing that in the two years following each recession since 1945 small caps outperformed large caps by an average of 9%.⁴ Another would be driven by data showing that real estate investment returns since 1945 are uncorrelated with long-term bonds except when long-term rates rise quickly, in which case they are positively correlated (in fact, both average negative returns during these periods).⁴

Have you met with your Sharper ♦ Granite advisor lately? We encourage you to take advantage of advisor accessibility and review your custom portfolio plan at least once per year. As life events and financial goals adjust, so too should your portfolio. Private client consultations are free, and taking the time to fine tune a portfolio can be worth many thousands of dollars over the years. We encourage at least one comprehensive meeting per year. Points your advisor may review with you include:

- **Adjusting financial goals.** Your advisor manages a dynamic financial model for your retirement or college goals based on your savings contributions, risk profile and time frame. Updating model assumptions and charting progress is wise to do annually.
 - **Fine tuning risk profile.** Your portfolio risk level (and corresponding expected return) can be readily adjusted by your portfolio manager. Questions to ask yourself include: Is my portfolio bouncing up and down too much for my personal taste? Am I getting enough upside when the market has a good quarter?
 - **Reviewing anticipated life events.** Kids, college, new job, retirement -- as major life events unfold, your portfolio should adjust to support changing needs.
 - **Updating outside assets.** Unless a client requests otherwise, Sharper ♦ Granite portfolios are customized to take into effect assets outside of our management. Significant changes to your asset base (e.g. corporate stock purchase, stock options, 401(k), real estate investment) may result in an adjustment to your portfolio.
- If your portfolio manager is tracking your 401(k) or 403(b), you should fax or email a statement once a year so that estimates of these assets can be synchronized and integrated with your Sharper ♦ Granite managed money.
- **Tax planning.** The recent tax changes have made long-term capital gain and dividend income more appealing. Portfolios are automatically adjusted to take advantage of these effects, but other assets you have may also be affected. We are always happy to give you our thoughts on management of your other assets .

When data during specific economic periods are factored, it improves the quality of our probability analysis and allows us to confidently nudge portfolios in certain directions. Over time, these tilts lead to enhanced portfolio performance. ●

Third Quarter 2004 Economy Review

In September the Federal Reserve Board increased short-term interest rates for the third time in the business cycle by 0.25% as expected. Interestingly, long-term rates, which are controlled more by market factors than by the Fed, actually fell significantly.

While this phenomenon has prompted much concern in the media, we feel this is merely a return of the yield curve to a more normal shape. Our measurements showed the yield curve in May to be the steepest since 1960. That is, short-term rates were unusually low relative to long-term rates.

Ultimately, the the yield curve will regain its traditional shape, and the whole curve, short and long, will rise. Gradually rising rates in this environment of strengthening corporate earnings are just fine for the economy.

Not so fine for the economy are oil prices sitting north of \$50/barrel. We have emphasized the importance of even modest oil price increases for the past year now in our quarterly letters. See the Winter, 2004 letter for a detailed look at oil price impacts on our economy. In short, high oil prices contribute to higher expected inflation, lower consumer spending and lower expected corporate profits. Every \$2/barrel increase costs the U.S. Gross Domestic Product (GDP) 0.1%/year.⁵ \$50/barrel for a year could cut the U.S. GDP by one-third.

So, is \$50/barrel a temporary spike? Not likely. While much of the media focus is on the supply side impacts of the day such as the Yukos vs. Russian government dispute, gulf hurricanes, Mid-east terror, and Nigerian sabotage and worker strikes, there is steady, strong demand in China and India that is unlikely to abate. Expect a renewed government focus on alternative energy sources no matter who wins the election. One final positive note on energy prices is that natural gas prices have fallen for the third straight month.⁶

United Kingdom regulators halted manufacturing at Chiron, the largest producer of influenza vaccines in the world. In normal years the flu costs U.S. corporations and individuals \$20 billion, 189 million missed school days and 126 million work days.⁷ Without enough vaccine, flu cases could increase exponentially as the flu potentially spreads more easily this year. Economists are scrambling to estimate the possible effects on U.S. and world economic productivity.

With all of that to be concerned about, we still rate the overall world economic outlook as slightly positive. The International Monetary Fund (IMF) reported this quarter that global financial markets are stronger than at any time since early 2000. It credits the U.S. Federal Reserve Board with increasing world financial calm by accurately communicating its rate increases and the economic thought behind them.



Our Leading Economic Indicator summary below is still slightly positive. The Conference Board's U.S Index of Leading Economic Indicators fell slightly this quarter.⁸ The Federal Reserve Board continues to insist that the overall economy is regaining traction.

Leading Economic Indicator Summary

- ↑ **Market Cycle:** The 1st week in October marks the two-year anniversary of the new bull market. The 1st year of bull markets tends to be the strongest, and this bull run is no different. The 1st year of this bull market yielded 34% S&P 500 returns while the 2nd year yielded 8%.

The 4th quarter is upcoming and tends to be the strongest of each year. November and December have been the strongest months for the S&P 500 since World War II.⁹

January is 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.⁹

We have begun a period of increasing interest rates. Stock market returns since 1970 have averaged only 8.7% in years of rising interest rates compared to 18.5% in years of declining interest rates.¹⁰

- ↑ **Political Cycle:** We are in the 4th year of President George W. Bush's term. Traditionally, the 3rd year in the presidential cycle is the strongest, but the 4th year is second best. Since World War II, the 4th year of the presidential cycle has seen the S&P 500 Index post an average gain of 8.6%. Eleven of the 14 post-WW II 4th years have been positive.⁸
- ↑ **GDP Growth:** Gross Domestic Product (GDP) is the official economic measure of the U.S. economy. It is a measure of all goods and services produced in the United States. 2nd quarter GDP was revised to 3.3%. This is the slowest growth in five quarters but in line with a healthy growing economy.¹¹ It was the eleventh consecutive quarter of expansion, or positive economic growth, since the official recession of 2001. We expect the high price of oil to take approximately 1% off of 2004 GDP growth.
- ↑ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, remained strong through the 3rd quarter, although the rate of growth slowed from the 2nd quarter.⁶ Economic activity in the manufacturing sector grew in September for the 16th consecutive month, while the overall economy grew for the 35th consecutive month.¹²
- ↑ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, grew just 0.1% in August. The core CPI has grown a mild 2.2% thus far in the year.⁸

However, commodity prices spiked upwards this quarter led by the record oil prices. The CRB Index, which is a benchmark price for a basket of goods, saw its largest increase since March, 1989. Furthermore, The ISM Prices Index still indicates significant upward pressure on prices.⁶ These indicators tend to predict the future direction of inflation.



↓ **Consumer Spending:** The Consumer Confidence Index fell consecutively in August, September and October, based largely on disappointing job growth.⁸ The UBS Consumer Sentiment Index is the lowest in a year, though not nearly as low as recession levels.¹³ Early retail earnings reports and holiday outlooks are disappointing. Expectations for holiday sales are low. This is perhaps positive in the sense that surprises to the upside are more likely.

↑ **Capital Spending:** Average commitment lead time for capital expenditures rose, indicating business managers are slightly less inclined to spend their budgets. However, overall capital spending behavior is strong in this economic recovery.⁸

↓ **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.

Despite a sideways stock market, bullish readings remain at high levels, where they have been for the most part since September, 2003.¹⁴ This represents yet another headwind against the market. One more encouraging study shows that hedge fund managers are becoming uncharacteristically bearish as the year winds down.¹⁵

↓ **Insider Trading:** Insider trading measures have been unusually bearish over the last twelve months. In the 3rd quarter insider sell-to-buy ratios were the highest in three years.¹⁶

Questions?
Contact us at:
questions@sharpergranite.com

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. Charles Schwab; Morningstar
3. Vanguard Group reports an underperformance of 3.0% annually over the last 20 years. The Wall Street Journal study, "Stock Funds Just Don't Measure Up," Jonathan Clements, October 5, 1999 found a 1.4% annual underperformance. A University of Chicago study found a 1.8% annual underperformance from 1961 – 1993, Mark Cahart. Blake, Elton and Gruber found a 1.6% annual underperformance from 1965 – 1984
4. Sharper ♦ Granite analysis
5. Merrill Lynch, April, 2003
6. Institute for Supply Management (ISM) – Chicago, October 1, 2004
7. University of Michigan Study
8. Conference Board, October 4, 2004
9. Jeremy J. Siegel, Professor of Finance, Wharton School of Business at Penn University
10. Charles Schwab, 2003
11. U.S. Commerce Department
12. Federal Reserve Board
13. UBS Consumer Confidence Study, October 4, 2004
14. Investors Intelligence, September 30, 2004
15. Market Profile Theorems Inc., October 4, 2004
16. Van Hedge Fund Advisors International, October 4, 2004