

SHARPER ♦ GRANITE



Optimal Portfolio Management

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The investment year ended with a whimper, registering only modest returns for 2005 in most asset classes. Stock and bond market returns, however, were in line with expectations during years of rising interest rates.

Throughout 2005 we highlighted a set of economic risk factors that continue to act out on stage. In order of importance to the markets they are: oil prices, interest rates, residential real estate prices, the U.S. trade deficit, and the uncertainty associated with war and terror.

Most of our attention in 2005 focused on the direction of oil prices and interest rates. While either of these factors could rise and negatively impact the financial markets, they could also unexpectedly decline. Either a decrease in oil prices or an end to the interest rate hike cycle could spark a market rally. A form of the latter occurred during the first week of 2006 when FOMC (Federal Open Market Committee) meeting minutes revealed that the rate hike cycle may end by March, 2006. During the first week of 2006, index gains rivaled those of entire 2005. The Dow gained 2.3%, the S&P 500 gained 3.0%, and the NASDAQ gained 4.5%. All three major indexes grew to 4½ year highs. Most secondary indexes also achieved multi-year highs, indicating the breadth of the rally. As the chart at left shows, positive beginnings to the year often translate into winning years.

| January Dow Up | Historical Chances of Up Year ¹ |
|-------------------------------|---|
| 1 st Day of Year | 78% |
| 1 st Week of Year | 86% |
| 1 st Month of Year | 91% |

As interest rates act out on center stage at the turn of the new year, this quarter we focus on the state of interest rates and their predictive power.

Financial Markets Summary

In the fourth quarter, when calibrated to the same risk as the S&P 500 Index, the average of all Sharper ♦ Granite client portfolios gained 0.9% (net of all costs).² During this time, the S&P 500 Index had a total return (stock price gain + dividends) of 2.1%. The Lehman Aggregate Bond Index increased 0.6%. The average of all Sharper ♦ Granite portfolios trailed the S&P 500 Index on a risk-adjusted basis for just the fourth quarter in the last twelve.



For the year 2005, two-thirds of all Sharper ♦ Granite portfolios beat the S&P 500 Index on a risk-adjusted basis. The average of all Sharper ♦ Granite portfolios increased 6.4% (net of all costs) when calibrated to the same risk as the S&P 500 Index. This increase surpassed the total return of each of the major market indexes. In 2005 the S&P 500 Index returned 4.9%, the Dow returned 1.7%, and the NASDAQ returned 1.5%. Bonds also returned little money in 2005 as the Lehman Aggregate Bond Index gained just 2.4%.

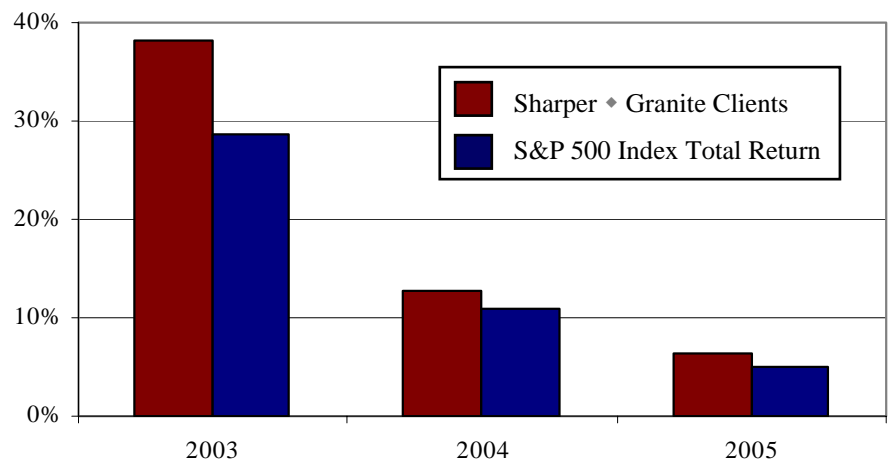
Note that all returns above are reported as *total returns*, that is, index price appreciation plus dividends. Most major index returns are reported with dividends excluded (e.g. *Wall Street Journal*, *New York Times*, *CNBC*). These reports

significantly understate actual market returns. Sharper ♦ Granite always compares its returns (net of fees and all costs) to the major index *total returns*.

By this measure Sharper ♦ Granite portfolios on average have outpaced the S&P 500 Index on a risk-adjusted basis each of the last three years.

\$100,000 invested three years ago in a Sharper ♦ Granite portfolio at a risk level similar to that of the S&P 500 would be worth \$165,645 today on average (net of all costs), compared with \$149,672 if invested in the S&P 500 with dividend reinvestment and no costs. ♦

Sharper ♦ Granite Returns Vs. S&P 500 Index ²



Dangers of Using Interest Rates for Market Prediction

On the first trading day of 2006, the S&P 500 Index rallied 1.6% in the same moment that the FOMC meeting minutes were released. Analysts interpreted the notes as implying that the rate hike cycle may end soon. While this was already current consensus, the market reacted strongly to even a slight increase in the likelihood of this estimation.



The stock market is indeed sensitive to rate-impacting news. 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.³ Rising rates are viewed as a headwind to investors since investors must borrow at a higher rate, thus diminishing the future returns on their investments.

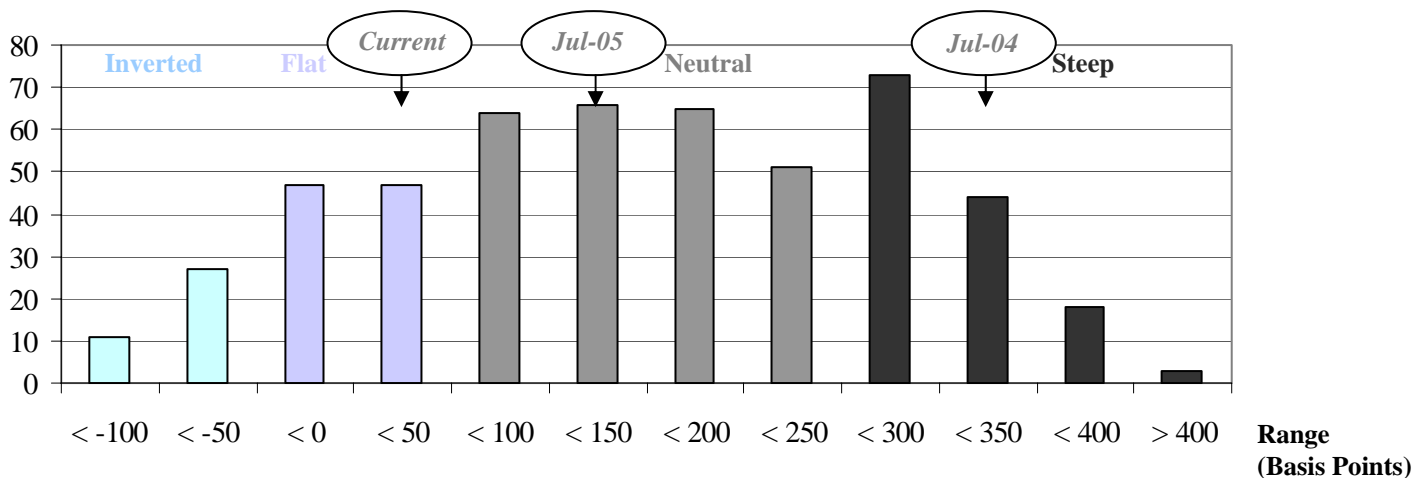
Interest Rate Predictive Power

Throughout 2005 investors and the media have been discussing not only the top of the interest rate cycle but also the shape of the yield curve. Conventional wisdom says that a steeper yield curve is better for the economy because it encourages investors to borrow short-term in order to invest in long-term projects which, for example, help corporations grow through development of new products and markets. Banks and other lenders also become more willing to lend, and thus fresh cash investments flow into the economy.

The concern in the financial news media is that the yield curve is near inversion (the 2-year and 10-year treasuries did momentarily invert during the final week of the year). Over the past 50 years, yield curve inversions have presaged recessions nine of eleven times. So do we have a recession coming or is this time different?

Rate Spread Occurrences Since 1962 ⁴

Number of Months Since 1962 that the Rate Spread has been in this Range



We do not see a recession on the horizon. First, the yield curve is still much more flat than it is inverted. While the curve has compressed significantly in the last year-and-a-half, it began at a historically steep level (the media does not draw as much attention to unusually steep curves).

Second, the predictive power of yield curves may be lessening. Sharper ♦ Granite analysis researched the correlation of rate spreads with S&P 500 Index performance each month from 1962 - 2004. One would expect that as the rate spread increases, S&P 500 stock performance would improve. Over this period, a correlation did exist; however, it was significantly less than expected at only +13%.⁴ What is even more interesting is that recently, in the period since 1994, the correlation actually reversed to -30%.

Third, because of the large trade deficit, foreign investors have been repatriating U.S. dollars gained from goods sold into long-term U.S. bonds. The Fed estimates that foreign buying alone has depressed the 10-year yield by 1.5%.⁵

Fourth, an aging U.S. population may be seeking long-term secure fixed income investments and driving up demand. And finally, the Fed's success in controlling inflation over the past twenty years has led investors to require less compensation to offset future inflation risk.

Predicting Interest Rate Movement

If yield curve shape is not a great predictor of economic strength, can't we at least identify whether the Fed is in a period of rising or falling rates, project how far it will continue, and then profit from this knowledge by buying or selling bonds?

Even this can be challenging. While the Fed controls short-term rates, long-term rates are dictated by the markets and are a larger part of our daily lives and our economy. Long-term rates tie to mortgages, community and state-sponsored

construction project debt, and most business debt. Since 1982 the *Wall Street Journal* has published a semi-annual survey of over 50 leading economists asking them to anticipate where the 10-year treasury rate will be a year later. In 23 years the majority of economists have been correct about the *direction* (forget about the actual value) of rates – up or down – only 30% of the time.

Bloomberg recently began a similar survey of 53 economists and has seen similar results. A year-and-a-half ago these economists predicted that the 10-year treasury bond would be higher -- up to 5.0% -- by the end of 2005. In reality the 10-year treasury fell to 4.3%.⁶ Few predicted the increased demand of U.S. debt and the lack of inflation, both of which acted to suppress long-term rates even as the Fed openly communicated its intentions of raising short-term rates.

Furthermore, incorrectly guessing the direction or magnitude of interest rates can be punitive. For example, a long-term bond manager investing with a belief that interest rates will fall by 1% over the next year would lose approximately 15% of principal if it turned out that rates instead rose 1%. Like the game of picking individual stocks, the game of predicting interest rates is a losing one with potentially severe consequences.

This example underscores the importance of staying balanced and not placing large bets based on directional guesses of interest rates in the short-term. Few opportunities exist in the investment world that increase returns without increasing risk. Sharper ♦ Granite believes the best path to superior risk-adjusted returns is through the use of basic principals such as diversifying stocks, laddering bonds, minimizing costs and keeping taxes efficient, rather than through stock or interest rate guesswork. Sharper ♦ Granite's proprietary RiskPoint software helps us construct optimal portfolios around exactly those principals. ●

Fourth Quarter 2005 Economy Review

With the calendar turning from a lackluster 2005 to a prosperous first week in 2006, so too have our Leading Economic Indicators turned from neutral to positive.

We look forward to modest stock and bond returns in 2006 as the economy expands at just the right pace with low inflation while clearing itself of the interest rate hike cycle. However, we caution that risk premiums across all major asset classes, stocks, bonds and real estate, are quite low. Stock price-to-earnings (P/E) ratios are in the upper-middle of their historic ranges. Corporate and other “risky” debt are offering historically low incremental yields above zero-risk treasuries as investors, especially foreign countries and retiring baby boomers, chase yield in a world where there is little. Real estate cap-ratios are half their traditional levels as rents remain low relative to property values.

FOMC chairman Alan Greenspan has been warning that history has not treated investors kindly who take on risk without adequate compensation. These historical anomalies are being factored into the 2006 Sharper ♦ Granite portfolios tilts.



Leading Economic Indicator Summary

- **Market Cycle:** Looking forward, the first quarter of each year tends to be strong, powered by January which has been the third strongest of the months for the S&P 500 since World War II.⁷

January is a good month but primarily for small caps and international stocks. Small caps have averaged 4.8% return in the month of January since 1925. In foreign countries, January returns account for 30% of the total annual return on average.⁷

However, for now we are still for now in a period of increasing interest rates. In the first week of January the market climbed on FOMC meeting notes implying that the rate hike cycle may end in January or March.

- **Political Cycle:** We are in the second year of President George W. Bush's second term. Historically, the second year in the presidential cycle brings only average returns for the stock market. Since World War II, the second year of the cycle has seen the S&P 500 post an average gain of 9.7%, overall and 11.0% under Republican presidents. When the data is reviewed back to 1888, second years average only 8.2% and 8.3% under Republican presidents.⁷

- ⬆ **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. Third quarter 2005 GDP was revised to 4.3%. This beat expectations and continued a trend of solid, steady growth and is in line with a healthy, growing economy. It was the 16th consecutive quarter of expansion, or positive economic growth, since the official recession of 2001.⁸

- ⬆ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, decreased throughout the fourth quarter but remained in a general uptrend that began last summer.⁹

Meanwhile, the Philly Fed Index, widely observed as a leading indicator, decreased slightly in the fourth quarter but continued to indicate strong future manufacturing growth.¹⁰

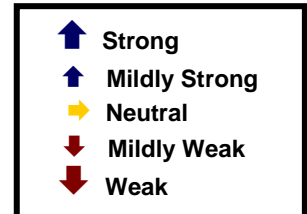
In another positive sign, U.S. productivity accelerated in the third quarter while labor costs fell. Increasing productivity is a rare “free lunch” to corporations in that it boosts profits without increasing inflation.

- ⬆ **Inflation Control:** The most widely accepted measure of inflation is the Consumer Price Index (CPI). The core CPI remained subdued, rising only 0.2% in both October and November. Core inflation for all of 2005 will total about 2.3%.¹¹

However, excluded from the core CPI is the high cost of energy. While energy costs are generally excluded from core CPI measurements because of their volatility, consumers are becoming increasingly used to high energy prices.

- ⬆ **Consumer Spending:** Economists keep a close eye on consumer spending because it accounts for two-thirds of all U.S. economic activity. The final holiday retail sales reports showed tepid December spending. December retail sales rose 0.7% but only 0.2% net of autos which were heavily discounted at year-end. This followed slight October and November increases of 0.3% each.¹² However, strong holiday gift card sales could boost 1Q06 sales as gift card sales are recorded at the time of the gift card exchange.

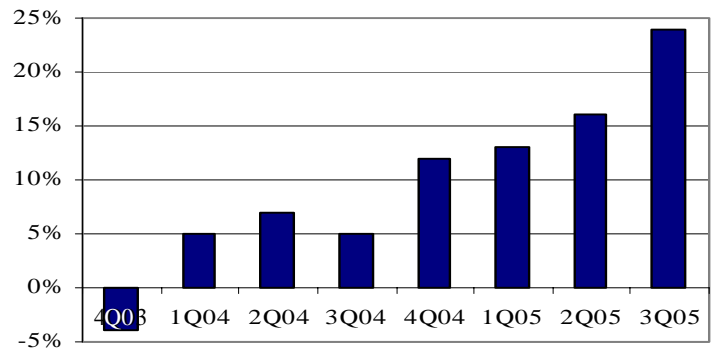
The University of Michigan Consumer Confidence Survey showed a sharp rebound from the post-Katrina lows.¹³ The Investors Business Daily (IBD) Economic Optimism Index jumped in November after a slight October dip.¹⁴



↑ **Capital Spending:** During the third quarter of 2005 S&P 500 companies increased their capital spending by 24% over 3Q04. This represents quite a change. From 3Q01 to 4Q03 these companies decreased capital spending. Since then, they have averaged 9% quarterly increases.¹⁵ This spending may accelerate as companies hold record cash levels and are pushed toward full capacity.

Another indicator, the National Federation of Independent Business' Optimism Index, measuring business managers' intent to spend, rose to its highest point all year.¹⁶

S&P 500 Capital Spending Change¹⁵



↓ **Investor Sentiment:** Investor sentiment has remained generally high since September, 2003.¹⁷ Investor optimism spiked in December.¹⁸ This situation is often bearish in that it indicates professional investors, who first place their bets and then tell the world their opinion, may have already pushed much of their available capital into the market.

↑ **Corporate Earnings:** The S&P 500 companies reported 14% higher profits and 13% higher revenues in the third quarter vs. 3Q04, again led by the energy sector.¹⁹ 66% of companies beat estimates while 21% missed; this ratio compares well to the long-term trend.²⁰

However, having energy as the biggest growth driver could mean that investors get little impact for each additional dollar of earnings. This sector carries a low P/E ratio, so positive earnings reports will have a relatively muted effect.

↓ **Insider Trading:** In 2005 insiders at Real Estate Investment Trusts (REITs) sold \$427 million worth of shares while buying \$3 million.²⁰

Notes and Acknowledgements:

1. CNBC, January 4, 2006 and *Wall Street Journal*, January 9, 2006
2. 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 4% of total assets. All client portfolios weighted equally in calculation
3. TDWaterhouse Research
4. Research provided by Sharper ♦ Granite analysis. Rate spread is calculated as the difference between the 10-year and 6-month treasuries. Correlation of rate spread and S&P 500 Index performance over 516 months from 1962 - 2004 was +13%. Correlation from 1993 - 2004 was -30%. When this rate spread was lagged one and two months behind the S&P 500 the correlation expanded to -32% and -34% respectively. When the S&P 500 was lagged one and two months behind the rate spread, the correlation contracted to -28% and -26% respectively. This may indicate that the stock market is a precursor to yield curve changes and not the reverse
5. "Economists Ask if Bonds have Lost their Predictive Power", *Wall Street Journal*, December 29, 2005
6. Bloomberg's *Wealth Manager*, December, 2005
7. Jeremy J Siegel, Professor of Finance, Wharton School of Business at Penn University; Sharper ♦ Granite analysis
8. Bureau of Economic Analysis, November 30, 2005
9. Institute for Supply Management (ISM), October 4, 2005
10. Philadelphia Federal Reserve Bank, September 15, 2005
11. U.S. Department of Labor, December 17, 2005
12. *Wall Street Journal*, January 13, 2006
13. University of Michigan Consumer Confidence Survey, December 17, 2005
14. Investors Business Daily (IBD/TIPP) Economic Optimism Index, November 9, 2005
15. Thomson Financial, December 22, 2005. All percentages represent year-over-year change
16. National Federation of Independent Business' Optimism Index, November 9, 2005
17. Market Vane, January 9, 2006
18. UBS Index of Investor Optimism, January 9, 2006
19. Zacks Research, December 3, 2005
20. Thomson Financial, December 3, 2005

Questions?
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