



# Park Piedmont Advisors LLC

Registered Investment Advisor

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## FEBRUARY 2006 COMMENTS

### ENCLOSURE:

**1) ELDERCARE SURVEY:** For the past two months, we have enclosed a one page Eldercare survey, requesting that you spend a few moments to complete the survey and return it to us. Many have already done so, and we appreciate your cooperation. For those who have not replied, we would like to hear from you, even if you have no interest in the services described. A no-interest response helps us gauge the overall degree of interest in these services. Another copy of the survey, and return envelope, are enclosed. We have also enclosed a separate one page memo on what we consider some of the more important issues involved with eldercare.

### TAX MATTERS for 2006:

**1) Cost Basis information for all securities sold during 2005:**

You should have received Form 1099s from National Financial Services (NFS). These forms report taxable dividends and interest, and also the proceeds of securities sold during the year. To the extent the forms do not have cost basis information to go with the proceeds of sales, please contact Lynette or Nick, who will provide all necessary information for your tax reporting.

**2) Cost Basis Reports for all unsold security positions in taxable accounts:**

Most clients have already received the reports with cost basis information for all current positions in their accounts. For those who have signed and returned the reports, you will now be able to see this cost basis information on your monthly statements. For those who have received, but not yet signed and returned, the reports, we would appreciate your doing so. For those clients who have not yet received these reports, you should be receiving them soon.

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*Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.*

**COMMENTS: INDEX RESULTS for period ending February, 2006**

<u>STOCKS</u>	<u>YEAR</u> <u>1999</u>	<u>YEAR</u> <u>2000</u>	<u>YEAR</u> <u>2001</u>	<u>YEAR</u> <u>2002</u>	<u>YEAR</u> <u>2003</u>	<u>YEAR</u> <u>2004</u>	<u>YEAR</u> <u>2005</u>	<u>YTD</u> <u>2006</u>	<u>CURR.</u> <u>MONTH</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6%)	(11.0%)	(21.0%)	28.4%	12.5%	6.0%	3.5%	0.0%
Standard & Poors 500 Index (2)	19.6%	(10.1%)	(13.0%)	(23.4%)	26.4%	9.0%	3.0%	2.6%	0.1%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2%)	(13.0%)	(23.7%)	25.9%	7.2%	5.1%	1.8%	(0.7)%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0%)	(20.9%)	32.2%	15.3%	7.1%	3.9%	0.7%
Dow Jones Industrial Average Index (2)	25.2%	(6.2%)	(7.1%)	(16.8%)	25.3%	3.2%	(0.6)%	2.6%	1.2%
NASDAQ Composite Index (2)	85.6%	(39.3%)	(21.0%)	(31.5%)	50.0%	8.6%	1.4%	3.5%	(1.1)%
Vanguard Midcap US Index Fund (1)	25.0%	2.6%	(4.8%)	(16.3%)	34.1%	20.4%	13.9%	4.4%	(1.2)%
Vanguard Smallcap US Index Fund (1)	19.6%	(4.2%)	1.0%	(21.6%)	45.6%	19.9%	7.4%	7.7%	(0.2)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(15.2%)	(22.6%)	(17.5%)	40.3%	20.8%	15.6%	6.1%	(0.8)%
Vanguard Real Estate Invest. Trust Fund (1)	(0.4%)	26.4%	12.4%	3.8%	35.7%	30.8%	11.9%	9.5%	2.0%
<b><u>BONDS</u></b>									
Vanguard Total Bond Market Index (1)	(0.8%)	11.3%	8.3%	8.2%	4.0%	4.2%	2.4%	0.3%	0.4%
Vanguard Intern. Tax-Exempt Index Fund (1)	(2.9%)	9.2%	5.0%	7.9%	4.4%	3.2%	2.4%	0.8%	0.5%
Vanguard Short-term Bond Index (1)	2.1%	8.9%	8.9%	6.1%	3.4%	1.7%	1.3%	0.4%	0.3%
Vanguard Short Tax-Exempt Index Fund (1)	2.6%	4.9%	4.8%	3.5%	1.6%	1.1%	1.8%	0.4%	0.1%
Vanguard High-Yield	NA	NA	NA	1.7%	17.2%	8.5%	2.8%	1.6%	0.7%

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.  
 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
		<u>1999</u>				<u>2000</u>				<u>2001</u>		
<b>S&amp;P 500</b>	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1
<b>NASDAQ</b>	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3
<b>BONDS</b>	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0
Interm. Tax.												
		<u>2002</u>				<u>2003</u>				<u>2004</u>		
<b>S&amp;P 500</b>	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8
<b>NASDAQ</b>	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9
<b>BONDS</b>	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0
Interm. Tax.												
		<u>2005</u>				<u>2006</u>				<u>2007</u>		
<b>S&amp;P 500</b>	(2.6)	0.9%	3.1%	1.6%								
<b>NASDAQ</b>	(8.1)	2.6%	4.4%	2.5%								
<b>BONDS</b>	(0.5)	3.0%	(0.7%)	0.6%								
Interm. Tax.												

## **FEBRUARY 2006 COMMENTS**

**STOCK** index prices for US large cap stocks were mixed in February. The S&P 500 gained 0.1%, the Dow Industrials gained 1.2%, but the NASDAQ declined (1.1)%. The Total Stock Market (TSM), which includes midcap and small cap stocks and has been consistently outperforming these large cap indexes, finally had a month when it did not do as well. The TSM had no change, and the midcap and small cap indexes actually had modest declines, as did the International index. REITs had the best monthly performance. Large cap value outperformed growth, as it has fairly consistently for a number of years. See page 2 for the monthly and YTD figures, as well as figures dating back to 1999.

**BOND** returns (price change plus interest) had modest gains in February, as the interest earned exceeded the modest price declines resulting from slightly higher interest rates. The Federal Reserve had no meeting in February (the most recent rate increase occurred on January 31<sup>st</sup>). The benchmark 10-year US Treasury yield closed the month at 4.55%, slightly higher than January's 4.52%. This 10-year yield was lower than the yield on the two-year bond (at 4.69%), indicating an inverted yield curve. The significance of this inversion is hotly debated among economists and bond market investors. Bond returns continued to lag the returns achieved on money markets, which benefit most directly from increases in short-term interest rates. Bond results for the month and YTD, and back to 1999, are reported on page 2.

The stock market rally that began decisively in March 2003 has raised the S&P 500 by 65% from its October 2002 low. While these gains have illustrated that stocks do not go down in perpetuity (a widely-held view during the depths of the 2000-02 bear market), the question of whether this recovery will continue depends, as always, on unknown, unpredictable future events. Note also that after a 50% price decline, it takes a 100% gain to return to the previous level. Since the S&P 500 reached its high of 1,527 in Q1 2000, and then declined by almost half to 777 during Q4 2002, the current level of 1,280 is 65% higher than the low, but still down (16%) from the prior high, and still 247 points, or 32%, from the prior high.

In order to keep the current recovery in perspective, we continue to show the chart below, which sets out the extent of the declines measured from the highs of Q1 2000. The chart also puts these declines in the context of results since the end of 1994 (also see the figures on page 12). Note that the three indexes have positive average annual returns ranging from 9.6% to 10.4% for the 11.2 year period from the end of 1994 through February 2006, very much in line with long-term stock returns going back to 1926. Further, as these returns converge more and more, the idea of "regression to the mean" seems quite applicable.

**The long-term investor therefore has a very different view of the stock market's returns than those measuring returns from the highest levels.**

	<u>S&amp;P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
Year End 2004	1,212	(21)%	10,783	(8)%	2,175	(57)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year 2006 thru Feb. 28, 2006	1,280	(16)%	10,993	(6)%	2,281	(55)%

**Context: Prior Five-Year Gains in Bull Market of 1995 - 1999**

	<u>S&amp;P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. % Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
February 2006	1,280	10,993	2,281
Gain	821	7,159	1,529
Avg. Ann. % Gain: '95-2/06; 11.2 yrs	9.6%	9.9%	10.4%

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

## I. UPDATE OF KEY ECONOMIC INDICATORS

The strength of the overall US and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. We, along with many market observers and academics who write about the markets, believe stock and bond prices already reflect consensus expectations of economic growth. Further, we believe that even if you could accurately predict any number of actual economic figures, the market's reaction to those figures is essentially unpredictable. In any event, an understanding of the direction of current economic trends may at times be useful as a context to help understand market conditions. This section of the Comments provides an update of key economic indicators.

- (1) Gross Domestic Product (GDP) is the broadest measure of goods and services produced in the US economy (GDP figures are inflation-adjusted, annualized growth rates). The initial estimate of GDP growth for the fourth quarter was 1.1%, "the slowest rate since the fourth quarter of 2002 and well below the average 4.1% growth of the prior ten quarters" (Wall Street Journal [WSJ], 1/28-29/06, front page). This initial estimate was revised upward to 1.6% (with very little news reporting; a one paragraph portion of an article about existing home sales declines) (WSJ, 3/1/06, A2).
- (2) Employment for January (reported first week in February) rose 193,000. "While the gain fell short of many analysts' expectations, any disappointment was offset by revisions to December and November figures showing 81,000 more jobs were added than originally estimated. Over the past three months, non-farm payroll employment expanded at a rate of 229,000 a month" (WSJ, 2/4-5/06, A3).
- (3) Interest Rates on longer-term bonds increased slightly in February. The benchmark 10-year US Treasury interest rate, which is set by buyers and sellers in the bond market, closed at 4.55%, above January's 4.52% close, and at its highest level since the 4.56% close in October 2005. On January 31, the Federal Reserve, as expected, raised the short term interest-rate it controls by    of 1%, to 4.50%, the fourteenth consecutive increase since mid-2004 (WSJ, 2/1/06, A2). The two-year bond yield is now 17 basis points higher than the ten-year bond yield, indicating an increasingly inverted yield curve. The implications of this inverted yield curve on the future direction of interest rates are much debated in the bond market.
- (4) Inflation, as measured by the Consumer Price Index (CPI) "core" rate, which excludes the volatile food and energy sectors, increased 0.2% in January, and was up 2.1% for the previous twelve months. With food and energy included, the monthly rate jumped 0.7%, and the most recent twelve month increase was 4%. "The gap between overall and core inflation continues a two-year-old trend: Consumers are paying more to fill their gasoline tanks and heat their homes, but are getting far better deals... in other parts of the economy" (WSJ, 2/23/06, A2). The Producer Price Index (PPI) core rate was up 0.4%, "the biggest monthly increase in a year." With food and energy included, the monthly rate rose 0.3%, and the past twelve month rate was up 5.7% (WSJ, 2/18-19/06, A2). (Note: The CPI measures prices of goods and services; the PPI, only goods).

(5) Sector Economic Activity was Mostly Higher

- (a) Durable goods orders (industrial and consumer) fell 10.2%, but actually rose 0.6% excluding the highly volatile aircraft sector (WSJ, 2/25-26/06, A9).
  - (b) Industrial production declined 0.2%, attributable to a decline in utilities' output due to "unseasonably warm weather." Excluding utilities, the production figure was up 0.7%, and manufacturing capacity utilization reached its highest level since July 2000 (Vanguard Economic Week in Review [VEWR], 2/13-17/06).
  - (c) Retail Sales "surged" 2.3%, "following a tepid 0.4% rise in December, and up 8.8% from a year earlier. Coming after an earlier report that employers added 200,000 jobs, . . . the report was cheered as evidence that the economy has roared back from a fourth quarter lull" (WSJ, 2/15/06, front page). (Retail sales are not adjusted for inflation, and include disparate categories such as gasoline sales, auto sales, and non-store retailers such as the Internet).
  - (d) Housing sales for existing homes declined "for the fifth straight month, and inventory rose, providing more evidence of weakening in the housing market." Further, "new home sales fell and the number of unsold homes on the market rose to nearly a 10 year high" (WSJ, 3/1/ and 2/28/06, A2 for both).
  - (e) Personal Income increased 0.7% in January, "confirming other recent reports that broad-based gains should ripple throughout the economy." Personal spending also rose, by 0.9%, so the personal savings rate continued negative (WSJ, 3/2/06, A2). Note, however, that the definition of personal savings is itself open to question, as discussed in previous Monthly Comments (e.g., capital gains on stocks and homes are excluded from savings, as one person's gains are another person's costs, with no new net savings for the economy).
- (6) Consumer Confidence, as measured by the Conference Board's Index, "fell in February . . . as consumer expectations for the next six months deteriorated to a three year low, excluding the months following Hurricane Katrina" (WSJ, 3/1/06, A2).
- (7) Corporate Profits for the S&P 500 stocks are "expected to ring up their 15<sup>th</sup> consecutive quarter of double digit growth for the first time in 20 years, according to S&P analysts" (WSJ, 1/17/06, C1). We found no new information reported on corporate profits during February, despite its significance to the future direction of stock prices (see the discussion that follows on pages 7-9)

Overall, the economic news reported during February was positive, with an improved employment picture, strong retail sales, and an upward revision in GDP. However, there was clear indication of a slowdown in the housing market, as the interest rate increases that began in June 2004 continued to have an impact. During the month, US stocks and bonds showed little change. Market prices and economic news appeared to have little connection.

## II. STOCK PRICES: DIFFICULTIES DETERMINING FAIR VALUE, PART II

Last month's Comments presented a discussion of some of the difficulties involved in determining fair value for stock prices, with a focus on a few of the highly controversial issues surrounding the proper reporting of corporate profits (also called earnings). This month we will discuss another central issue in the effort to determine fair value for stock prices, namely the appropriate amount of money to pay for a given amount of corporate earnings (assuming the earnings are appropriately reported). Put another way, what is a fair price to pay for a given amount of earnings. (We have not repeated the background points and definitions presented last month; please refer to those Comments if necessary).

In discussing this issue, we will be referring to two primary sources: "Stocks for the Long Run," a very well-known book in the investment field written by Jeremy Siegel, a Professor of Finance at Penn's Wharton School, and "The Four Pillars of Investing," by William Bernstein, a less well-known but well-respected author, who concentrates on asset allocation.

To better understand the issue, let's start with a simple fact: Exxon Mobil, which has the highest market value in the US stock market (value is determined by the price per share multiplied by the number of shares outstanding), had a total value as of 2/21/06 (WSJ, pg. C7 and C11) of \$385 billion and a P/E ratio based on its last twelve months' earnings of 10.4 (the stock price per share was \$60.55). The second largest company by market value was General Electric, valued at \$356 billion, with a P/E of 19.3 (stock price of \$33.61 per share). Remember that the P/E tells us the price (P) investors are willing to pay for a dollar's worth of a company's earnings (E). The question is why investors pay \$10.40 for every dollar of Exxon's earnings, and almost twice that amount, or \$19.30, for every dollar of General Electric's earnings. By using these two huge companies to frame the issue, we have eliminated a host of extraneous factors, such as: (a) the companies are not well known to Wall Street or the professional investment community; (b) their businesses are not fully understood; (c) the factors that affect their futures are not fully understood. So here are these two giant companies, in business for decades, presumably with reasonable futures, and all investors taken as a group are willing to pay twice as much for one dollar of General Electric's earnings as they are for one dollar of Exxon's earnings. Why???

The same question can be posed using time as the variable rather than two different companies. Currently, using the earnings reported by the WSJ each day, all the stocks in the S&P 500 index have a combined P/E of 18 based on trailing twelve month earnings. By contrast, when stock prices "moved into all-time high ground in the year 2001, (the market P/E ratio) reached a level (over 30) more than twice its historical average value of 14.5 calculated since 1870" (Siegel, pg. 96). The point here is that at the stock market's (represented by S&P 500 companies) all-time highs in 2001, investors paid more than \$30 for one dollar of earnings of these companies, and five years later they are paying \$18 for one dollar of earnings. Note also that at the current 18 P/E, investors are paying almost 25% more than the long term historical average P/E of 14.5. (Siegel states that an appropriate P/E level for the market going forward should be "in the low 20s, as long as inflation stays low and tax policy remains favorable" [pp. 119-121].)

We need to return to the question of why P/Es can be so different, both for individual stocks in the same time frame (Exxon vs. GE) and for the same index in different time frames (2006 vs. 2001 for the S&P 500 stocks). Here is how Siegel explains differences in P/E ratios: “The single most important variable determining the P/E ratio... is the expectation of future earnings growth. If investors believe that earnings growth is going to accelerate, they will pay a higher price relative to current earnings than if they expect earnings to stagnate or decline. However, earnings growth is not the only variable influencing the P/E ratio. P/E ratios are also influenced by other factors, such as interest rates, risk attitudes of investors, taxes, and liquidity, among others” (pg. 95). Therefore, in order for investors to make a fair evaluation of P/E levels, either for individual stocks or the market as a whole, they need to have a knowledgeable point of view on: (a) future earnings growth rates; (b) the future direction of interest rates; and (c) market psychology as measured by “risk attitudes of investors,” to name only some of the factors mentioned by Siegel. We consider this a tall order indeed for even so-called market professionals, let alone amateur individual investors.

Siegel provides some additional insights into what P/E ratios can signal about future market price movements. He points out that if P/E ratios “spike upward, based on a sharp drop in earnings,” real (i.e., after adjusting for inflation) returns over the following five years have “averaged a robust 9.7% annually,” because “sharp declines in earnings have always been temporary,” whereas when P/E ratios rise based on a surge in stock prices, the subsequent five year average returns have averaged only 1.1% (pp. 96-97).

Siegel also explains the fundamental rationale for the long-term average P/E ratio of the stock market at 14.5, by describing how stock and bond returns are calculated. “The current yield of a bond is measured as the ratio of the interest received over the price paid and is a good measure of future return if the bond is not selling at a large premium or discount to its maturity value. A similar computation can be made for stocks by computing the earnings yield, which is the earnings per share of a company divided by its price per share. The earnings yield is the inverse of the P/E ratio (the long term average 14.5 P/E ratio therefore produces an earnings yield of 6.8%). This earnings yield exactly matches the 6.8% real return on equities from 1871 – 2001” (pg. 97).

Bernstein adds the following insights to this discussion (although it is worth noting that much of what he writes on this subject is more complex than what we choose to present in these Comments). He cites Princeton Professor Burton Malkiel (author of “A Random Walk Down Wall Street”) as saying, “God Almighty himself does not know the proper price-earnings multiple for a common stock.... In other words, it is impossible to know the intrinsic value of a stock or the market” (pg. 55). “Viewed from an historical perspective, what has happened is that stocks have had an incredible run in the past few decades (Our note: The book was published in 2002, and Bernstein is referring to the decades of the 1980s and 1990s. Because of the bear market in stocks of 2000-2002, the current decade is still showing negative returns for the large US stock indexes, but his observations are still applicable)... Their prices have been bid up dramatically, so their future returns will be commensurately lower.... On an intellectual level, most investors have no trouble understanding the notion that high past returns result in high prices, which, in turn, result in lower future returns. But at the same time, most investors find this almost impossible to accept on an emotional level. By some strange quirk of human nature, financial assets become more attractive after their price has risen greatly” (pg. 56).

This passage from Bernstein's book relates to the P/E discussion in several ways: (1) The difficulty, if not the impossibility, of determining whether a given P/E level is appropriate; (2) when stock prices (the P side of the ratio) rise at substantially higher rates than the supporting underlying earnings (the E side of the ratio) over some extended time period, then logic dictates that future price increases will be at significantly lower rates. While the time period is an unknown, eventually stock price increases are closely related to earnings growth, so that the P/E ratio can only be stretched so far before returning to long-term historical levels. While Siegel argues for a current P/E ratio in the low 20s as against the historical 15, it is also clear that once prices go beyond his more expansive figure, even he would likely acknowledge lower future returns from stocks. Note that if the WSJ P/E of 18 for the S&P 500 index stocks is based on truly reliable earnings in the neighborhood of \$70 per share, then the current stock market would be in a reasonable price range based on Siegel's analysis.

Bernstein writes in another section about "one of the most dangerous of all investment illusions...the great company/great stock fallacy." He explains how certain companies that recorded excellent earnings growth for some period, e.g., Coca Cola, Disney, and Microsoft, saw their prices grow to the point where their P/Es were three to four times the valuation of a typical company. The problem is that the earnings growth that led to these astronomical multiples cannot be sustained over an extended time period, and that as a result their stock prices are subject to major declines when earnings growth returns to more normal levels. "Even most professionals are unaware of just how ephemeral earnings growth is. If you simply look at stocks with high prior earnings growth, you discover that their future earnings growth is exactly the same as the market's.... These stocks (with the high past growth rates) wind up getting grossly overpriced relative to their actual future growth" (pp. 174-5).

Our purpose in presenting this material is not to have our readers avoid the stock market. Rather, it is to provide some insights as to just how difficult it is for anyone, amateur or professional, to arrive at a correct view of a fair price level for stocks. This conclusion leads us back to the advice presented by David Swensen in his book (cited in our four most recent Monthly Comments): "Yet investors must guard against relying on equities to exhibit their general characteristics (of providing superior returns over reasonably long holding periods) in any specific time frame or allowing for equities to account for too large a portion of the target portfolio. History may overstate the attractiveness of US stocks. Returns of bonds and cash may exceed returns of stocks for years on end. For example, from the market peak of October 1929, it took stock investors fully twenty-one plus years to match returns generated by bonds (Our note: The years 2000-2005 are another such period in which bonds have outperformed stocks).... The best protection for investors against the shortcomings of equity investments lies in owning an all-inclusive, market-like portfolio of equity securities in the context of a well diversified collection of asset classes" (pg. 47, "Unconventional Success").

The next section of these Comments takes another look at whether so-called "alternative investments" can help enhance the returns from the stock portion of your overall allocation. We'll be comparing the views of Jonathan Clemens, the WSJ columnist and index investing proponent, with those of Swensen on this subject.

### **III. ALTERNATIVE INVESTMENTS: CAN THEY ADD TO YOUR INVESTMENT RESULTS?**

Clements' article, entitled "Investing Like the Pros Do: Combining Index Funds with Alternative Strategies" (WSJ, 2/8/06, pg. D1), makes the case for owning low-cost index funds for most of the stock portion of your portfolio, and then investing the remaining portion of that allocation in so-called alternative investments, "like private equity, venture capital, real estate and hedge funds."

Clements starts by stating that "if you're like many mutual fund investors, you own a mix of actively managed stock funds that tap into a host of market sectors, such as large companies, small stocks and foreign shares. And of course you are hoping to beat the market. Problem is, a lot of what you're paying for isn't stock picking skill, but basic market exposure – and you could get that a whole lot cheaper by buying market-tracking index funds. Indeed, institutional investors have woken up to this fact. It explains their enthusiasm for not only prosaic index funds, but also exotic investments like hedge funds and venture capital, where returns depend less on the market, and much more on the investment manager's skill."

The article continues by explaining that "a fund's performance can be split into two parts. First, there's the return that a fund should get simply because it is invested in the market.... Second, there is the performance that can't be explained by the fund's market exposure. This 'unexplained' return reflects the manager's luck or skill." The article then quotes an investment professional who says that "the idea is not to overpay for market exposure, for which you might as well use the most efficient vehicles possible, such as exchange traded index funds (ETFs) or regular index mutual funds." Then, with the rest of the stock market money not allocated to the broad market exposure, the idea is to use the alternative investments. "Over the past decade, pension funds have favored the two extremes, buying both humdrum index funds and also alternative investments like private equity, venture capital, real estate and hedge funds." Clements suggests that when using this strategy, "you really want to index both US and foreign markets, and then tack on bets that have the potential to deliver a lot of "alpha" (the term used to explain the investment return attributable to the manager rather than to the market).

Clements makes three interesting points as conclusions to his article: (1) Because the "alpha bets can generate big tax bills, keep them in your retirement account"; (2) with regard to hedge funds, since they "often aim to eliminate basic stock market exposure by buying promising shares and simultaneously 'shorting' unattractive stocks, their performance isn't driven by broad stock market swings, and can arguably be used as a substitute for part of your bond portfolio"; and (3) "if your alpha bets are not doing especially well, maybe you should give up the pursuit of alpha and stick exclusively with low cost index funds."

We would like to analyze the Clements article with our own observations and reference to Swensen. First, the idea of considering a hedge fund as an alternative to bonds may appear sound in concept, but if your particular hedge fund manager is wrong enough in his choices on both the buy side and the "short sale" side, you can end up with major losses. Given the enhanced risk exposure that can come from hedge funds, we do not suggest thinking of them as alternatives to bonds, but rather as part of your stock allocation.

Clements' final comment about forgetting the whole idea of alternative investments and sticking to index funds is exactly what Swensen recommends (although Swensen does not suggest first taking a shot and then finding your alternative investments "not doing especially well.") Even though Swensen heads the highly successful Yale endowment fund, and has been extremely successful using alternative investments for that endowment, he recommends AGAINST individual investors using any of these investment choices. So the whole premise of Clements' article, that individuals can invest like the pros by using alternative investments, is in fact contradicted by Swensen's book addressed to individual investors.

Here again is some of Swensen's advice regarding alternative investments:

1) Hedge funds: "In the case of investment approaches designed to avoid correlation with returns of traditional marketable equities and bonds (of the kind Clements discussed), investors depend solely on active management skill to generate investment returns.... To achieve success in the hedge fund world, investors must identify active managers with sufficient skill to overcome the typically rich fee arrangements.... In traditional asset classes, both finance theory and real world experience teach that the majority of actively managed assets fail to exceed market returns.... In the hedge fund world, as in the whole of the money management industry, consistent, superior active management constitutes a rare commodity. Assuming that active managers of hedge funds achieve success levels similar to active managers of traditional marketable securities, investors in hedge funds face dramatically higher levels of prospective failure due to materially higher levels of fees" (pp.125-6).

2) Private Equity: Swensen discusses private equity along with leveraged buyouts in a section headed "Leveraged Buyouts." He defines leveraged buyouts as "private ownership of mature corporate entities that have greater than usual levels of debt," and continues that "the high levels of leverage produce a correspondingly high degree of variability in outcomes, both good and bad.... While the value added by operationally oriented buyout partnerships may, in certain instances, overcome the burden imposed by the typical buyout fund's generous fee structure, in aggregate, buyout investments fail to match public market alternatives. After adjusting for the higher level of risk and the greater degree of illiquidity in buyout transactions, publicly traded equity securities (using a marketable security index fund) gain a clear advantage.... In the absence of truly superior fund selection skills (or extraordinary luck), investors should stay far, far away from private equity" (pp. 133-4).

3) Venture Capital: "Venture capital provides financing and company building skills to start-up operations, working to develop companies into substantial, profitable enterprises.... Over reasonably long periods of time, aggregate venture returns more or less match marketable equity returns, indicating that providers of capital failed to receive compensation for the substantial risks inherent in start-up investing" (pg. 139).

4) Real Estate: Swensen endorses this asset category because there are investable indexes available. "For individual investors, publicly traded real estate securities generally provide reasonable low cost exposure to relatively high quality pools of real estate assets" (pg 70). "Market mimicking index management represents the starting point for investors who wish to gain exposure to real estate securities.... Vanguard REIT Index fund provides high quality, low cost exposure to its target market" (pg. 76).

S&P 500 (1)                      DOW JONES (1)                      NASDAQ (1)

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

**I. Figures From Period Starting 2000 (% Figures Are Cumulative Declines From 1/01/00)**

Start of 2000	1,470		11,500		4,070	
End of 2000	1,320	(10.1)%	10,785	(6.2)%	2,470	(39.3)%
Sept. 21, 2001 <u>Low</u>	965	(34.3)%	8,235	(28.4)%	1,425	(65.0)%
End of 2001	1,148	(21.9)%	10,020	(12.9)%	1,950	(52.0)%
Oct. 9, 2002 <u>Low</u>	777	(47.1)%	7,286	(36.6)%	1,114	(72.6)%
End of 2002	880	(40.1)%	8,342	(27.5)%	1,336	(67.2)%
End of 2003	1,112	(24.3)%	10,454	(9.1)%	2,003	(50.8)%
End of 2004	1,212	(17.5)%	10,783	(6.2)%	2,175	(46.5)%
End of 2005	1,248	(15.1)%	10,718	(6.8)%	2,205	(45.8)%
Through February 31, 2006	1,280	(12.9)%	10,993	(4.4)%	2,281	(44.0)%

**II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)**

Start of 1995	459		3,834		752	
End of 1999	<u>1,470</u>		<u>11,500</u>		<u>4,070</u>	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	<u>1,148</u>		<u>10,020</u>		<u>1,950</u>	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	<u>880</u>		<u>8,342</u>		<u>1,336</u>	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
End of 2003	<u>1,112</u>		<u>10,454</u>		<u>2,003</u>	
9 Year Gain; Annualized %	653	10.3%	6,620	11.8%	1,251	11.5%
End of 2004	<u>1,212</u>		<u>10,783</u>		<u>2,175</u>	
10 Year Gain; Annualized %	753	10.2%	6,949	10.9%	1,423	11.2%
End of 2005	<u>1,248</u>		<u>10,718</u>		<u>2,205</u>	
11 Yr Gain; Annualized %	789	9.5%	6,884	9.8%	1,453	10.3%
Through February 31, 2006	<u>1,280</u>		<u>10,993</u>		<u>2,281</u>	
11.2 Yr Gain; Annualized %	821	9.6%	7,159	9.9%	1,529	10.4%



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