



# Park Piedmont Advisors LLC

Registered Investment Advisor

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## APRIL 2006 COMMENTS

### **CHECKING ACCOUNT and CREDIT CARD FACILITIES:**

You can have both a checking account and credit card from National Financial Services (NFS), the custodian of the securities in your accounts managed by Park Piedmont Advisors (PPA). NFS is 100% owned by Fidelity Investments. For further information, contact either Lynette, Victor, or Nick

### **REFERRALS of ACCOUNTANTS as POTENTIAL INVESTMENT ADVISORS:**

PPA is looking to expand its business by associating with currently practicing accountants who also have an interest in providing investment advice to their clients using the PPA methodology of setting an appropriate asset allocation and implementing with indexed investments. If you know of an accountant who might be interested, please let us know.

### **IMPORTANT INSIGHT (see page 7 for full quote and cite)**

On the use of historical data in trying to estimate future risk and return: ...”the overwhelming historical data do not guarantee accuracy in estimating these risk-reward parameters... As Nobel laureate Paul Samuelson is fond of saying, ‘We have but one sample of history.’”

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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 April, 2006**

<b><u>STOCKS</u></b>	<b><u>YEAR</u></b> <b><u>1999</u></b>	<b><u>YEAR</u></b> <b><u>2000</u></b>	<b><u>YEAR</u></b> <b><u>2001</u></b>	<b><u>YEAR</u></b> <b><u>2002</u></b>	<b><u>YEAR</u></b> <b><u>2003</u></b>	<b><u>YEAR</u></b> <b><u>2004</u></b>	<b><u>YEAR</u></b> <b><u>2005</u></b>	<b><u>YTD</u></b> <b><u>2006</u></b>	<b><u>CURR.</u></b> <b><u>MONTH</u></b>
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6%)	(11.0%)	(21.0%)	28.4%	12.5%	6.0%	6.5%	1.1%
Standard & Poors 500 Index (2)	19.6%	(10.1%)	(13.0%)	(23.4%)	26.4%	9.0%	3.0%	5.0%	1.3%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2%)	(13.0%)	(23.7%)	25.9%	7.2%	5.1%	3.3%	0.0%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0%)	(20.9%)	32.2%	15.3%	7.1%	8.0%	2.7%
Dow Jones Industrial Average Index (2)	25.2%	(6.2%)	(7.1%)	(16.8%)	25.3%	3.2%	(0.6)%	6.1%	2.4%
NASDAQ Composite Index (2)	85.6%	(39.3%)	(21.0%)	(31.5%)	50.0%	8.6%	1.4%	5.3%	(0.8)%
Vanguard Midcap US Index Fund (1)	25.0%	2.6%	(4.8%)	(16.3%)	34.1%	20.4%	13.9%	8.7%	1.2%
Vanguard Smallcap US Index Fund (1)	19.6%	(4.2%)	1.0%	(21.6%)	45.6%	19.9%	7.4 %	12.2%	0.0%
Vanguard International Index Fund (EAFE) (1)	25.3%	(15.2%)	(22.6%)	(17.5%)	40.3%	20.8%	15.6%	15.1%	5.6%
Vanguard Real Estate Invest. Trust Fund (1)	(0.4%)	26.4%	12.4%	3.8%	35.7%	30.8%	11.9%	10.6 %	(4.2)%
<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%	(1.0)%	(0.3)%
Vanguard Intern. Tax-Exempt Index Fund (1)	(2.9%)	9.2%	5.0%	7.9%	4.4%	3.2%	2.4%	0.1%	0.0%
Vanguard Short-term Bond Index (1)	2.1%	8.9%	8.9%	6.1%	3.4%	1.7%	1.3%	0.3%	0.2%
Vanguard Short Tax-Exempt Index Fund (1)	2.6%	4.9%	4.8%	3.5%	1.6%	1.1%	1.8%	0.7%	0.2%
Vanguard High-Yield	NA	NA	NA	1.7%	17.2%	8.5%	2.8%	1.8%	0.2%

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	3.7										
<b>NASDAQ</b>	(8.1)	2.6	4.4	2.5	6.1										
<b>BONDS</b>	(0.5)	3.0	(0.7)	0.6	(0.7)										
Interm. Tax.															

#### APRIL 2006 COMMENTS

**STOCK** index prices for US large cap stocks were mostly higher in April. The S&P 500 and Dow Industrials gained 1.3% and 2.4% respectively, but the NASDAQ declined (0.8)%. The Total Stock Market (TSM), which includes Midcap and Smallcap stocks and has had better results for several years, trailed slightly in April with a gain of 1.1%, as the Smallcap sector was unchanged for the month. The International index had the best monthly result whereas the REIT index had the worst, but the REIT continued to be among the best performers YTD and over the past few years. Largecap Value continued its outperformance of Largecap Growth. See page 2 for the monthly and YTD figures, and figures from 1999.

**BOND** returns (price change plus interest) declined significantly in April, as the benchmark 10-year US Treasury yield closed at 5.07%, its highest level since 2002 and a 52 basis point increase over the past two months. Although the Federal Reserve raised the short-term interest rates it controls only once, by 25 basis points to 4.75% during this period, the longer-term rates set by the bond market increased twice as much. YTD returns for short- and intermediate-term bonds, taxable and tax-exempt, range from +0.7% to minus (1.0)%. Bond returns continued to lag the returns from money markets, which benefit most directly from increases in short-term interest rates. Even with these disappointing returns, however, it should be remembered that **rising interest rates, while they adversely affect bond results over the short term, eventually provide higher returns in the form of higher interest rates.** Bond results for the month, YTD, and since 1999 are reported on page 2.

The stock market rally that began decisively in March 2003 has raised the S&P 500 almost 70% from its October 2002 low, but is still 216 points from its all-time high of 1,527 (this is 14% from the all-time high, and 28% from the 2002 low). This result occurs because after a 50% price decline, prices must increase by 100% to reach their previous high levels. By contrast, the Dow Jones Industrials are a mere 3% below their all-time high, while the NASDAQ remains a stunning 54% below its all-time high. While the longer-term results of these three averages are quite similar (see next paragraph and chart below), the differences in the magnitude of both the gains and declines since 1994 are strikingly large.

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 10). Note that the three indexes have positive average annual returns ranging from 9.7% to 10.4% for the 11.33 year period from the end of 1994 through April 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. Note also that the best performing index over the 11.33 year period (the NASDAQ) also has had by far the most severe decline since the 2000 highs, and is still down more than 50% from those highs.

**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 Apr 30, 2006	1,311	(14)%	11,367	(3)%	2,323	(54)%

**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%
April 2006	1,311	11,367	2,323
Gain	852	7,533	1,571
Avg. Ann. % Gain: '95-4/06; 11.33 yrs	9.7%	10.0%	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 Q1 2006 was 4.8%, "following a tepid 1.7% increase in Q4 2005, and the largest quarterly advance since Q3 2003" (WSJ, 4/29-30/06, A3). In reporting on this "robust" gain of 4.8%," the Vanguard Economic Week in Review (VEWR, 4/24-28/06) wrote of a "resilient US economy, despite fast-climbing gasoline prices." And, we would add, despite rising interest rates.
- (2) Employment for March (reported first full week in April) rose 211,000, "a pace down slightly from February, but one that still points to solid economic growth. Employers have produced 2.1 million jobs over the past year... Last month's gains pushed the unemployment rate down to 4.7% from 4.8%" (WSJ, 4/8-9/06, A3).
- (3) Interest Rates on longer-term bonds increased significantly again in April. The benchmark 10-year US Treasury interest rate, which is set by buyers and sellers in the bond market, closed at 5.07%, reaching a four-year high. There was no Federal Reserve meeting during April, so there were no further short-term rate increases from the Fed above the current 4.75% figure. However, the financial press has numerous articles speculating on how many more rate increases are likely before the Fed sees some signs of an economic slowdown that it in turn considers helpful in controlling inflation. A recent example is the WSJ front page article "Economy's Surge Stirs Questions About When Slowdown May Come" (4/27/06), in which the author states that "the prospects for further increases in short-term rates by the Fed will depend on what new economic data show."
- (4) Inflation, as measured by the Consumer Price Index (CPI) "core" rate, which excludes the volatile food and energy sectors, increased 0.3% in March, which "stoked worries that more interest rate increases may be needed to tamp down inflationary pressures." With food and energy included, the monthly rate was up 0.4%, and the most recent twelve-month increase was 3.4% (WSJ, 4/20/06, A2). The Producer Price Index (PPI) core rate was up 0.1%, and "up just 1.7% from the year-ago level, and with food and energy included, rose 0.5%, driven by a sharp escalation in gasoline prices" (VEWR, 4/17-21/06). (Note: The CPI measures prices of goods and services; the PPI, only goods). The close relationship between inflation rates and interest rates has been discussed at length in a number of recent Monthly Comments.

(5) Sector Economic Activity was Strong

- (a) Durable goods orders (industrial and consumer) rose 6.1%, the largest monthly gain in a year, and was “broad-based, pointing to overall strength in the manufacturing sector” (VEWR, 4/24-28/06).
  - (b) Industrial production rose 0.6% in March, “benefiting from a post-hurricane jump in business spending..., but economists see slower growth in the months ahead.” Also, “the average capacity utilization rate rose to 81.3%, the highest level in nearly six years..., but only slightly above the long-term average of 81.0%” (WSJ, 4/15-16, A3).
  - (c) Retail Sales increased 0.6% in March, while February’s decline was revised upward. “Together with January’s 2.9% gain, the March report bolsters the view that consumer spending is recovering strongly from a lull late last year” (WSJ 4/14/06, A2). (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 increased 0.3% in March, following a strong February, “indicating the housing market isn’t experiencing the severe downturn some have feared” (WSJ, 4/26/06, A6). Sales of new homes jumped 13.8%, “erasing much of the 15.8% decline seen over the two previous months” (WSJ, 4/27/06, front page).
  - (e) Personal Income increased 0.8% in March, and personal spending “was estimated to rise at an annualized, inflation-adjusted rate of 3% in the second quarter, compared to 5.5% in the first quarter, and consistent with expectations that the economy’s rate of growth will slow” (WSJ, 5/2/06, A2).
- (6) Consumer Confidence for April, as measured by the Conference Board’s Index, “rose to its highest level in four years”, although consumers are “more optimistic about the current economic situation than they are about future conditions” (WSJ, 4/26/06, A6).
- (7) Corporate Profits for the fourth quarter of 2005 “grew 14.4% from the previous quarter, the strongest rate since 1992. Pretax profits in the third quarter fell 4%, adversely affected by the hurricanes. Corporate profits accounted for 11.6% of gross domestic product in Q4, the biggest share of the nation’s income companies have taken since 1966” (WSJ, 3/31/06, A2). (Note: There were no articles during April updating the general corporate profit picture for Q1 2006).

Overall, the economic news reported during April continued to be positive in almost all respects, with no apparent slowdown even in the face of rising interest rates and sharply higher gasoline prices. Whether this continued growth generates higher rates of inflation, and in turn higher interest rates designed to force an economic slowdown, is likely to be a major factor in the near-term future direction of both stock and bond prices.

## II. INVESTMENT RISKS

All investments contain elements of RISK. Risk is the opposite side of the gains/rewards that investors seek from making investments with their money. The relationship between risk and reward is a fundamental constant in investing; the greater the gain sought, the greater the risk involved in obtaining that gain.

Investment risk can be defined in a variety of ways. One definition used by the academic investment community relates risk to volatility, which is defined as the variation of investment returns around a long-term average return (Siegel, pg 32; for a more complete listing of the references used in this discussion, see the paragraph below that precedes the Cash Equivalents section). Our definition is the **likelihood of financial loss in a time frame relevant to you**. The three key points of this definition are:

- (1) **Likelihood:** Based on the long-term history of various investment results (and recognizing the limitations of history in trying to assess probabilities), what is the likelihood of a range of investments results occurring in the future;
- (2) **Financial loss:** Can be either nominal, which would be the decline in value of an investment portfolio, and/or inflation-adjusted, which would take into account a decline in purchasing power of the portfolio even if there is a nominal increase in value; and
- (3) **Time frame relevant to you:** Historical investment returns demonstrate that risk changes over time, so risk should be evaluated based on each investor's personal time frame regarding the use of the investment portfolio.

In discussing the use of historical data in trying to estimate future risk and return, Siegel writes that "the overwhelming historical data do not guarantee accuracy in estimating these risk-reward parameters because you can never be certain that the underlying factors that generate asset prices have remained unchanged... As Nobel laureate Paul Samuelson is fond of saying, 'we have but one sample of history.' Yet you must start with the past in order to understand the future" (pg. 26).

This discussion will focus on liquid investments, namely cash equivalents, bonds (i.e., income-oriented investments), stocks, and various so-called alternative investments that have become popular of late. The quoted sources include "Unconventional Success," by David Swensen (Chief Investment Officer of Yale's highly successful endowment fund); "Stocks for the Long Run," by Jeremy Siegel (Professor at Penn's Wharton School); Ibbotson's 2006 Yearbook, "Market Results for 1926-2005"; and Wall Street Journal (WSJ) articles.

Cash Equivalents (CEs, which include money markets, short-term Certificates of Deposit (CDs), and short-term bonds with maturities of less than one year): CEs are the least risky investments in terms of the likelihood of a decline in the nominal value of the investment. However, because they also have the lowest long-term investment returns, they run the risk of providing little to no long-term return in excess of the rate of inflation. Over an 80 year period from 1926-2005, Ibbotson reports that the average annual return for CEs was 3.7%, with inflation over the same time period at 3.0%. This means that the annual inflation-adjusted rate of return for CEs was less than 1% (pg. 31). The same chart shows the risk of CEs, in terms of one-year volatility, as a mere 3.1%, meaning that the range of annual returns around the average 3.7% return was, during two-thirds of the years in the period, plus or minus 3.1% for a high of 6.8% and a low of 0.6%.

The key characteristic of CEs is that they show little or no change in price. Virtually all the investment return comes from the interest rate earned during the time the investment is outstanding. When interest rates are low, the investment return is low. When interest rates rise, as they have for the past two years, the returns increase. The rise and fall of short-term US interest rates is most directly influenced by the Federal Reserve, which adjusts rates based on its views of the overall economic environment, seeking to balance economic growth with low inflation.

Timing and opportunity costs are part of the risk associated with CEs. For instance, investors who give up other investments to take advantage of the current increase in short-term interest rates may find that those rates stop going up sooner rather than later, and then begin to decline. At the same time, the investments that they have given up, particularly bonds, may begin to rise, since bond prices rise as interest rates decline. So even with CEs, there is risk that the returns are not likely to provide any substantial return above inflation, and that using CEs may reduce allocations to investments in asset classes more likely to provide better returns. Finally, it should be noted that CEs can be taxable or tax exempt, but the after-tax returns tend to be similar because tax-exempt CEs pay lower interest rates.

Bonds (Income-Oriented Investments): Bonds have longer maturity dates than CEs, and because of these longer maturity dates, their prices fluctuate during the time period in which they remain outstanding. When interest rates are rising, bond prices decline, and when interest rates are falling, bond prices rise. The reason this occurs can be explained with an example: One year ago, the 10-year US Treasury bond would have been issued with a 4% interest rate (called a "coupon"). Currently, a new 10-year US Treasury bond would be issued with a coupon close to 5%. The owner of the bond with the 4% coupon is now earning 1% less than the owner of the new 5% bond. In order to provide an equivalent total return, the owner of the 4% bond would have to lower the price of the bond so that a buyer would get the same total return from buying the 4% bond as he would from buying the 5% bond. Price change also occurs when interest rates are falling; if the new 10-year bond had a 4% interest rate, the owner of the 5% bond would be able to raise the price of the bond so that the new buyer's total return would be 4% by the time the 5% bond matures.

This change in bond prices occurs whether the bonds are owned as individual bonds or in a mutual fund. The only difference is that individual bonds mature, so that the owner receives the proceeds at maturity, whereas those same bonds, if owned by a mutual fund, mature within the fund and are reinvested by the fund at the prevailing interest rates. The fund itself does not mature, but the bonds in the fund do.

To compensate investors for the risk associated with fluctuating prices, interest rates paid on bonds are typically higher than on CEs. The long-term (i.e., 80 year) historical average annual return for intermediate-term government bonds is 5.3% (given inflation of 3.0%, the "real" (i.e., after-inflation) return from bonds has been 2.3%). With a volatility measure of 5.7% (Ibbotson, pg. 31), the range of returns from bonds two-thirds of the time was plus 11.0% to minus (0.4%). Bond returns can be negative when the price decline for the period in question is greater than the interest received during that period. But the longer the time period, the more likely the returns are to become positive, both because rising interest rates do not continue indefinitely and investors eventually earn the higher interest rates that brought prices down once the lower coupon bonds mature.

Interest paid on bonds provides a greater degree of certainty to at least a portion of the bond investment return when compared to investments that rely on long-term price gains for their returns (the latter investments will be discussed in the paragraphs that follow). In addition to their varying maturities, bonds have different credit risks (governments and financially strong and weak companies all issue bonds). Recently, some bonds have been issued with inflation protection, adding to the choices available to investors.

Stocks: Stocks rely on price increases for most of their investment return. Income in the form of dividends has represented a small portion of the return from stocks for decades. It is common knowledge that stock prices fluctuate widely, and the risk associated with declines in stock prices is often used as an explanation for why stocks have a significantly higher long-term rate of return than bonds. Ibbotson's long-term average annual return (same 80 year period) for Large Company US Stocks was 10.4%, a full 7.3% above the 3.1% rate of inflation. In order to achieve this higher rate of return, however, investors take on significantly greater short-term volatility. Ibbotson's range of returns for stocks was 20.2%, meaning the range of returns two-thirds of the time around the 10.4% average was plus 30.6% to minus (9.8%).

One of Siegel's main points regarding the risks associated with stocks is that "while stocks unquestionably are riskier than bonds or bills (CEs) in the short run... , it is very significant that stocks, in contrast to bonds or bills (CEs), have never offered investors a negative "real" (inflation-adjusted) return over periods of 17 years or more. Although it might appear to be riskier to accumulate wealth in stocks rather than bonds over long periods of time, precisely the opposite is true: the safest long-term investment for the preservation of purchasing power clearly has been a diversified portfolio of equities" (pp. 26-27). The key point here is that over time, the risk in holding stocks diminishes. But even with this position, Siegel acknowledges that "although the dominance of stocks over bonds is readily apparent in the long run, it is more important to note that over one- and even two-year periods, stocks outperform bonds only about three out of every five years. This means that in nearly two out of every five years a stockholder will fall behind the return on bonds or bills (CEs). The high probability in the short run of underperforming bonds and bills is the primary reason why it is hard for so many investors to stay in stocks" (pp. 28-29). Siegel also acknowledges that an investor's personal risk tolerance, along with his/her objective time frame for holding investments, needs to be considered in developing an appropriate allocation between stocks on the one hand, and bonds and CEs on the other (pp. 37-38).

Swensen, while also acknowledging the superior long-term historical record of stocks, adds a number of references to the overwhelming importance of developing an asset allocation appropriate to the individual's preferences and circumstances. "Yet investors must guard against relying on equities to exhibit their general characteristics (that is, "superior returns over reasonably long holding periods,") in any specific time frame or allowing 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 in October 1929, it took stock investors fully 21 and \_ years to match returns generated by bond investors (Our note: the current 2000 through April 2006 period is another example of stocks underperforming bonds)... 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)

Swensen's reference to a "well-diversified collection of asset classes" includes bonds along with stocks. Although he advocates "owning an all-inclusive, market-like portfolio of equity securities" for the stock portion, it is important to note, in any discussion of the asset class, that there are many ways to participate in the stock market. There are the broad-based indexes that Swensen advocates, specifically the Total Stock Market, which is comprised of all Large, Medium and Small Cap stocks, as well as the separate S&P 500, Midcap, and Smallcap indexes. These broad-based indexes can also be purchased based on a breakdown referred to as "style." The "Growth" style emphasizes buying stocks with high prices relative to their earnings, with investors expecting continued rapid growth of the company's earnings to justify the stock's high prices. The "Value" style, on the other hand, focuses on buying stocks that have low prices relative to their earnings, usually because of some perceived problem relating to the company or the industry, with investors looking for a recovery to justify higher future prices.

There are also sector indexes, which allow investors to concentrate on particular segments of the stock market. During the late 1990s, the technology sector was all the rage; in the current stock market environment, Energy and International (both Developed and Emerging Markets) have become most popular with investors. Other large sectors include Financial (the largest sector in the S&P 500), Pharmaceuticals, and Industrials. Smaller sectors include Biotech, REITs (Real Estate Investment Trusts), and Gold.

Further, stock investing can be done using individual stocks or mutual funds. When dealing with mutual funds, the funds can be either indexes or so-called actively managed funds (all individual stock portfolios are by definition actively managed). Actively managed funds/portfolios rely on a professional manager(s) to pick certain stocks for their portfolios, and not pick certain others, with the goal of outperforming a collection of stocks that do not go through such a selection process. This collection of "unselected" stocks represents the indexed approach. While most of the Wall Street investment community is involved in the stock picking process, most of the academic literature, and now even a highly successful portfolio manager such as Swensen, advises that indexed investments are the better way to invest, primarily because of the higher costs associated with active stock picking.

Certain risks associated with stock investing cannot be avoided. A broad decline in stock prices, last seen during the 2000-2002 period, negatively affects any diversified stock portfolio. Other risks associated with stock investing, which many investors take on voluntarily in the hope of gaining higher returns, can in fact be avoided. One such risk is to own only a few stocks, or a few sectors, to the exclusion of all other stocks/sectors. This type of undiversified portfolio assumes the greater risk associated with concentrating on only a few stock investments, again with the hope/expectation that the concentrated portfolio will provide a better result. Swensen cites Nobel Prize winner Harry Markowitz as describing diversification as "one of the economic world's rare 'free lunches.'" By diversifying, investors gain risk reduction without return diminution (or return enhancement without risk expansion). Ultimately, the behavioral benefits of diversification loom larger than the financial benefits. Investors with undiversified portfolios face enormous pressures, both internal and external, to change course when the concentrated strategy produces poor results... The act of diversification...increases the likelihood that an investor will stay the course in difficult market environments" (pg. 17).

Another popular stock investment activity that increases risk is to buy the stocks/funds/sectors that have most recently performed well. This is referred to as “chasing past performance.” Investors tend to believe that what has done well in the recent past is likely to continue to do well in the future. Swensen discusses this behavior as follows: “Investors magnify the far too common experience of investment failure by chasing returns of hot, lucky managers, investing near the peak and suffering from poor relative (and perhaps, absolute) performance. Regression to the mean (Our explanation: the tendency of prices to return to their long term averages), one of the most powerful influences in the world of finance, explains the tendency for reversal of fortune. Hot stocks and hot funds attract interest from the investment community. Investors, fund managers, research analysts, investment bankers, financial journalists, and television pundits direct time, energy and attention to the flavor of the month... As ever more money crowds into the rapidly appreciating sector, the resulting price increases sow the seeds of the trend's eventual demise” (pg. 154). Technology in the late 1990s was an excellent example of this behavior; which currently hot sector is next to fall victim to regression to the mean remains to be seen.

The WSJ, clearly part of the financial press referred to by Swensen, also had a recent article on this subject entitled “As Many Investors Take On More Risk, Here's How to Tell if You're Going Too Far” (4/26/06, pg. D1). The article states that “in a throwback to the dot-com era, too many investors these days are simply chasing these hot markets (referring to international stocks and commodities) in order to juice their returns.” While observing that these asset classes can, in moderation, actually reduce a portfolio's overall volatility (i.e., risk) while improving returns, the issue is the amount of new money flowing into these and other currently hot-performing sectors. The author cites data from a firm that tracks money flows into mutual funds showing “that investors are shoveling billions of dollars into more aggressive domestic small company funds at the expense of conservative and moderate funds, where dollar flows are down sharply.” The article discusses the far greater degree of volatility of certain of these sectors, and the number of investment firms actually advising their clients to beware of the greater risks. The author writes: “That advice doesn't mean you should sell off your entire position to avoid the risk that certain markets turn down. Instead, if you've benefited from a profitable surge (in a hot performing sector), chances are good your portfolio is now too heavily weighted in that asset, so scale back to a level more appropriate to your risk tolerance, or at least in line with a predetermined asset allocation mix (Our note: this strategy is referred to as rebalancing; see next page). What that mix is depends on how you'll react to a downturn. If a bear market in one of these sectors would lead you to sell, be careful about buying into hot sectors today. They will inevitably cool (Our note: remember Swensen and regression to the mean), and investors who started buying into these stocks too late will likely end up selling out at a loss – just as so many did during the dot-com bust.”

In addition to chasing hot recent performance, many investors also try to time the markets, which is the effort to be in the stock or bond market, or certain parts of these markets, when it is going up more than the market in general, and then to get out when that market or market segment is underperforming or going down. While everyone would like to do this successfully, it is an extremely difficult task to perform with any consistency. One obvious reason is that for every buyer of an investment there is a seller; the buyers are looking for above-market gains, while the sellers have concluded that that investment will not provide such gains. One side will be correct, the other will not, and each will pay some transaction cost to effect the purchase or sale, making the activity a less than zero sum game.

Swensen's discussion of market timing is as follows: "Market timing represents a short-term bet against well-articulated long-term asset allocation targets. Market timers hope to underweight prospectively poorly performing asset classes and overweight prospectively strongly performing asset classes, employing tactical moves to enhance portfolio returns. Active market timers usually fail. Timing decisions involve the large questions of asset class valuation, forcing short-term asset allocators to develop views on an impossibly broad range of factors. Even if the market timer overcomes the odds by making a correct call, notoriously fickle markets may fail to resolve valuation discrepancies in the short run. Serious investors avoid entering the market timing morass" (pg. 151).

The opposite of undesirable market timing is the highly favored activity of rebalancing. Swensen again: "Rebalancing involves taking action to ensure that the current portfolio characteristics match as closely as is practicable the targeted portfolio allocations. As market forces cause various assets to rise or fall in value, proportions of portfolios allocated to the various assets rise and fall concurrently. To maintain desired allocations, investors sell assets that appreciate in relative terms and buy assets that depreciate in relative terms. Unless investors engage in systematic rebalancing of portfolios, the risk and return profile of the actual portfolio invariably differs from the risk and return profile of the desired portfolio... Under normal market conditions, systematic rebalancers trim winners and bolster losers, moves that go against the conventional grain" (pg. 183).

As to what constitutes the appropriate asset allocation, Swensen writes that "instead of concentrating on the central issue of creating sensible long-term asset allocation targets, investors too frequently focus on the unproductive diversions of security selection and market timing... Investors ultimately reap rewards only if they maintain positions in the face of market woes. Individuals who prove unable to withstand the inevitable market traumas frequently end up whipsawed, abandoning sensible strategies just as the out of favor moves into the limelight (pg. 29). Swensen also emphasizes the importance of developing asset allocations in line with investor's personal circumstances and risk tolerances: "Incorporating personal preferences in portfolio decisions guards investors from counterproductive actions after the fact by limiting exposure to poorly loved asset classes before the fact" (pg. 85).

As a summary to this Stock section of our Part I discussion on Risk, we of course agree that asset allocation implemented with a broadly diversified portfolio of low cost indexed investments is the most appropriate method of controlling investment risk, and that the activities of chasing recent hot performers and market timing should be avoided. We also advocate rebalancing as a further step towards risk reduction, selling portions of the most recent hot performers and adding to the recent underperformers, to take advantage of the "powerful influence" of regression to the mean.

Our Part II discussion of Risk will continue in our next Monthly Comments, in which we will discuss the variety of so-called alternative investments that have been developed in an effort to convince investors to abandon the more traditional asset classes for either: (a) potentially higher performance (but with potentially more risk); or (b) potentially less risk with reasonable investment returns. These alternative investments include leveraged buyout and venture capital funds, commodities and currencies, hedge funds, and annuities.

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 April 30, 2006	1,311	(10.8)%	11,367	(1.2)%	2,323	(42.9)%

**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 April 30, 2006	<u>1,311</u>		<u>11,367</u>		<u>2,323</u>	
11.33 Yr Gain; Annualized %	852	9.7%	7,533	10.0%	1,571	10.4%



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