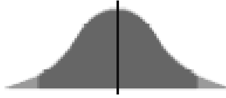

Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON **NICK LEVINSON**

NOVEMBER 2005 COMMENTS

IMPORTANT NOTICES:

TRIP to INDIA: Victor and his wife have returned safe and sound from their trip to India, a trip which proved highly interesting. A more lengthy description of impressions from the trip will be presented after some time has passed for additional reflection. We thank everyone for their good wishes and consideration during this period.

THOUGHT for the MONTH (from PPA): There are three basic parts to your financial situation: (1) Work-related earnings, after tax, including retirement income; (2) amount of, and after-tax returns on, accumulated capital; (3) amount of spending, adjusted for inflation. You have most control over spending, and least control over investment returns, which are determined by market results. If items (1) and (2) equal or exceed (3), your financial situation is favorable; but if (3) exceeds (1) and (2), then some spending is coming from accumulated capital, which calls for periodic review.

YEAR END TAX MATTERS: Between now and year end, we will be working on:

1) Required Minimum Distributions from IRA accounts. Clients affected will be receiving letters from NFS, and we will be following up to assure timely compliance.
2) Cost Basis information for all securities sold during 2005.
3) Cost Basis Reports for all unsold security positions in taxable accounts.

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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.

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COMMENTS: INDEX RESULTS for period ending NOVEMBER, 2005

STOCKS	YEAR 1999	YEAR 2000	YEAR 2001	YEAR 2002	YEAR 2003	YEAR 2004	YTD 2005	CURR. MONTH
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6%)	(11.0%)	(21.0%)	28.4%	12.5%	5.8%	4.0%
Standard & Poors 500 Index (2)	19.6%	(10.1%)	(13.0%)	(23.4%)	26.4%	9.0%	3.1%	3.5%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2%)	(13.0%)	(23.7%)	25.9%	7.2%	5.5%	4.3%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0%)	(20.9%)	32.2%	15.3%	6.3%	3.6%
Dow Jones Industrial Average Index (2)	25.2%	(6.2%)	(7.1%)	(16.8%)	25.3%	3.2%	0.2%	3.4%
NASDAQ Composite Index (2)	85.6%	(39.3%)	(21.0%)	(31.5%)	50.0%	8.6%	2.6%	5.1%
Vanguard Midcap US Index Fund (1)	25.0%	2.6%	(4.8%)	(16.3%)	34.1%	20.4%	12.4%	5.4%
Vanguard Smallcap US Index Fund (1)	19.6%	(4.2%)	1.0%	(21.6%)	45.6%	19.9%	7.4 %	4.7%
Vanguard International Index Fund (EAFE) (1)	25.3%	(15.2%)	(22.6%)	(17.5%)	40.3%	20.8%	9.9%	2.8%
Vanguard Real Estate Invest. Trust Fund (1)	(0.4%)	26.4%	12.4%	3.8%	35.7%	30.8%	12.0%	4.6%
BONDS								
Vanguard Total Bond Market Index (1)	(0.8%)	11.3%	8.3%	8.2%	4.0%	4.2%	1.4%	0.5%
Vanguard Interm. Tax-Exempt Index Fund (1)	(2.9%)	9.2%	5.0%	7.9%	4.4%	3.2%	1.4%	0.4%
Vanguard Short-term Bond Index (1)	2.1%	8.9%	8.9%	6.1%	3.4%	1.7%	0.9%	0.3%
Vanguard Short Tax-Exempt Index Fund (1)	2.6%	4.9%	4.8%	3.5%	1.6%	1.1%	1.4%	0.2%
Vanguard High-Yield	NA	NA	NA	1.7%	17.2%	8.5%	1.8%	0.9%

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.

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%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
		1999				**2000**				**2001**		
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3
BONDS	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.												
		2002				**2003**				**2004**		
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9
BONDS	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.												
		2005				**2006**				**2007**		
S&P 500	(2.6)	0.9%	3.1%									
NASDAQ	(8.1)	2.6%	4.4%									
BONDS	(0.5)	3.0%	(0.7%)									
Interm. Tax.												

NOVEMBER 2005 COMMENTS

STOCK index prices gained in November, approximating their best monthly gains of the year achieved during July. The advance in prices more than offset the declines of October. The S&P 500, Dow Industrials, and NASDAQ all gained between 3.4% and 5.1%. The Midcap, Smallcap, REIT and International indexes, which have been outperforming the Large Cap indexes all year, continued to do so, with gains ranging from 2.8% to 5.4%. For 2005 year-to-date (YTD), the S&P 500 is up 3.1%, the Dow up a mere 0.2%, and the NASDAQ up 2.6%. By contrast, the Midcap, Smallcap, REIT and international indexes are up between 7.4% and 12.4%, continuing to outperform the Largecap indexes. The Total Stock Market index is up 5.8%, benefiting from the Midcap and Smallcap performance. Also notable is the convergence of Large Cap Growth and Value results, after five consecutive years of outperformance on the Value side. See page 2 for the monthly and YTD figures.

BOND returns (price change plus interest) posted modest gains, after two consecutive months of significant declines. The benchmark 10-year US Treasury yield closed the month at 4.50%, slightly below the October close of 4.56%, but still well above September’s level of 4.33% and far above August’s close of 4.02 %. YTD figures for most intermediate- and short-term bond funds are now between plus 1.0% and 1.5%, continuing below the returns achieved on money markets, which are benefiting most directly from increases in short-term interest rates. Bond results for the month and YTD are reported on page 2.

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The stock market rally that began decisively in March 2003 has raised the S&P 500 by 61% 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 is, as always, dependent on unknown, unpredictable future events. Indeed, prior to November's results, the major indexes were all down for 2005. (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 1,250 is 61% higher than the low but still down (18%) from the prior high, and still 277 points, or 36%, from the prior high. Note also the NASDAQ, even after doubling from its low, remains down (56%) from its 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 15). Note that the three indexes have positive average annual returns ranging from 9.6% to 10.5% for the 10-year, 11-month period from the end of 1994 through November 2005, 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.

	S&P 500 (1)		**DOW (1)**		**NASDAQ (1)**	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
April 10, 2001 Low	1,103	(28)%	9,390	(20)%	1,684	(67)%
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)%
November 30, 2005	1,250	(18)%	10,806	(8)%	2,233	(56)%

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

	S&P 500 (1)	**DOW (1)**	**NASDAQ (1)**
End 1994	459	3,834	752
End 1999	1,470	11,500	4,070
Gain	1,011	7,666	3,318
Avg.Ann.%Gain:'95-'99; 5 years	26.2%	24.6%	40.2%
November 2005	1,250	10,806	2,233
Gain	791	6,972	1,481
Avg.Ann.%Gain:'95-11/05; 10.92 yrs	9.6%	9.9%	10.5%

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

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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. See the August 2005 Comments for reference to a NY Times [NYT] article titled "Economic View" (7/31/05, Financial section, pg. 4), which lists the major components of GDP). The initial estimate of GDP growth for the third quarter was 3.8%, but was adjusted higher, to 4.3%. "The U.S. economy continues to show momentum, growing at a revised 4.3% annual rate, the fastest pace since the first quarter of 2004… Increased consumer…and business spending were behind the upward revision" (Wall Street Journal [WSJ], 12/1/05, pg. A2).

(2) Employment for October gained 56,000 jobs, "a little more than half the number expected" (Vanguard Economic Week in Review [VEWR], 10/31-11/4/05), but then added 215,000 jobs in November, "as the economy rebounded from the devastating impact of Hurricane Katrina" (NYT, 12/3/05, pg C1). "Employers outside the farm sector added 215,000 jobs in November after adding only 44,000 in October and 17,000 in September in the wake of devastating hurricanes" (WSJ, 12/3-4/05, front page; October and September figures as adjusted).

(3) Interest Rates declined slightly in November after two consecutive months of sharp increases. The benchmark 10-year US Treasury interest rate, which is set by buyers and sellers in the bond market, closed at 4.50%, compared to 4.56% in October and 4.33% in September. August's level was 4.02%, just after Hurricane Katrina. The Federal Reserve, as expected, raised the short term interest rate it controls by _ of 1%, to 4%, the twelfth consecutive increase since mid-2004. Fed Chairman Green- span "expressed satisfaction with the economy's current pace of growth, but also said 'more uncertainty surrounds the outlook for inflation'" (VEWR, 10/31-11/4/05).

(4) Inflation, as measured by the Consumer Price Index (CPI) "core" rate, which excludes the volatile food and energy sectors, increased a modest 0.2% in October, and the overall CPI was also up 0.2%, "the slowest rate of increase in four months" (VEWR, 11/14-18/05). The most recent twelve months show overall inflation at 4.3%, and the core rate at 2.1%, with the major reason for the difference being energy prices (WSJ, 11/17/05, pg. A2). The Producer Price Index (PPI) core rate was down (0.3)% in October, and up 0.7% with food and energy included. "Inflation at the wholesale level tapered off in October after surging in the immediate aftermath of the hurricanes" (NYT, 11/16/05, pg. C2). (Note: the CPI measures prices of goods and services; the PPI, only goods).

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(5) Sector Economic Activity was Mostly Higher

(a) Durable goods orders (industrial and consumer) "rose a stronger-than-expected 3.4% in October…, and analysts were upbeat about the expected pace of future new orders" (VEWR, 11/28-12/2/05).

(b) Industrial production increased 0.9% in October, based on "hurricane-related recoveries, …and the resolution of a strike at Boeing." (VEWR, 11/14-18/05).

(c) Retail Sales declined (0.1)% in October, but, excluding weak auto sales, "increased a robust 0.9%, and stood 9.9% above their year-ago level" (VEWR, 11/14-18/05). (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 by (2.7)% in October, with "the expectation of further cooling in the coming months," while new home sales soared 13.0%, although "some analysts were skeptical of the accuracy of the report" (VEWR, 11/28-12/2/05).

(e) Personal Income increased 0.4% in October and personal spending rose 0.2%. Personal savings declined (0.7)%, "the seventh month of negative or zero savings, which means consumers are paying for purchases by borrowing, dipping into savings, or selling assets" (VEWR, 11/28-12/2/05). Note, however, that the definition of personal savings is itself open to question.

(6) Consumer Confidence, as measured by the Conference Board's Index, "jumped an unexpected 13.7 points in November" (VEWR, 11/28-12/2/05), up from its depressed level in October, which was "its lowest level in two years and a drop of more than 19% since January" (VEWR, 10/24-28/05). The Director of the Center said that "while the index remains below pre-Katrina levels, the shock of the hurricanes and subsequent leap in gas prices has begun wearing off just in time for the holiday season" (VEWR, 11/28-12/2/05).

(7) Corporate Profits for the S&P 500 stocks increased 14% in the first quarter and 12% in the second quarter, both figures significantly higher than analysts' expectations (see cite below). Expectations for the just completed third quarter were for profits to exceed 15% (NYT, Sunday Financial section, 10/2/05, pg. 7), but no final figures have been reported as yet. While corporate profits are a major driver of stock prices, it is important to note that over extended periods of time, the rate of profit growth is closely related to the rate of overall economic growth.

Overall, the economic news reported in November was favorable, and the broadly diversified liquid investment markets for both US stocks and bonds improved, particularly stock prices. For the full year 2005, stock returns are now positive in the low to mid-single digits, while bond returns range from positive 1.0 to 1.5%. As for the future, market prices will, as always, be determined by unpredictable, unknowable future events. The next section discusses in more detail the basic fact of market price fluctuations for various investment choices.

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II. INVESTMENT RETURNS, INVESTMENT CHOICES & PRICE CHANGES

The erratic movement of stock and bond prices, exemplified most recently by October's declines in both categories followed by the improved results during November, provide the context for this discussion. (Quotes, unless otherwise indicated, are from the book written by David Swensen, "Unconventional Success: A Fundamental Approach to Personal Investment," directed at how individual investors should best handle their investments. Swensen is the Chief Portfolio Manager for Yale's highly successful endowment).

The basic investments available to investors are cash equivalents, bonds, and stocks. Within these three categories are a number of variations. In addition to these three basic categories are so-called alternative investments, which will be discussed with Swensen's help below. Before considering theses various choices, there are some fundamentals to review.

The first fundamental point is that there are only two sources of investment return: One is the income paid by the investment (e.g., interest on bonds and dividends on stocks); and the other is the price gains from the investment itself. Losses come when investments bought for price gains go down in price instead.

A second fundamental point is that the tradeoff between risk and return is a constant in investing; less risk, less return, and more risk, more potential for higher returns, but with a greater possibility of loss. (The long-term history of investment returns bears this out.) Risk refers to a number of concepts: One is described as volatility, or the up and down variations around an average return; another is the chance of losing money in an investment.

In the advice we give to our clients, a third fundamental point is that investors should take no more risk than is necessary to achieve their financial objectives. No matter how much money is being made in certain investment categories during certain time frames, if that category is not appropriate for the circumstances of the investors, then they should not be investing in it. Why? The answer leads to a fourth fundamental principle: The future is inherently unpredictable, and investments doing well in the recent past are just as likely (if not more likely) to do poorly in the future.

The technology experience of the late 1990s provides an extreme example of this idea. Swensen refers to the "far too common experience of investment failure caused by chasing returns of hot, lucky mangers, investing near the peak and suffering from poor relative (and, perhaps, absolute) performance. Regression to the mean (our definition: the tendency of prices to return to their long term averages) 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 even more money crowds into the rapidly appreciating sector, the resulting price increases sow the seeds of the trend's eventual demise" (pg. 154).

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Turning to the discussion of the various investment choices:

Cash equivalents (“CEs”) are the least risky investments, and have the lowest returns based on long-term historical results. Examples of CEs are money markets, short-term bonds (maturities of one year or less), and Certificates of Deposit (“CDs”). The key characteristic of these CEs is little or no change in price; all the investment return comes from the interest rate. When rates are low, returns are low; when rates go up, as they have over the past 18 months, returns go up. Indeed, for 2005 through October 31st, money markets had a higher return than either bonds (measured by an intermediate bond index), or stocks (measured by the S&P 500 index). Short-term interest rates are set by the Federal Reserve, based on a variety of factors, including keeping inflation under control, impacts on the US economy, and countless other influences. The risk of buying CEs now, even with rates rising, is that when rates stop going up and then start going down (as eventually occurs; only the timing is at issue), CE rates do the same. CEs can be either taxable or tax-exempt, but the after-tax rates tend to be quite similar (that is, taxable rates are higher, but may be roughly equivalent after taxes are paid).

Bonds have longer maturity dates than CEs, and typically pay higher interest rates. Bond prices do fluctuate, because when interest rates change, the value of existing bonds (with their fixed interest rates) changes as well. When rates are rising, as now, it is typical for bond prices to fall, but eventually, when the bonds mature and are replaced at the higher rates, the bond investor benefits from the higher rates. Short-term price declines are typically offset by the higher interest rates earned in the future. Bond prices have historically fluctuated much less than stock prices (assuming intermediate maturities and good credit quality), primarily because they have a definite value at maturity. Further, the interest income provides a level of certainty to the ongoing investment result that does not exist in investments that rely on price gains for most of their return. Bonds have different maturities and different credit qualities (issuers can be the Federal and State governments, municipalities or companies), and recently some have been issued with inflation protection, all of which adds to the choices available with bonds.

Stocks rely on price increases for most of their return. While they have had considerably higher historical returns than bonds or CEs, their results are far more erratic. Consider the decade starting with 2000: The basic S&P 500 index of large company stocks is still down 18% from its high, and this is the sixth year of the decade. Significant price declines over extended time periods are a definite part of the investment history of stock market results.

There are all sorts of factors that affect stock prices, such as rate of profit growth, nature of industry, competition levels, and the more general economic factors of growth rates and interest rates and inflation rates. Further, there are all sorts of stock sub-sets, including large companies, mid-size companies and small companies; growth style and value style, which focuses on how much to pay for expected future earnings; a wide variety of sectors, including technology, financial, real estate, energy, healthcare, consumer products; and international or domestic. Needless to say, in each time period some parts of the stock market do well, and others do poorly. The problems are that no one can predict which parts will do better in the future, and that past results, be they recent or long-term, are not predictive of the future results likely to be realized by any given investor (refer to the Swensen quote in the final paragraph of the previous page, found on page 154 in his book).

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During times when the basic CE, bond, and stock choices provide disappointing investment results, many investors look elsewhere to try and achieve better returns. Aside from the basic problem of moving money from one category to another in the hope of catching favorable prices during any particular time frame (that is, market timing), there are specific objections raised by Swensen to each of these so-called alternative investments.

1) Hedge funds (pp. 125-126) "encompass a range of investment approaches so broad as to preclude classification in a single homogenous class. With categories ranging from event driven to relative value to macro strategies to fixed income arbitrage, the hedge fund investor faces a lengthy menu of distinct options from which to choose… Such absolute strategies (of hedge funds) attempt to produce positive returns regardless of the state of the markets… Absolute return hedge fund investing only makes sense if the investor identifies managers with superior active management skill… In contrast, investors in traditional marketable asset classes expect returns to derive fundamentally from the underlying asset class, modified in the case of actively managed accounts by the increment or decrement provided by security-selection decisions. To achieve success in the hedge fund world, investors must identify active managers with sufficient skill to overcome the typically rich fee arrangements commanded by fund managers… In the hedge fund world, as in the whole of the money management industry, consistent, superior active management constitutes a rare commodity."

2) Leveraged Buyouts "involve private ownership of mature corporate entities that have greater-than-usual levels of debt on their balance sheets… 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 grater degree of illiquidity, publicly traded equity securities gain a clear advantage. In the private equity world, active management success goes hand-in-hand with investment success. In asset classes such as domestic equities and fixed income (our note: reference is being made to the basic stock and bond market choices discussed above), which contain passive investment alternatives, investors can buy the market. By owning a marketable security index fund, investors reap market returns in a cost efficient, reliable manner (our note: this is Park Piedmont's methodology). In the absence of truly superior fund selection skills (or extraordinary luck), investors should stay far, far away from private equity investments" (pp. 133-134).

3) Venture Capital "provides financing and company building skills to start-up operations, working to develop companies into substantial, profitable enterprises… Unfortunately for investors, the promise of venture capital exceeds the reality. 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 startup investing… Investors also…face a problem of adverse selection. The highest quality, top tier venture firms generally refuse to accept new investors and ration capacity even among existing providers of funds. Venture firms willing and able to accept money from new sources may represent relatively unattractive, second tier investment opportunities" (pg. 139). See also an article in the Sunday, November 13, 2005 NY Times Financial section (pg. 1), discussing "The Great Global Buyout Bubble," and how too much capital is chasing a shrinking supply of attractive deals, the usual result after an investment category has success and attracts the latecomers looking to profit on yesterday's trends (Swensen, pg. 154).

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4) Commodities and Currencies (not discussed by Swensen). Commodities are physical items such as gold, oil, metals and agricultural products. They tend to do well in inflationary times, and can be purchased in mutual funds. As a source of diversification for a modest portion of an overall portfolio, we favor this investment. Currencies are traded in relation to each other, that is how many dollars does it take to buy a given amount of euros or yen, for example. These too can be purchased in mutual funds. The relative value of currencies depends on many, many factors, and success depends on timing when one currency is likely to gain at the expense of some other currency. Again, as a diversification for a small portion of a portfolio, this investment can make sense.

A basic principle of PPA's investment advice is that investors who have already accumulated substantial amounts of capital, who have no real need to expose themselves to the risks associated with the investments that have a higher potential reward, and for whom a steady, income-oriented return meets their financial needs, should choose the better-known, more reliable, income-oriented alternatives available in the marketplace. Returning to Swensen, "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" (pg. 29). He also emphasizes that personal preferences and personal circumstances "play pivotal roles in developing effective, long-lasting portfolio structures… Incorporating personal preferences in portfolio decisions guards investors from the counterproductive actions to adverse developments after the fact by limiting exposure to poorly loved asset classes before the fact" (pg. 85).

We believe our basic approach to investment advice is consistent with Swensen's views that investors are best served by: (a) Developing a sensible asset allocation suitable to the individual's particular circumstances; (b) implementing the allocation with cost efficient, market-mimicking indexes; and (c) leaving the activity of chasing riskier returns to others.

This month's Comments will now turn to a more detailed discussion of Swensen's views with regard to the related topics of Re-balancing and Market Timing.

III. SWENSEN, ON "REBALANCING" and "MARKET TIMING"

(Note: The first two paragraphs are repeated from last month's Comments, presented there in one paragraph on page 10) Swensen begins (pp. 11-12) by stating that there are "three tools to employ in generating investment returns: Asset allocation, market timing and security selection… Asset allocation refers to the long-term decision regarding the proportion of assets that an investor chooses to place in particular classes of investments… Market timing refers to deviations from long-term asset allocation targets. Active market timing represents a purposeful attempt to generate short-term, superior returns based on insights regarding relative assert class valuations… Passive market timing consists of the inadvertent deviations from long-term targets caused by the action of market forces on the value of a portfolio's various asset classes… Security selection refers to the method of construction of portfolios for each of the individual asset classes, beginning with the choice of passive and active management."

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"Passive management, the baseline against which other options must be measured, involves replication of the underlying market. In the case of domestic equities, the S&P 500, the S&P 1500, the Russell 3000, and the Wilshire 5000 represent broad-based indices that provide reasonable definitions of the market and sensible alternatives for investors pursuing passive management. Active management involves making bets against the market, with the investor attempting to overweight attractively-priced stocks and underweight expensively-priced stocks. The returns resulting from the active manager's deviations relative to the benchmark represent security selection returns."

(Note: This paragraph is repeated from page 12 of last month's Comments.) Swensen observes that institutional investors avoid market timing, perhaps because they "recognize the futility of consistently making the relative asset class valuation assessments necessary for market-timing success, particularly when such assessments rely on a bewildering collection of unknowable economic and financial variables" (pg. 20). Then he turns to individual investors, stating that "the available evidence points to a pattern of excessive allocation to recent strong performers offset by inadequate allocation to recent weak performers. Strong evidence exists that markets exhibit mean-reverting behavior, a tendency for good performance to follow bad and bad to follow good. In markets characterized by mean reversion, investors who fail to rebalance portfolios to long-term targets end up with outsized exposure to recently appreciated assets that prove most vulnerable to poor future results" (pg. 21).

Turning to the specific chapters on Rebalancing and Market Timing, Swensen describes rebalancing (pg. 183) as "taking action to ensure that the current portfolio characteristics match as closely as 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 arise 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."

The basic idea here is to sell asset groups that have gone up in value, while buying asset groups that have declined in value, in order to maintain the established allocation. So if an allocation that started at 60% stocks/40% bonds moves to 65% stocks because stock prices have gone up relative to bonds, then 5% of the stock portfolio is sold, with the proceeds used to buy bonds. Conversely, if the same initial allocation changes to 55% stocks because stock prices have declined relative to bonds, then 5% of the bond portfolio is sold, with the proceeds used to buy stocks. In each case, the rebalancing brings the portfolio back to 60/40. "In the world of investment, failure sows the seeds of future success. The attractively-priced, out-of-favor strategy frequently provides much better prospective returns than the highly-valued, of-the-moment alternative. The discount applied to unloved assets enhances expected returns, even as the premium assigned to favored assets reduces anticipated results… Disciplined rebalancers sell what's hot and buy what's not" (pg. 185).

The text points out that rebalancing in taxable accounts can create additional tax liabilities, "giving investors pause," and suggests a variety of alternatives to avoid generating taxable gains, including "directing fresh flows of funds to underweight asset classes," using losses to offset gains, or using tax deferred accounts for rebalancing activities (pg. 184).

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In the summary of the Rebalancing section, Swensen writes that "rebalancing forces investors to act against the crowd. When an asset class performs relatively poorly, rebalancing requires compensating purchases. When an asset class performs relatively well, rebalancing requires compensating sales….In spite of the central importance of rebalancing to effective portfolio management, investors appear largely indifferent to the process. Evidence indicates that, at best, investors allow portfolios to drift with the ebb and flow of the market, causing strong relative performance to increase allocations and weak relative performance to diminish holdings. At worst, investors behave in a perverse fashion, chasing strong performers and shunning weak performers" (pg. 199).

If rebalancing is a positive, what of market timing, which appears to provide another way of trying to own an asset class at times of rising prices, and not own that asset class in times of falling prices? Swensen defines market timing as 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….Active market timers usually fail. Market timing requires taking relatively few, generally undiversifiable positions. Timing decisions involve the large question 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**" (pg. 151).

(Note: We regularly point out that: (a) there are so many factors that affect prices that no one can predict them correctly; and (b) even if a correct call/guess is made, the market prices may not follow as expected. This year's example: Predicting correctly the rise in short-term interest rates, only to see prices of longer-term bonds actually rise as longer-term yields fell. Another recent example comes from 2001, as stock prices finished higher at year-end than they were the day before 9/11.)

Swensen continues: "Serious investors avoid entering the market timing morass….Some evidence points to individual investor acceptance of a passive form of market timing that allows asset allocations to drift with the ebb and flow of markets. More worrying, a fair number of individual investors engage in counterproductive performance-chasing that results in buying high and selling low. Buying yesterday's winners and selling yesterday's losers invariably hurts tomorrow's performance" (pg. 151).

It is still necessary to distinguish market timing activities from rebalancing activities. Market timers try to predict the future and choose those asset classes that will perform better than others in the future. By contrast, rebalancers make portfolio changes based on past price movements, selling the better performing assets and buying the poorer performing assets to restore the desired asset allocation, while relying on regression to the mean to achieve favorable investment results. The market timer must correctly predict the future; the rebalancer is simply responding to known price moves to re-establish the desired asset allocation. There is no predictive feature to rebalancing.

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And how does the popular press treat these distinctions? In a feature article in the Wall Street Journal's Money & Investing Personal Finance section (11/12/05 Weekend edition), titled "Rebalancing Your Portfolio," the authors begin by stating that "A year of major shifts in the world's financial markets is forcing investment advisors to overhaul some of their basic advice on asset allocation… Financial planners are increasingly advising clients to test the waters of foreign investments, especially in Europe and Japan, as well as alternative investments such as hedge funds." In our view, the shift to foreign investments represents an example of chasing recent favorable performance. Indeed, investors with already established positions in international stocks looking to rebalance should be sellers, not buyers, since this part of the stock market has outperformed domestic stocks. If the purpose of adding international stocks, or even hedge funds, is to provide broader diversification through additional asset classes, this would not be an example of either market timing or rebalancing (and remember Swensen's warnings about hedge funds).

The WSJ article continues: "Portfolios that haven't been rebalanced this year also likely drifted toward US real estate holdings, intermediate-term bonds, value stocks, and small-cap stocks, all of which should be reined in." This actually is a rebalancing suggestion, since each of these categories has shown recent outperformance. For example, REITS (for real estate) have outpaced stocks and bonds for a few years; value stocks and small cap stocks have outperformed large cap growth stocks; and intermediate bonds (at least until September and October) had done surprisingly well in the face of rising short-term interest rates, based on declining rates for longer-term bonds and a narrowing of the yield curve.

But the article then states that "US stocks have been relatively flat this year, which has sent investors looking for better returns elsewhere." This activity of looking for better returns elsewhere is a classic market timing effort, and has nothing to do with the notion of rebalancing. Indeed, rebalancing would suggest adding to the US stock allocation, given its relative underperformance.

Swensen suggests a limited number of core investment holdings, namely domestic (i.e., US) equity, foreign developed and emerging market equity, real estate, and US Treasury bonds and US Treasury Inflation-Protected securities (pg. 34). Given these limitations, intra-asset class rebalancing such as going from smallcap to largecap, or value to growth, would be unnecessary. "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). Our example of such an "all-inclusive, market-like portfolio of equity securities" would be Vanguard's Total Stock Market fund. However, we favor the use of a broader range of portfolio holdings than Swensen, a subject that will be discussed in a future Comments.

Returning to the WSJ article, there are additional examples of future-predicting, market-timing calls described as rebalancing. One glaring example is in the discussion of bonds, where advisers are quoted as suggesting reducing the percentage of bond holdings (based on the usual reasons of rising interest rates, inflation fears, etc.) rather than increasing them (as the rebalancer would do), based on the relative underperformance of bonds lately. Then there is the example of the strong performance in international stocks, leading many strategists to "raise their recommended foreign-stock allocations, rather than cutting back." Our comment: If the WSJ can't get these ideas straight, is it likely the investing public will do so?

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	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)

	S&P 500	%	DOW JONES	%	NASDAQ	%
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 Low	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 Low	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)%
November 30, 2005	1,250	(15.0)%	10,806	(6.0)%	2,233	(45.1)%

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

	S&P 500	%	DOW JONES	%	NASDAQ	%
Start of 1995	459		3,834		752	
End of 1999	1,470		11,500		4,070	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	1,148		10,020		1,950	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	880		8,342		1,336	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
End of 2003	1,112		10,454		2,003	
9 Year Gain; Annualized %	653	10.3%	6,620	11.8%	1,251	11.5.%
End of 2004	1,212		10,783		2,175	
10 Year Gain; Annualized %	753	10.2%	6,949	10.9%	1,423	11.2%
November 30, 2005	1,250		10,806		2,233	
10.92 Yr Gain; Annualized %	791	9.6%	6,972	9.9%	1,481	10.5%

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