

WEDGE WATCH

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A Telling Discount?

*'You don't tug on Superman's cape
You don't spit into the wind
You don't pull the mask off the 'ole Lone Ranger
And you don't mess around with Jim'
—From the song "You Don't Mess Around with Jim"
written and recorded by Jim Croce (1943-1973)*

Early in the first chapter of his 1986 best-seller *Winning on Wall Street*, Marty Zweig, then a successful money manager, newsletter writer and frequent panelist on *Wall Street Week with Louis Rukeyser*, made the following pronouncement: *"The major direction of the market is dominated by monetary considerations, primarily Federal Reserve policy and the movement of interest rates."* In other words, he believed that when the FOMC was in a protracted tightening mode it was best to decisively moderate exposure to equities. Hence the familiar and often cited Wall Street maxim: **"Don't fight the Fed"** which, as legendary early 1970's balladeer Jim Croce intimated, is akin to the messy proposition of "spitting into the wind." On the other hand, Zweig advocated decisively upping equity exposure when the nation's central bankers reverse course (moving into an extended easing mode) because he believed that under such a scenario market headwinds tend to dissipate, paving the way for higher stock prices. As he stated in his book, *"the tape is the final arbiter of any investment decision"* which, per his cardinal rule, means: *"Never fight the tape."* More specifically, Zweig equated buying stocks during market swoons to *"catching a falling safe,"* stating that *"investors are sometimes so eager for its valuable contents that they often ignore the laws of physics and attempt to snatch the safe from thin air as if it was a (baseball) pop fly. Not only is this game dangerous,"* he wrote, *"but it is pointless as well. It is easier, safer and, in almost all cases, just as rewarding to wait for the safe to hit the pavement and take a little bounce before grabbing the contents."*

Although Zweig, who earned a Ph.D. in finance from Michigan State, was often perceived to be somewhat of a technician during his heyday (he liked to say that he *"is a trend follower, not a trend fighter"*), he actually incorporated a multiplicity of technical, monetary and fundamental indicators into his methodology (including an emphasis on buying stocks selling at low multiples of earnings relative to their underlying or projected earnings growth rates). His relatively exhaustive data studies were geared toward unearthing investable correlations, which ran the gamut from the mundane to the arcane, in an effort to minimize downside risk and to increase the probability of being on the right side of a stock and/or market move. As he wrote in *Winning on Wall Street*, *"Big money is made in the stock market by being on the right side of major moves. I don't believe in swimming against the tide."* More specifically, he urged investors to be particularly concerned with *"the probability of success or, alternatively, the probability of losing money"* which, of course, one wants to minimize as much as possible. The bottom line, from Zweig's perspective, is that *"the only consistent way to make money in the market is to cut losses and run with profits."*

Now in his 60's, Marty Zweig is no longer active in the investment business and is instead presumably enjoying the considerable fruits of his long labor on Wall Street (i.e., according to *Forbes* magazine, he

Fourth Quarter 2005 Financial Statistics

DJIA: 10717.50

S&P 500: 1248.29

90-Day T-Bill: 4.07%

30-Yr. T-Bond: 4.53%

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Discount

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put his Fifth Avenue penthouse apartment on the market in late 2004 for a then-record \$70 million). However, for several reasons, which we will highlight momentarily, we thought it might be instructive to “dust off” and revisit one of his primary theories. More specifically, we want to explore in more detail recent academic research regarding monetary policy and its historic impact on stock prices (both pro and con). This relationship, which again was purportedly the primary driver behind Zweig's methodology, may now be of particular relevance as we approach the pending leadership transition at the Fed (from Greenspan to Bernanke).

The soon-to-be Fed Chairman, Ben Bernanke, will likely remain an investor wildcard for some time, absent, at this point, a measurable track record in that highly critical financial oversight role. However, using history as a rough guide (in regard to both the duration of a typical Fed tightening cycle and the timing of a subsequent policy reversal), along with the futures market's current estimate of this cycle's final tightening move (mid-year 2006), it seems reasonable to anticipate that a reversal in favor of monetary ease by the Fed could be upon us at some point during the latter half of this year. Based on our interpretation of Zweig's views, such a directional change by the Fed would typically be a plus for stocks (with a likely positive shift in investor sentiment emerging several months or more ahead of the Fed's policy shift, as *Mr. Market* begins to sniff out the pending reversal). Such an outcome might have particular relevance for broad market indices such as the S&P 500, which has produced a negligible price gain in the seven long years since late 1998 (primarily as a result of fairly dramatic compression in the price-earnings multiples of the largest capitalization names dominating that cap-weighted index).

Early last year (2005), the *Financial Analysts Journal* published an academic study (authored by Conover, Jensen, Johnson and Mercer – CJJM) titled *Is Fed Policy Still Relevant to Investors?* which sought to quantify the impact of interest rates on stock prices. More specifically, the authors of the study “evaluated the cross-sectional consistency relative to three

characteristics of securities commonly used by investment professionals as portfolio selection criteria - namely, whether the company is a 'growth' or 'value' stock and company size, company industry, and country of incorporation” (which we've excluded here due to space limitations). According to CJJM, numerous prior empirical studies “*present strong evidence supporting the prominent role that monetary policy plays in the determination of security returns.*” Or more specifically, that “*periods of monetary easing represent favorable periods for the stock market whereas periods of monetary tightening are, to the contrary, unfavorable.*” However, the researchers make the case that previous research on the subject is incomplete, in part, because the studies did not examine “*the time-series consistency of the return patterns.*” The work referenced here is an attempt to fill that gap while expanding on previous research in several ways.

The CJJM time-series study covered long-term stock returns (using daily returns of the CRSP NYSE/Amex/NASDAQ value-weighted total-return index) following changes in monetary policy that were clearly signaled by the Fed in the period from July 19, 1963 to January 2, 2001. Returns were separated into the 21 separate monetary periods (and further into three relatively equal sub-periods) that occurred during the approximately 38-year study period. For each period, returns were measured from the day after a two-day announcement period through the day prior to the subsequent change in policy in the opposite direction. Omitting the two-day announcement period was part of a conservative approach designed to make the results consistent with an investable strategy. ***One other unique and important aspect of the work was utilizing changes in the discount rate, as opposed to the fed funds rate, as the primary measure of Fed policy.*** Amongst several advantages of this approach cited by the authors, the discount rate, unlike the fed funds rate, has been used throughout the Fed's history and can therefore be applied to the entire time-series returns. In addition, the Fed has indicated in the past that discount rate changes (which typically occur less often than changes in the fed funds rate) serve as signals of the Fed's general long-term monetary policy. A partial summary of the results follows:

Table 1 shows the results of the analysis of stock performance by periods with the results for the full sample period (Policy Periods 1-21) indicating, according to CJJM, “*the superior investment perform-*

Table 1

U.S. Stock Market Performance: Full-Period (1963-2001) and Subperiod Results

Monetary Policy Period	Annualized Return or Yield			Standard Deviation	
	Restrictive Period	Expansive Period	Return or Yield Difference	Restrictive Period	Expansive Period
<i>A. Annualized U.S. stock returns and standard deviations</i>					
Periods 1-21	2.84%	21.86%	19.02%	14.49%	12.28%
Periods 1-8	3.60%	27.78%	24.18%	10.47%	8.05%
Periods 9-15	-1.54%	20.39%	21.92%	14.62%	12.80%
Periods 16-21	6.58%	21.01%	14.42%	17.63%	12.94%

Source: Financial Analysts Journal

ance of the stock market during expansive monetary policy periods.” In addition, per the report, “the economic significance of the return difference (19.02 percentage points per year)” is both distinct and statistically significant, two key factors in the analysis. The data also show that the standard deviation of returns was higher during periods when the Fed was tightening (adding additional support to the relative attractiveness of expansive periods for stocks).

Table 2

U.S. Stock Market Performance: Results by Monetary Period

A. Restrictive policy periods

Policy Period	Start Date	Annualized Mean Return	Standard Deviation
1	19 Jul 1963	11.79%	8.39%
3	22 Nov 1967	14.80%	9.99%
5	23 Dec 1968	-11.07%	13.51%
7	20 Jul 1971	-15.37%	12.19%
9	17 Jan 1973	-26.23%	18.30%
11	01 Sep 1977	14.16%	12.29%
13	30 Sep 1980	3.87%	14.32%
15	11 Apr 1984	12.51%	11.23%
17	09 Sep 1987	3.03%	18.79%
19	19 May 1994	22.55%	7.99%
21	26 Aug 1999	-2.91%	22.79%

B. Expansive policy periods

2	11 Apr 1967	14.79%	8.02%
4	20 Aug 1968	43.91%	5.28%
6	13 Nov 1970	36.21%	8.29%
8	15 Nov 1971	26.78%	8.47%
10	11 Dec 1974	21.27%	11.75%
12	02 Jun 1980	75.54%	12.43%
14	04 Nov 1981	13.80%	13.91%
16	27 Nov 1984	28.68%	11.44%
18	20 Dec 1990	13.64%	10.11%
20	02 Feb 1996	22.50%	16.08%

Source: Financial Analysts Journal

Table 2 provides additional insight by showing the annualized stock returns and standard deviations for each of the 21 monetary periods measured. According to CJJM, the results “demonstrate an impressive consistency in return patterns. In particular, **the minimum return in any expansive policy period is 13.64 percent** (Policy Period 18), which exceeds the return in all but three of the restrictive periods. Furthermore, four restrictive policy periods contain negative raw returns and two other periods contain returns below 4 percent.” There does, however, appear to be one aberrational period which stands out. Policy Period 19, which was restrictive, shows an unusually high mean return and a standard deviation that is unusually low. Despite this aberration, however, the authors note that “equity performance in the final two monetary periods (20 and 21) is consistent with the prior pattern of superior performance during periods of expansive policy and inferior performance during restrictive policy periods. Moreover, four of the last five policy periods are consistent with the long-run relationship.”

In an effort to provide additional perspective regarding monetary policy and its broad impact on stock prices, **Table 3** breaks out the mean stock returns in expansive and restrictive monetary policy environments for the six investment portfolios constructed by market capitalization (small versus big) and style (value versus growth). These results, like those cited earlier, point to a distinctly positive differential in annualized returns for each size/style group during periods of monetary accommodation (with the results being both economically and statistically significant for each sub-period measured). As highlighted in the report, “the return differences are economically large in all cases with the differences between the small-cap portfolio (Small) returns by monetary policy period much larger than the differences for the large-cap (Big) portfolios.”

Table 3**U.S. Investment Strategy Performance: Full-Period (1963-2001) and Subperiod Results**

Investment Strategy	Annualized Mean Return (all policy periods)		Expansive-Period Return minus Restrictive-Period Return			
	Restrictive Periods	Expansive Periods	All Policy Periods	Policy Periods 1-8	Policy Periods 9-15	Policy Periods 16-21
Small Growth	4.70%	33.32%	28.62pps	34.94pps	37.41pps	21.11pps
Small Blend	11.13%	41.85%	30.72	35.12	40.25	20.61
Small Value	16.68%	54.54%	37.86	31.13	46.36	30.31
Big Growth	2.24%	21.60%	19.36	27.78	22.38	12.92
Big Blend	5.04%	24.45%	19.41	19.06	28.06	13.36
Big Value	8.03%	27.06%	19.03	25.52	30.18	9.35

Source: Financial Analysts Journal

Table 4**U.S. Stock Market Sector Performance: Full-Period (1973-2001) and Subperiod Results**

Sector	Annualized Mean Annual Return (all policy periods)		Expansive-Period Return minus Restrictive-Period Return		
	Restrictive Periods	Expansive Periods	All Policy Periods	Policy Periods 9-15	Policy Periods 16-21
Resources	7.45%	16.67%	9.22pps	11.59pps	6.68pps
Basic Industries	0.01%	18.91%	18.90	18.83	17.99
General Industrials	1.96%	22.60%	20.64	26.55	14.35
Cyclical Consumer Goods	-8.96%	25.46%	34.42	45.16	26.28
Noncyclical Consumer Goods	8.78%	17.84%	9.06	13.12	1.87
Cyclical Services	-3.70%	22.93%	26.63	27.51	24.34
Noncyclical Services	5.84%	19.60%	13.76	11.98	14.54
Utilities	7.90%	15.32%	7.42	20.95	-4.25
Information Technology	-4.57%	26.99%	31.55	34.67	27.27
Financials	4.06%	22.72%	18.66	18.57	16.73

Source: Financial Analysts Journal

This differential has been highlighted by other research studies in the past and seems to, according to CJJM, “support prior claims (in other research studies) that small companies are more sensitive than large companies to changes in credit conditions.”

“Life is really simple, but we insist on making it complicated.”

— Confucius

The final data set highlighted here, **Table 4**, drills down beneath the surface to show mean returns for the 10 Standard & Poor's sector indexes utilizing industry return data from 1973 forward (which is the earliest date from which such data was available). According to CJJM, the numbers “speak for themselves” with the return differences showing consistency for all 10 sectors and statistical significance for 8 of the 10. In addition, the economic significance of the return differentials exhibit high statistical significance. Interestingly, though not surprisingly, the return patterns for the cyclical

sectors are most prominent while those for the non-cyclicals (i.e., utilities, resources and non-cyclical consumer goods) are less robust.

The results of the CJJM study would appear to support the view (Zweig's and others) that monetary policy remains a highly relevant factor impacting returns for diversified equity indices and individual market sectors. A strong case is made by the authors that stock returns are consistently higher and less volatile when the Federal Reserve is in an easing mode and that the monetary-policy related return patterns of companies considered to be most sensitive to changes in monetary conditions (i.e., cyclicals) are decidedly more pronounced than average patterns. Although our analytical focus here at WEDGE is decidedly bottom-up in regard to stock selection and portfolio construction, the CJJM research is not irrelevant to us or our clients (especially from an asset allocation perspective). In fact, given the distinctly modest price gains generated by a number of prominent major market indices over the

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past six to seven years, it seems plausible to anticipate that an eventual (and inevitable) reversal in Fed policy could begin to shift investor sentiment back in favor of stocks *in a broader sense*. **Unlike the tendency in past cycles, stocks with the largest market caps could lead such a rebound given that they have lagged the most in recent years. In particular, the valuations of many prominent large cap and mega-cap stocks now appear attractive.**

Although it is far from a given that the Fed will reverse course next year, the duration (18 months) and the magnitude (325 basis points) of the current fed funds tightening cycle, along with our interpretation of the official statements and minutes from recent FOMC meetings, suggests to us that the probability of such a policy shift by year-end 2006 is increasing. As a result, given the current healthy backdrop of record corporate profitability and very robust balance sheet liquidity (i.e., above norm cash positions and strong free cash flow generation), we believe a change of direction by the Fed *could* help embolden a relatively sizable contingent of cautious (risk-averse) investors who've avoided equities

in recent years. Such a potential improvement in investor sentiment might be especially relevant for diversified equity portfolios given the extreme narrowness of the 2005 broad market (where energy stocks, in particular, far outpaced all other sectors). In the meantime, regardless of what transpires at the Fed or with the broad market, we will continue to actively scour the landscape for mis-priced stocks possessing our preferred quantitative attributes; especially those appearing to exhibit an adequate margin-of-safety from both a valuation and balance sheet perspective. Like *tugging on Superman's cape and/or pulling the mask off the 'ole Lone Ranger*, overpaying for individual stocks (especially of low quality) is a risk we proactively attempt to avoid. It is this time-tested "all seasons" approach to stock selection that has, on average, served us and our clients well and that we will continue to rigorously employ in the years ahead.

As always, we appreciate your business and continued support. **Have a happy, healthy and prosperous New Year!**

Index	12/31/05 Price	4th Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	10717.50	1.4%	-0.6%
S&P 500	1248.29	1.6	3.0
Value Line Composite	412.50	0.7	2.0
American Exchange Comp.	1759.08	1.3	22.6
NASDAQ Composite	2205.32	2.5	1.4

**Does not include dividend income.*

Fixed Income

Show Me the Money!

This familiar line from the Oscar-nominated 1996 film *Jerry Maguire* continues to be a fixture in colloquial American slang. In the film, Cuba Gooding, Jr. portrays the egomaniacal but marginally-talented wide receiver Rod Tidwell (of the NFL's Arizona Cardinals), who is represented by former up-and-coming but now down-

on-his-luck sports agent Jerry Maguire (Tom Cruise). In the film's most famous scene, a highly animated Tidwell repeatedly implores Maguire, to "show me the money!" as he attempts to play Maguire off Bob Sugar, Maguire's former boss, who is supposedly wooing Tidwell to jump ship and re-sign with his firm.

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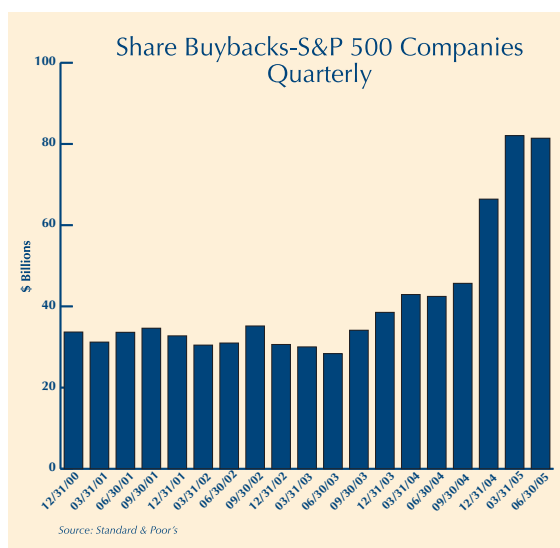


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In today's financial markets, investors (principally institutional shareholders) have, in a sense, begun to take on the persona of Gooding's flamboyant character. More specifically, after several years of significant balance sheet strengthening, robust cash flow growth and cash accumulation, shareholders are figuratively shouting "show me the money!" to a growing number of America's leading public companies. Interestingly, this rabble-rousing is being led, in several high profile cases (i.e., Time Warner and General Motors), by aging though still feisty corporate raiders of years past, namely Carl Icahn and Kirk Kerkorian. They, along with help from very aggressive and increasingly influential hedge funds and private equity firms, are publicly pressuring companies to return excess cash to shareholders, *sooner rather than later*.

Chart 1 graphically depicts the notable ramp in the amount of cash that has been returned to shareholders by S&P 500 companies in recent quarters. After hovering around a \$30-\$40 billion quarterly run-rate for three years, **share repurchase activity nearly doubled over the last three quarters measured**. During the same time frame, dividends have increased markedly as well, although at a rate of growth decidedly below that of buyback levels.

Chart 1



Bondholders are, of course, well aware of these emerging trends to enrich and/or placate restless

shareholders. As a result, the corporate credit markets are, where applicable, attempting to compensate (through higher debt spreads) for this emerging financial dynamic. However, **returning excess cash to shareholders isn't necessarily a problem for bondholders, as long as it does not impair a company's core creditworthiness**. Unfortunately, in some instances, companies have rewarded shareholders *at the expense of bondholders* by borrowing all or a part of the funds ultimately distributed to the stockholders.

A recent example of such a leveraged recap is instructive. DuPont, historically one of the strongest industrial credits in the U.S., announced in late October a very sizable \$5 billion share repurchase program, partially funded by an increase in debt. In response, all three major debt rating agencies (Moody's, Standard & Poor's and Fitch) lowered DuPont's ratings by two notches each, from low-AA to mid-A. In its press release explaining DuPont's downgrade, Fitch noted that "*The rating downgrades reflect DuPont's \$5 billion stock buyback announcement and willingness to maintain higher debt levels.*"

In recent quarters, we have observed such shareholder-focused corporate behavior evolving at what we believe is an unsettling rate. In addition, the increasingly prominent threat of leveraged buyouts, spin-offs or other recapitalizations is adding to the range of mostly bad outcomes that can transpire for corporate bondholders. To make matters even more complicated, although credit spreads in general have risen during 2005, they remain relatively narrow compared to recent historic averages.

As we have articulated on several occasions in past issues of *WEDGE Watch*, **we simply do not believe corporate bondholders are being adequately compensated for the risks present in today's marketplace**. As a result, we are maintaining a higher than average credit quality in client portfolios, while focusing on adding value in other market sectors (such as taxable municipal bonds) where we perceive a more favorable risk/reward backdrop.

