WEDGE WATCH

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A Measure of Time

"In times of change, learners inherit the Earth, while the learned find themselves beautifully equipped to deal with a world that no longer exists."
–Eric Hoffer, famed American author, known as the "Longshoreman Philosopher" (1902-1983)

Fourth Quarter 2006 Financial Statistics

DJIA: 12463.15

S&P 500: 1418.30

90-Day T-Bill: 5.01%

30-Yr. T-Bond: 4.81%

For an investor, the next best thing to a crystal ball would likely be a time machine. Had an opportunistic sort been fortunate enough to have access to such miraculous technology at the turn of the 20th century, he would have been able to predict, among many other things, stock market returns over the ensuing century. Assuming he seized the opportunity to travel forward in a sequential year-by-year progression to the threshold of the new millennium, he would have encountered several history-making events of monumental significance. Each of these incidents might have given even the die-hard optimist considerable pause regarding the future of mankind (e.g., Nazi concentration camps, Hiroshima and Nagasaki), not to mention the prospective long-term return potential for stock prices (i.e., The Crash of 1929). With the passage of time, however, his point of view would have become more balanced and less extreme. *It is typically only in looking back, over many decades, that one can gain important insight and perspective regarding how such jarring dislocations impact and shape the future economic landscape*.

With the benefit of perfect foresight, our time traveler friend, and his future heirs, would have been extremely well-served had they leveraged his wondrous information advantage by continuously owning a diversified basket of U.S. equities from the dawn of the 20th century to the threshold of the next. According to London Business School researchers Elroy Dimson, Paul Marsh and Mike Staunton (DMS), authors of *Triumph of the Optimists: 101 Years of Global Investment Returns*, (from which quotes and paraphrased extracts are highlighted in quotation marks), "**the U.S. stock market compounded at 10.1 percent per annum (on a total return basis) from 1900 through the end of the year 2000**. Adjusted for inflation, real returns compounded at 6.7 percent, which, when compared to the real return for U.S. Treasury bills (0.9 percent)," was undeniably quite impressive. However, *the fact that the U.S. economy was so remarkably successful over that time frame (growing to dominate the world economy and its capital markets), should give mindful fiduciaries pause, at a minimum, about extrapolating such healthy returns far into the future*. **Caution might be particularly warranted by those who adhere to the *school of thought* that argues the capitalistic preeminence and political clout of the U.S. has already peaked**, in part, as a result of the rise in economic power of hugely populous and ambitious countries like China and India.

From a theoretical perspective, the logic underlying such a cynical view regarding the U.S.'s supposed decline in global stature has some obvious appeal. One has to look only at the prolonged multi-year decline in the value of the U.S. dollar relative to a number of other major currencies to get a sense that something *might* be amiss here from a structural perspective. Taking this train of thought a step further, the most vocal *bears* on the U.S. economy have been known to emphatically cite the situation in Iraq as just another profound example of America's waning influence and prestige. We could go on but you

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Time

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get the drift. The point here is not to denigrate our great country, however, or to create undue cynicism regarding the future of the U.S. economy. We articulate this pessimistic line of reasoning simply to help provide context for fiduciaries faced with crucial country and style allocation decisions vis-à-vis the long-term outlook for U.S. stocks and other equity markets around the globe. A look back to a specific example at the dawn of the 20th century may help provide important insight regarding the potential implications for investors if this dour view ultimately proves accurate.

At the beginning of 1900, despite emerging challenges from the U.S. and Germany, the United Kingdom (U.K.) remained the world's leading economy and foremost beneficiary of its pioneering push to industrialize in the early 1800s. Not surprisingly, *"the U.K. equity market was also the largest in the world at the turn of the 20th century,"* dominating what was then only an emerging U.S. equity market. "At the time, there were nearly 800 companies quoted on the U.K. exchange, over six times as many as quoted on the NYSE. In addition, the market capitalization of London-quoted equities, using the dollar-pound exchange rate at the time, was $4.3 billion, an amount over 50 percent greater than the value of NYSE-quoted stocks." This lofty position of wealth and influence, methodically and carefully built over several centuries would, nevertheless, ultimately prove to lack staying power.

British commercial supremacy arguably lasted until the outbreak of World War I (WWI) in 1914. Although Britain emerged among the war's victors, and her rule expanded further into new geographies as a result (including Iraq), the heavy costs of the war had undermined her capacity to maintain what had been the world's most vast and powerful empire. Despite that, Britain continued to hold sway over approximately 450 million people, or roughly one-quarter of the world's population. Basking in the tenuous but still bright glow of victory after the war, it was said that *the sun never sets on the British Empire* as, given its remarkable geographic spread, some territory, somewhere, was always experiencing the light of day. Unfortunately for the Queen, however, a seemingly unrelenting darkness would soon begin to slowly and surreptitiously envelope the Monarchy and its people.

Today, a thoughtful and introspective student of history and economics might conclude that the U.K. of 1900 shares important and potentially ominous commonalities or parallels with the modern day U.S. For example, as the British did at the turn of the 20th century, the U.S. controls the world's greatest concentration of wealth, while simultaneously dominating the globe's rapidly growing capital markets. In addition, it presides over the world's strongest military machine and exhibits (in the minds of some) an expansionist and/or interventionist penchant militarily and politically (e.g., the U.S. military invasion of Iraq), just as the British did during the early years of the last century. *Though these supposed parallels might be debatable, in an effort to make an important point, let's assume that distinct and important similarities do, in fact, exist.*

Despite its hard won stature as the world's dominant financial superpower in 1900, the U.K. would soon embark on a harrowing walk in the wilderness, characterized by a slow and agonizing decline of influence and wealth. Although they were on the winning side of both WWI and WWII, the toll taken was sizable. The resulting economic and political stress led to "decolonization and the subsequent dissolution of Britain's incomparable Empire. Yet the government and its people were slow to come to terms with the country's diminishing global role. Against that backdrop, the U.K. continued to overstretch itself in cash and resource-draining areas such as defense, while also suffering severe economic, labor, productivity and investment problems. Of great consequence economically, these problems were not properly addressed until the late 1970's. As the world's first country to industrialize, the U.K. would eventually develop deeply-rooted legacy problems as its industrial economy matured; an unfortunate by-product of its unrivaled economic success in decades past." (Close followers of General Motors and the U.S. auto industry may recognize this all too familiar and predictable outcome.) Noted British economist and current President of Queens' College (Cambridge), John L. Eatwell, summed it up this way in his 1982 book *Whatever Happened to Britain? The Economics of Decline:*

The weakness of the British economy… is the cumulative product… of the entire history of Britain since the end of the nineteenth century, when it first became evident that Britain was unable, or unwilling, to adapt to a competitive world in which her pre-eminence could no longer be taken for granted.

Suffice it to say, the less than rosy picture just described shouldn't strike an educated observer, at least at first blush, as an immensely fertile backdrop for U.K. stocks across the entire span of the 20th century. With that in mind, *let's take the side of the naysayers and assume that today's relatively mature U.S. economy will confront similar challenges and consequences over the next 50 years, if not longer. How might such an economic malaise impact U.S. stock prices in the decades ahead?*

Although the U.S. economic experience of the 20th century was far more favorable than that which evolved in the U.K., their investment record from 1900 to 2000 was, surprisingly and quite remarkably, nearly as robust as that posted here. According to DMS, *"cumulative returns for U.K. equities (10.1 percent per annum) actually matched absolute returns for U.S. stocks, with real returns compounding at a slightly lower comparative rate (5.8 percent vs. 6.7 percent),* as higher inflation was a more negative drag in the U.K."

Like U.S. stock prices, the U.K. equity markets had to digest two major wars and a global depression during the first 50 years of the century. However, "unlike the U.S., which experienced its worst stock market returns during the depression of the 1930's, the steepest decline in U.K. equity prices occurred during the 1973-74 Middle East oil crisis. The resulting runaway inflation, triggered by the upward spiral in energy costs, crushed an already stressed U.K. economy which was being throttled, in part, by rampant labor unrest, poor economic management and misguided monetary policy."

Eventually the clouds would dissipate, however, and ***mean reversion*, the value investor's most trusted ally, would characteristically kick in, near the point of maximum pain,** vindicating the rattled but tenacious holder of U.K. stocks. In fact, "in 1975, the year after the U.K. market made its low, U.K. equities rose an astonishing 97 percent on a real return basis. Even more impressively, from the 1974 bottom of that savagely brutal bear market, dollar gains on U.K. stocks through year-end 2000 exceeded all other major stock markets worldwide."

We know from experience that **long time horizons pay the best dividends for investors in common stocks**. There is just too much randomness in any given year to confidently predict returns over such short time intervals. The nervous investor who reactively *zigged and zagged* in and out of the market in a knee jerk emotional response to headline grabbing world events would, most likely, have woefully underperformed the broad market over any extended period during the 20th century.

A sobering statistic recently cited by mutual fund industry veteran Jack Bogle is a good example of what can happen when investors rely on market timing instead of purposefully and patiently remaining fully invested for the long-term. According to Bogle, *from 1983 to 2003, S&P 500 index funds compounded at 12.8 percent while the average mutual fund gained 10.0 percent per annum. However, the average holder of mutual funds generated per annum returns of only 6.3 percent, a stunning relative shortfall*.

"The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay this propensity the appropriate toll."
–John Maynard Keynes, British economist and investor (1883-1946)

Emotions triggered by *fear* and *greed* are without question the worst enemy of investors, professional and amateur alike. In the case just cited, a tendency to trade in and out of funds at precisely the wrong time led to a substantial loss of compounding power during one of the modern era's greatest bull market runs. The average holder of mutual funds would have been far better off (at least financially) had he or she spent those same 20 years on a remote island somewhere in the South Pacific, entirely cut off from the noise and hyperactivity of Wall Street. **In today's world of real-time, global interconnectedness, easy access to information can often do investors more harm than good.**

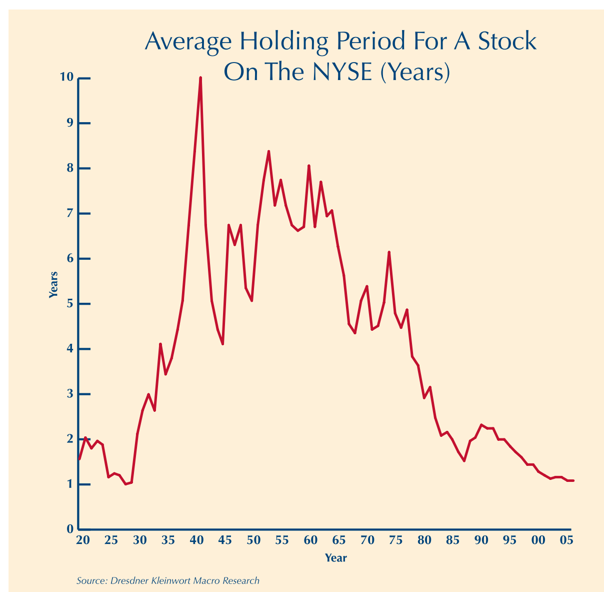
Although there is no such thing as a "holy grail" in the realm of investing, nor is a *time machine* at the portfolio manager's disposal, there are certain *controllable variables* that can give investors a decided leg up over time. Though even the most disciplined

and well-conceived value-oriented approach can produce periods of relatively extended underperformance, the true value investor understands this implicitly and, as a result, gears his or her strategy to incorporate time horizons of sufficient duration to trump this drag over time.

"Patience is the companion of wisdom."
–Saint Augustine (354-430)

In a study highlighted in a recent report by *Dresdner Kleinwort's* Chief Global Equity Strategist, James Montier, *it was found that value managers were by far the most patient holders of stocks,* with holding periods averaging 5 years, versus an average holding period of only 11 months for the archetypal portfolio manager **(see Chart 1)**. Apparently the majority of investors, institutional and amateur alike, underrate (or don't fully comprehend) the inherent benefits of patience and extended time horizons. That, of course, is perfectly fine with us here at WEDGE as **we believe our willingness to sit while others maniacally churn will remain a key *point of separation.*** *No time machine needed here (though that would certainly be nice), just a fair measure of common sense, patience and intestinal fortitude - scarce and valuable commodities indeed.*

Chart 1



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

Stock Market

A Look Ahead

Among the many things we have to be thankful for heading into the New Year, 2006 stock returns could easily make our Top Ten list. Although broad-based indices such as the S&P 500 produced very solid mid-teens total returns last year, *value* once again led the *style parade*, with key value indices up, on average, over 20 percent (on a total return basis). These robust and above-average returns are a continuation of an eye-catching trend for stocks that has been in place now for nearly four years. (Through year-end 2006, the S&P 500 has compounded at 18.3 percent off its 3/11/03 low.) More specifically, according to *Ned Davis Research* (NDR), **we are in the midst of the longest rally since 1926 (using the DJIA as a proxy) without a material correction in stock prices (see Chart 2)**. As NDR recently cautioned, however, "the market almost never goes five years without a cyclical bear market." In fact, "history shows that *normally* there is a cyclical bear market at least once in a four-year *Presidential Election Cycle*."

Chart 2

Longest Rally Without A 9.6 Percent Correction Since 1926

Begin Date	End Date	# Days	% Gain
03/11/2003	12/19/2006	1379	65.75
10/11/1990	01/31/1994	1208	68.21
07/24/1984	08/25/1987	1127	150.55
04/04/1994	03/11/1997	1072	97.17
06/26/1962	05/14/1965	1053	75.38
12/04/1987	07/16/1990	955	69.79

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As we've highlighted in the past, the Presidential Election Cycle has been remarkably consistent over the years, with the third year of the cycle (2007 in this case) historically producing the best returns for stocks (since 1888, the average percentage gain has been 11.2 percent).

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So far this cycle, the historic trend appears to remain intact, *although 2006 was much stronger than usual from a cycle perspective*. With that said, *if* stock prices continue to follow the typical pre-Presidential Election year trends, the broad market should produce solid gains in 2007. According to NDR, **"the S&P 500 has closed higher the last 14 pre-election years."**

Although we remain cautiously optimistic regarding the outlook for stocks in 2007, we would not be surprised if something "out of left field" derailed this powerful rally *on an interim basis*. Key plusses appear to abound, however. In particular, the domestic economy continues to grow, although at a decelerated rate, without obvious signs of meaningful inflationary pressures emerging. If this slowing growth trend continues, it would not be unreasonable to assume that the Fed is done tightening for this cycle (an environment which typically triggers multiple expansion for stocks). In addition, global liquidity appears to remain quite ample, with private equity deals continuing to proliferate. Adding potential stability to this backdrop, a relatively divided Congress is unlikely to harm investors via higher taxes this year or next. Nevertheless, *a sustained and material move up in stock prices from here would potentially increase the market's vulnerability to a meaningful, though not likely fatal, setback*. In the mean time, **we remain close to fully invested, with an increasing bias, from a valuation perspective, in favor of mega-cap value**.

Index	12/31/06 Price	4th Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	12463.15	6.7%	16.3%
S&P 500	1418.30	6.2	13.6
Value Line Composite	457.77	7.4	11.0
American Exchange Comp.	2056.43	7.8	16.9
NASDAQ Composite	2415.29	6.9	9.5

**Does not include dividend income.*

Fixed Income

Friends in Low Places

In 1990, Garth Brooks released his second album, entitled "No Fences." Brooks and his album went on to achieve stunning success, largely due to the music's wide crossover appeal. Cutting across a variety of music genres, more than 10 million copies of "No Fences" were sold by 1993.

One of the more memorable tracks on the album was the song "Friends in Low Places." Bond investors today can definitely relate to *low places*. How, you may ask? Well, many current bond market characteristics seem to fit that description to a tee. First, **Treasury yields**, as measured by the 10-year constant maturity yield, **are near multi-decade lows (Chart 3)**. These low yields reflect the abundant supply of liquidity and, most importantly, the very **low inflation expectations**

Chart 3

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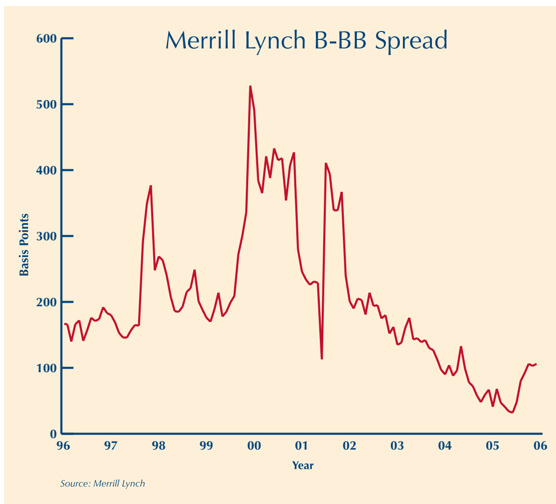
embedded in the current market. Second, as we have pointed out many times, **credit spreads are quite tight**.

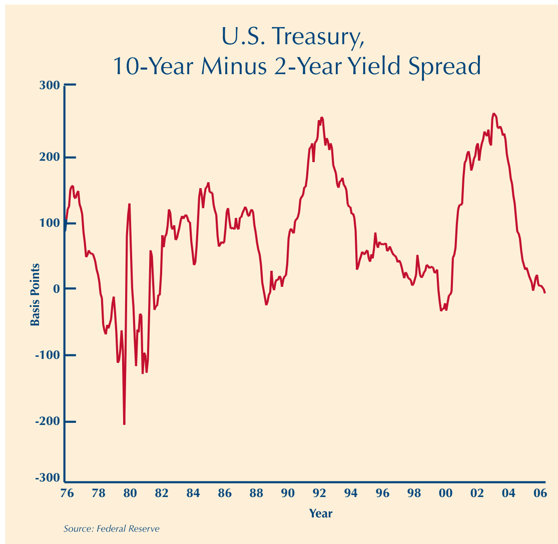
Even within the high-yield marketplace, spreads between more risky and less risky issues are meaningfully compressed versus history. **Chart 4** shows the yield spread between the B-rated and the BB-rated sectors. As can be seen, this spread is remarkably narrow compared to prior periods.

Chart 4



There are several other *low places* confronting bond investors. Last quarter, we pointed out **how mild interest rate volatility has been** (and continues to be). Additionally, **corporate default rates have approached historic lows**. Not to be outdone, the **yield spread between the 10-Year and 2-year Treasury is tight - so tight, in fact, that it is negative (Chart 5)**. *Low places* can also be used to describe bond returns in recent years - *the three- and five-year total return numbers for the Lehman Aggregate Index have been roughly 3.7 percent and 5.0 percent, respectively*.

Chart 5



We don't mean to imply that each of these *low places* is necessarily bad. In fact, bond investors would prefer several of these *friends in low places* stick around a while longer, such as inflation expectations, default rates and interest rate volatility. *But if any or all of these begin to rise, the move could be quite unfriendly to a broad spectrum of bondholders*.

Over the past several quarters, we have been preparing client portfolios for what we think will be an eventual move by some of these *friends in low places* toward higher ground - namely, the *yield curve slope*, *credit spreads* and *volatility*. While we don't profess to know exactly how the future will unfold, we suspect some sectors of the bond market have grown too comfortable with one or more of these so called friends. **And if what we suspect might happen ever comes to fruition, some bond investors may begin to recall the adage, "…with friends like these, who needs enemies."**

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