

May 3, 2004

This is the May 2004 monthly Wealth Management newsletter from Hoffman, White & Kaelber Financial Services, LLC. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular monthly basis by sending their name and email address to info@hwkfs.com. Feel free to forward this to any of your friends who may find it useful. Thanks for your interest and I hope you enjoy the letter.

Which way is the stock market going? Which way are bonds going? Commodities? Real estate? Where should I invest?

"Would you tell me please, which way I ought to go from here?"

"That depends a good deal on where you want to get to," said the Cheshire Cat.

"I don't much care where--" said Alice. "--So long as I get somewhere," she added.

"Oh, you're sure to do that," said the Cat, "if you only walk long enough."

---Lewis Carroll, Alice's Adventures in Wonderland

As mentioned in our prior newsletters, we strive to provide articles on various aspects of wealth management to assist your understanding of why planning for the present and for your future has importance. Yes, we also promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience. (This month we delve into some of the more technical aspects of investing. Please let me know if this level of discussion is helpful or not. Keep those referrals coming! We love it!)

Successful investing for the next several years will require you to think very differently than most investors have in the last twenty years. We started the last bull market with high interest rates, very high inflation and low stock market valuations. All elements were in place to launch the greatest bull market in history. Now, we're in the opposite environment. Potential run-away inflation is knocking at the door, the stock market has high valuations, interest rates have nowhere to go but up, the dollar is dropping all with budget and trade deficits staring us in the face.

In this letter, we will discuss our view and strategy in navigating through these market trends and, as always, we finish with an update on our investment activities.

**Which way is the stock market going? Which way are bonds going?
Commodities? Real estate? Where should I invest?**

Both stockbrokers and mutual fund sales people will tell you, "Now is the time to buy stocks! You can't time the markets, so you should buy and hold for the long term and not worry about the short term drops." This advice has been the same year in and year out and has been wrong about half of the time.

My favorite economic analyst, John Mauldin, whose work contributed significantly to this newsletter, reflects that "there are long periods of time when stock markets go up or sideways and long periods of time when markets go down or sideways. These cycles are called secular bull and bear markets." By *secular*, Mauldin means ten to twenty year's time. "Each cycle favors different types of investing opportunities." Mauldin believes, and I agree, "We are currently in the beginning of a secular bear market." The problem is that the products stockbrokers and mutual fund sales people sell do not do well in secular bear markets.

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In secular bull markets, risk taking is more easily rewarded and many adventuresome investors focus on investments that offer **relative returns**. By that I mean they look for investment opportunities that offer the potential of performing better than the market averages. If you can consistently beat the market averages you are doing well.

In secular bear markets that same strategy can be a prescription for disaster. If the market goes down 20% and you go down only 15%, Wall Street proclaims your performance to be “winning”. However, you are still down 15%. For years 2000, 2001 and 2002 the average annual return was down 15%. And, during that time, most adventuresome “stock market only” investors saw their portfolios cut in half or worse.

In markets like those we face today, the focus should be on **absolute returns**. Your benchmark is a money market fund. Success should be measured in terms of how much you make above Treasury Bills. In secular bear markets, success is all about controlling risk and carefully and methodically compounding your asset returns.

Inflation – Interest Rate – Stock Market Connection

Inflation is defined as a sustained rise in overall price levels. As the economy grows, businesses and consumers spend more money on goods and services. In the growth stage of an economic cycle, demand typically outstrips the supply of goods, and producers can raise their prices. As a result, the rate of inflation increases. If economic growth accelerates very rapidly, demand grows even faster and producers continually raise prices.

In the U.S., inflation is often described as “too many dollars chasing too few goods” in other words, as spending outpaces the production of goods and services, the supply of dollars in an economy exceeds the amount needed for financial transactions. The result is the purchasing power of a dollar declines.

What Causes Inflation?

Rising commodity prices are perhaps the most visible inflationary force because when commodities rise in price, the cost of basic goods and services generally increases. Higher oil prices, in particular, can have the most pervasive impact on an economy. Higher oil prices mean first, that gasoline prices will rise. This, in turn, means that the prices of all goods and services that are transported to their markets by truck, rail or ship will also rise. At the same time, jet fuel prices go up, raising the prices of airline tickets and air transport; heating oil prices also rise, hurting both consumers and businesses.

By causing price increases throughout an economy, rising oil prices take money out of the pockets of consumers and businesses. Economists therefore view oil price hikes as a “tax,” in effect, that can depress an already weak economy. Surges in oil prices were followed by recessions or *stagflation* – a period of inflation combined with low growth and high unemployment – in the 1970s, 1980s and early 1990s.

How Does Inflation Affect Investment Returns?

Inflation poses a “stealth” threat to investors because it chips away at real savings and investment returns. Most investors aim to increase their long-term purchasing power. And, inflation puts this goal at risk because investment returns must first keep up with the rate of

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inflation in order to increase real purchasing power. For example, an investment that returns 2% before inflation in an environment of 3% inflation will actually produce a loss of 1% when adjusted for inflation.

If investors do not protect their portfolios, inflation can be harmful to fixed-income returns, in particular. Many investors buy fixed-income securities because they want a stable income stream, which comes in the form of interest payments. However, because the rate of interest on most fixed-income securities remains the same until maturity, the purchasing power of the interest payments declines as inflation rises.

Inflation can adversely affect fixed-income investments in another way. When inflation rises, interest rates also tend to rise either due to market expectations of higher inflation or because the Federal Reserve has raised interest rates in an attempt to fight inflation. When interest rates rise, bond prices fall. Thus, inflation may lead to a fall in bond prices, potentially reducing total returns on bonds.

Unlike bonds, common stocks have often been a good investment relative to inflation over the very long term, only if companies are able to raise prices for their products when their costs increase. Higher prices may translate into higher earnings. Yet, over shorter time periods, stocks have often shown a negative correlation to inflation and can be especially hurt by unexpected inflation. When inflation rises suddenly or unexpectedly, it can heighten uncertainty about the economy, leading to lower earnings forecasts for companies and lower equity prices.

So far this year, the CPI (Consumer Price Index) showed a 0.5% growth in inflation for January, 0.5% growth in February and 0.6% growth in March. The markets immediately seemed to multiply that information and project 6% to 7% inflation for the remainder of this year. The amusing part of this is 1) year over year inflation is still below 2%; 2) the first quarter of 2003 started off similarly before growth tapered off; and 3) much of the rise in inflation this year was from sources like apparel that are unlikely to be big sources for inflation in the future because there is significantly more capacity than being utilized.

Nowhere To Go But Up! Rates Will Rise, But When?

Two weeks ago, Fed Chairman Greenspan provided his most optimistic assessment yet on the US economy, saying, "growth has come into a period of more vigorous expansion." Even more important, **Greenspan hinted that the extended period of extraordinarily low short-term interest rates would come to an end.** "As I have noted previously, the federal-funds rate must rise at some point to prevent pressures on price inflation from eventually emerging," Greenspan told the Joint Economic Committee of Congress on April 21st.

Most people are aware that there is a government body that acts as a guardian over the economy - an economic sentinel who implements policies designed to keep the country operating smoothly. Unfortunately, most investors do not understand how or why the government involves itself in the economy. In the United States, the answer lies in the role of the Federal Reserve. The Fed, as it is more commonly referred to, is the gatekeeper of the U.S. economy. It is the bank of the U.S. government, and regulates the nation's financial institutions. The Fed watches over the world's largest economy and therefore is one of the most powerful organizations on earth. The Fed dictates economic and monetary policies that have profound impacts on individuals in the United States and around the world.

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Morgan Stanley Chief Economist Stephen Roach thinks the Fed should raise rates by 2%. Many economists are calling for the Fed to raise rates this week or in June, allowing rates to rise to a more "Natural" range of 3% to 3.5%. Recent Fed governor speeches seem to agree with this line of thinking. They suggest this, as the natural rate, because they feel interest rates should be at least 1% above inflation, which seems to be approaching 2% and rising (in terms of CPI).

While it is difficult to determine how and when the Fed will react, the recently released Kiplinger Letter forecasts that the Fed will raise rates in August or September. They say, "Look for a quarter percentage point increase in the benchmark federal funds rate, a move likely to be duplicated in December. Both moves will bring the rate to 1.5% by year-end from 1% now. In 2005, the Fed will keep ratcheting upward, about one hike every two months. That'll put the rate at about 4% by the middle of 2006."

How Does This Impact Stocks?

Michael Santoli, at Barron's, writes, "Bullish market analysts have been busily crafting arguments that stocks need not suffer as interest rates rise. A rough consensus among strategists seems to be that higher stock prices can coexist with rising rates. However, history is rather clear, though, in its verdict that stocks are at a disadvantage as monetary conditions tighten..."

Bear Stearns strategist Francois Trahan noted that the vast majority of all stock market appreciation since 1970 has occurred while market interest rates were falling. In months when rates were declining, the S&P 500 rose at an annualized rate of 6.9%. Whereas, in months when rates were climbing, that annualized return slipped to 1.4%...

The potential sting of higher rates, by one way of thinking, could be more intense this time around due to the all-time high proportion of financial shares in the broad stock market indices... Financial stock profits are reliably slowed down by higher rates... Financials make up about 22% of the S&P 500's market capitalization, compared to about 15% in 1994, the last time the Fed embarked on a tightening cycle. Yet, there's always a chance that the widely expected rise in rates will be forestalled, or that the adverse effect of tighter money won't exert a downward pull on stocks for some time."

Aside from interest rates, however, there's a separate concern for equity investors. The pace of economic acceleration and profit growth both appears to be cresting for the time being. The middling reaction to the acceleration on job growth and to generally stellar first-quarter earnings reports also prompts questions about whether the market has taken full account of this bounty and is preparing for less impressive results.

As stated earlier, "In markets like those we face today, where potential run-away inflation is knocking at the door, the stock market has high valuations, interest rates have nowhere to go but up, the dollar is dropping all with budget and trade deficits staring us in the face, the focus should be on **absolute returns**. Your benchmark is a money market fund. Success should be measured in terms of how much you make above Treasury Bills. Success is all about controlling risk and carefully and methodically compounding your asset returns.

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Hoffman, White & Kaelber Financial Services Investment Performance Update

This was an extremely interesting month! All market sectors posted negative returns for the month and hardest hit were long and intermediate-term bond and REIT (real estate investment trust) sectors. All but S&P500 and MSCI EAFE indices were below their beginning of the year values and US Treasury Bonds and REIT sectors exhibited 2 to 4.5 times their normal volatility. The markets, this past month, were very ugly indeed!

For the month ended April 30, 2004, our one-month performance is down 6.24% (our first down month), our three-month return is down 4.51%, our one-year return is up 12.87%, and our average annualized return since inception is up 13.50%. Our (since inception) risk profile has increased to +/-8.07%, which remains low relative to the volatility exhibited by all market indices over the same time periods except for Short-Term US Treasury Notes. As we have not increased our targeted risk, we expect this measure to steadily rebound lower in subsequent months. As well, this increased volatility experience impacted our Sharpe Ratio by bringing it down to a very respectable 1.55. Given, the extreme recent volatility in the markets, we continue to be very proud of our risk/reward record!

About Measuring Risk and Sharpe Ratios

Investment pros borrow a tool from the statisticians—standard deviation—to measure investment risk. It shows the **range** of returns that investments are likely to earn over a given period of time and it has two sides, the out-performance and the under-performance of an average rate of return.

For example, let's look at the S&P 500 Stock Index¹ and consider the average rate of return 12.1% and standard deviation +/-19% for 100 years. The standard deviation tells us that a relatively bad year for the Large Cap market overall would have been negative -6.9% and a relatively good year would have yielded a higher positive return 31.1%. The range from -6.9% to 31.1% corresponds to outcomes within one standard deviation of the 12.1% average. It captures 68 of the total 100 observations. If the trend of this previous century carries into the next, we might expect that 2/3 of the time; this collection of stocks will provide a return within this range.

The Sharpe Ratio is a commonly used measure of portfolio earnings quality. In short, the Sharpe Ratio is a measure of return achieved per risk taken. Sharpe ratios can be better than just looking at performance because it incorporates the issue of risk. Some would say it is a measure of a manager's ability to perform consistently. The number by itself, however, is hard for many to understand without comparing it to something.

Let's take a look at the S&P 500 Index for a quick comparison. The Standard & Poor's 500 Index is usually considered the benchmark for US equity performance. As the name suggests, the S&P 500 consists of 500 companies from a diverse range of industries. Contrary to popular belief, the S&P 500 is not a simple list of the largest 500 companies by market capitalization or by revenues. Rather, it is 500 of the most widely held US-based common stocks, chosen by the S&P Index Committee for market size, liquidity, and sector representation. For the last ten years, the Sharpe Ratio for the S&P 500 is less than 0.40 and it doesn't look much better when looking over the past thirty years.

HOFFMAN, WHITE & KAELBER FINANCIAL SERVICES, LLC
INVESTMENT MANAGERS & FINANCIAL ADVISORS

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Are you familiar with Morningstar, Inc.? They are a Chicago-based, global investment research firm, providing information, data, and analysis on the mutual fund industry. They say that a Sharpe Ratio of over 1.0 is "pretty good" and outstanding funds achieve something over 2.0. Using this "yardstick", we are more than pleased with our accomplishment to date.

For most investors, the Sharpe makes good intuitive sense because they not only hate to lose money but they often compare the returns to risk free investing. You owe it to yourself to understand and consider this measure when making investment decisions.

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