

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Perspectives On 2004 and Beyond

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Due to a 4th quarter rally, the stock market returned 12% in 2004. A fourth quarter gain of 10% has compounded with a 2% return in the first nine months to produce this 12% return for the year. As you can see, most of the return for the year 2004 was earned in the last three months, and even more specifically in the months of November and December, which delivered 4.5% and 3.5% returns, respectively. Looking back over the past five years, commencing in 2000 when the growth bubble burst, the stock market as measured by the S&P 500 has suffered cumulative unannualized losses of about 10%, making this comparable to the 1970-74 period in terms of 5-year loss. In this commentary we present some near and long term perspectives on capital market behavior, motivated by two primary concerns.

First, we hope that these perspectives can prove helpful to decisions going forward. Namely, you can decide if trends will continue or reverse, but first you need to know what the trends are. While some segments of the market have been clobbered, others have thrived. Despite a 10% gain for the year, technology stocks have lost 55% of their value in the past five years, with large cap growth technology suffering the most, chalking up an incredible 75% cumulative loss. By contrast, small and mid value companies are up over 120%, with the small cap value healthcare segment enjoying a whopping 670% cumulative increase in value over the past five years. Yes, it has been possible to make money in this market – and a lot of it. In the following, we describe a continuation of these trends in 2004, with small cap value earning 25%, while large growth stocks gained only 6%. You can decide whether we'll have more of the same in 2005.

Second, the search for investment manager talent puts a lot of emphasis on recent past performance. Unfortunately, in evaluating past performance, style is routinely confused with skill. After general market effects, the most important determinant of performance is style, followed by a distant third residual that we use to find manager skill. Detecting skill is tough for this reason. Although it's easy to confuse style with skill, it's hard to make good decisions once this mistake has

been made. As usual, style effects have been very strong in the recent past.

The following commentary puts recent market behavior into perspective for several time periods: 4th quarter, the year 2004, the last five years and decade, and the past 79 years. Understanding the past and learning from it is an important aspect for making solid decisions for the future.

Fourth Quarter 2004

As mentioned in the introduction, the fourth quarter of 2004 was very good, returning over 10%. To put this number into perspective, a 10% return earned each quarter for a year would accumulate to 46%.

Figure 1 on the next page provides a quick overview of the fourth market. In a nutshell, both size and orientation mattered. Small and mid-sized companies outperformed large companies. Within size groups, growth outperformed value, a reversal of what had occurred in the first nine months of the year.

Here's how to read the graph. The floating bars in the graph are Portfolio Opportunity Distributions (PODs) for each of nine styles and the total market. PODs are all of the possible portfolios that investors could have held in the indicated style. Note the

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middles of the bars, which are the medians. The median return for large value is 8.9%, for large core it's 7.2%, and so on. The best performing median is small growth with a 16.7% return, and the worst is large core with a 7.2% return. Also note the ranges of returns, representing the risk and opportunity in each style. As you would expect, the more volatile styles, like small growth, have a wider range.

Now turn your attention to the blue shaded area at the bottom of the graph, which shows the style profile of the S&P 500. Here we classify each stock in the S&P 500 into the nine style groups and show the aggregate dollar allocation. The S&P is currently 31.47% large value, 25.52% large core, 26.65% large growth, 7.83% mid value, 3.55% mid core, 4.91% mid growth, 0.01% small value, 0% small core, and 0.08% small growth. This is roughly 84% large, 16% mid, and 0% small, representing a large company tilt relative to a broad



market that is 65/25/10 (by our definition). The broad market style profile is shown as the red line in the bottom of the chart. This tilt hurt S&P performance in the quarter since smaller companies were in favor.

Lastly, the red dots in the chart show how the style sub-portfolios within the S&P fared against their respective style PODs. Note for example that the mid cap value companies in the S&P, treated as a separate cap-weighted portfolio, performed at the third quartile of the mid cap core POD: the stocks selected by the S&P committee in this style underperformed in the month. In fact, S&P stocks generally performed at or somewhat below median for every style, except small growth, but there is a negligible .08% allocation.

In summary, the S&P's large company orientation in the quarter hurt performance, plus stock selection in mid cap value also subtracted value. Yes, the S&P is a managed portfolio; it's just managed by committee. The net result is shown in the far right bar, where the S&P has underperformed the broad market. Sometimes the S&P outperforms the broad market, and sometimes it underperforms. For purposes of evaluating investment performance, it's extremely helpful to know when and why.

These are important insights, but not when they're limited to just the S&P. The most important consideration is how your own portfolios stack up in this framework. We call this analysis a "wealth scan" because of its similarity to a "health scan." A health scan is an electronic comparison and evaluation of your internal organs relative to a norm. A wealth scan compares and evaluates your portfolio's sector and style composition relative to an appropriate benchmark.

The Year 2004

Now let's look at the entire year 2004. Figure 2 summarizes style and sector results for 2004.

Large companies lagged in the year, returning 9%, while small- to mid-sized firms earned about 20%, which is more than double the large cap return. There was a substantial premium earned by investors in smaller companies. Value stocks performed best in the year, earning 18% vs 8% for growth stocks, another case of more than double. As mentioned in the introduction, small-to-mid value did very well,

Figure 1. Style Performance for S&P 500 (Quarter Ending 12/31/2004)

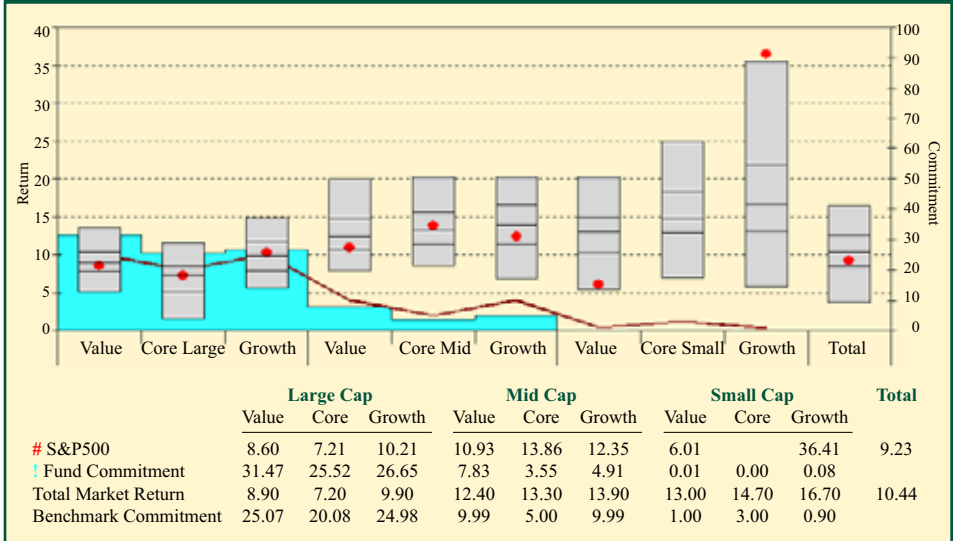


Figure 2. Style and Sector Returns for 2004





earning 25%, continuing the trend of the previous four years. In other words, style effects were particularly pronounced in the year.

On the sector front, value-oriented sectors Energy and Utility fared best, while growth-oriented sectors like Technology and Health Care lagged. It's worth noting that drug recalls at Pfizer and Merck struck the Health Care sector hard. Large Health Care companies earned 1% in 2004, while small- to mid-sized Health Care companies returned a much more respectable 14%.

Now let's extend our perspective back further in time, to incorporate the past five years and decade.

The Past Five Years and Decade

The year 2000, after March, saw the growth stock bubble burst, then 2001 followed with the terrorist attack on the twin towers, followed by 2002 with corporate scandals like Enron and WorldCom. Following these three years of disappointing markets, 2003 and 2004 have been respectively good and average. The good news recently has been stronger than expected productivity gains. All of these factors influence market segments in different ways. Figure 3 shows style and sector performance for the five years ending December 31, 2004.

As this exhibit shows, smaller company value investing has generally paid off, with small cap value delivering a whopping 25% per year, which compounds to 225% unannualized. By contrast, growth of all sizes has fared poorly, losing a painful 15% per year, which represents a cumulative 5-year loss of 55%. Note that this is a spread of 28,000 basis points in compound unannualized return.

On the sector front, Technology is the only sector in negative territory, suffering cumulative losses of 60%, or -16% per year. By contrast, Energy and Utility stocks have appreciated more than 10% per year.

These observations are of paramount importance to performance evaluators, who must make the important distinction between style and skill. A couple of examples will show how important this distinction is for periods ending December 2004, including the past decade.

Let's start by looking at a typical performance evaluation for a mystery manager. We'll disclose the mystery soon. In the following

Figure 3.
Annualized Style and Sector Returns for the Past Five Years



Figure 4, the manager is evaluated against an S&P 500 universe for periods ending December 31, 2004, using Portfolio Opportunity Distributions (PODs). A recent survey conducted by the Investment Management Consultants Association (IMCA) reveals that 96% of performance evaluators use the S&P 500 as the benchmark. As introduced above, PODs are all of the portfolios that a manager could have held when selecting stocks from a particular index, in this case the S&P 500. The answer to the question "What funds are in a POD universe?" is "All of them that matter."

As you can see from the Figure 4, this manager has performed very well and is, in fact, "off the charts" for periods longer than a year. Think we should allocate more assets to this good performer? Before you answer, let's

unveil the mystery. Look for the text under the chart in Figure 4.

There's a reason that this manager is off the charts. The manager has a style that has been in favor, namely small cap value. The following Figure 5 shows that this manager is just median (mediocre) when evaluated against the appropriate style. The lesson, of course, is that style matters. You should now be alerted to the fact that 2004 is no exception to this rule.

The struggles of the 2000-2002 stock markets have caused many to look to alternative investments, especially hedge funds, for higher returns; but despite the high costs involved and the significant demand, investors are mostly flying blind when it comes to hedge evaluation. Even investment consultants who help investors select among these funds readily admit that there is no way to scrutinize hedge



funds the way they would a less complex money management firm – that is, until now. The heart of the problem has been the fact that traditional performance evaluation approaches simply don't work for hedge funds. That's attributable to two basic truths:

- Traditional peer groups and indexes are poor benchmarks for traditional performance evaluation.
- Traditional peer groups and indexes are simply a joke for non-traditional performance evaluation.

To solve these problems, performance evaluation in general – and hedge fund performance evaluation, in particular – should be viewed as a hypothesis test where the validity of the hypothesis “performance is good” is assessed. To accept or reject this hypothesis, we construct all of the possible outcomes and see where the actual performance result falls. If the observed performance is toward the top of all of the possibilities, the hypothesis is correct; and performance is good. In other words, PODs are what it takes to fairly and accurately evaluate hedge fund performance.

So how does this recent past fare against the long-term history of the market? Let's take a look.

79-Year History

Figure 6 chart plots real (in excess of inflation) returns on the S&P500 over the past 79 years. The 1990s are shown in green, and the 2000s are shown in blue. As you can see, returns are not distributed in the bell-shaped curve known as a normal distribution. For example the mean return of 7.3% is to the left of the mode (most frequent return), which is between 10%-20%, and the left side is fatter than the right. Readers using mean-variance optimizers should take note. Also observe that the past five years have generally been below average, with 2003 being the exception. The markets of the 2000s have not been kind to investors. Some have argued that this is because the 1990s were too good. As you can see, the 1990s never had a losing year below –10%, whereas three of the last five years have been to the left –10%. In the meantime, bond returns have been generally been dead-on normal, in the 0%-10% above inflation range.

Figure 4.
Rankings Against the S&P 500

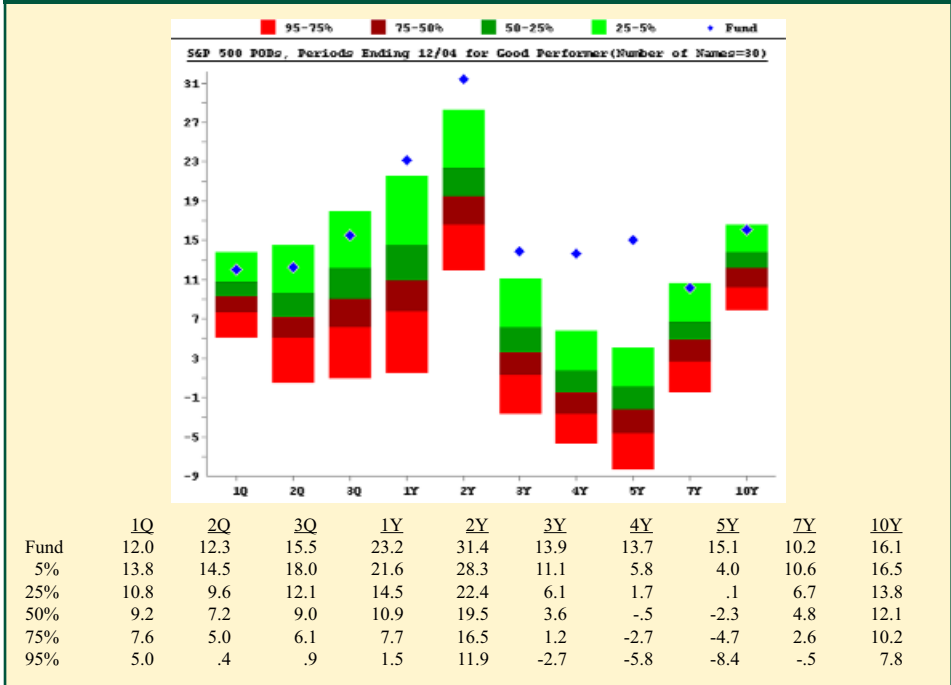


Figure 5.
Rankings Against the S&P 600 Small Cap Value

