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Briefing Note

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What a Ride!

Early in October, we concluded our 3rd quarter “*Chartwell Review*” with the suggestion domestic equity markets were poised to outperform Treasury bonds by 30+% over the next two years, through a combination of positive stock market performance and poor bond returns. We expanded on this thought in a November 3rd briefing note to clients, recommending that actual equity allocations should be raised to at least neutral target levels (most investment pools being quite underweight equities as the 4th quarter began).

The investment markets responded as if on cue during October and November, with the S&P 500 gaining 15.5% and the US Treasury Bond index falling 2.1% (long-term Treasuries are off 4%). We’re already more than halfway to fulfilling on the 30+% performance differential in two *months*, not years.

While the positive instant feedback is gratifying, this has all happened too fast for many funds to take advantage of. Those that didn’t begin a rebalancing effort during the 3rd quarter have seen the market only partially “re-balance their plans for them”. The pertinent question is what to do now?

First, some observations –

- The S&P 500 index rose from 777 on October 9th, to 936 at the end of November, for a 20% gain in less than eight weeks. The NASDAQ Composite advanced a breathtaking 33% during the same period. It would be very normal if the equity markets took some time to “consolidate” those gains (which may mean going down some);
- As investors bought stocks, they sold bonds. The 10-year Treasury’s yield rose from 3.61% to 4.21% during this same timeframe. This only partially reversed the 3rd quarter’s bond rally, and we don’t expect too much retracement;
- From a relative value perspective, the equity market still remains cheap compared to bonds based on trailing corporate earnings (the 3rd quarter numbers having come in as expected). The recent rally took our Fed Model stock/bond yield ratio down to 1.11 at the end of November (from an incredible 1.51 level in early October), but any number above 0.92 is statistically cheap;
- While this is purely anecdotal, we’ve observed a number of economically sensitive companies make positive noises about their near-term prospects. Perhaps as important, investors seem to actually believe them;



- Although Iraq has allowed UN inspectors, we are merely one week into a 10-15 week process. The “war card”, as we call it, is a long way from being played. We expect equity markets to undergo numerous mini-rallies and declines in the week’s ahead based on what is really partial information (if that). You’ll recall this occurred during the months preceding the Gulf War, but collectively amounted to just so much noise.
- Our economy continues to recover and grow gradually, with increasing corporate productivity evident. Inflationary pressures are low, as is the marginal cost of capital for many enterprises. Historically, this kind of environment has been conducive to increasing corporate profitability;

After distilling all these points, we **don’t** think it is appropriate to conclude you’ve missed “the move.” While it would have been great to take full advantage of the recent run-up in stocks and avoid the run-down in bonds, the overall medium-term thesis supporting a re-weight toward equities remains intact. If your investment pool remains underweight equity exposure compared to your neutral strategic asset allocation target, then we believe a shift is still indicated. We recommend adopting and executing a definitive program to close any equity underweight gap.

However, if the equity re-weighting still to be done is significant (>4%), we favor a patient approach. Break the re-allocation into at least two pieces, and complete the shift over the next few months. If the equity market does go through a normal consolidation phase in the weeks ahead, your later re-allocation(s) into equities will have been “bought low”.

It’s certainly possible the equity markets will extend their rally straight through December/January. These are traditionally favorable months for stock investing. If so, our patient approach would see your plan *gain less* than it could have. However, if the equity markets temporarily break down, a multi-tranche approach will keep you from *losing more* than you might have. At this stage, positioning oneself to gain less instead of losing more seems like the better risk.

- RDS