

Zemenick & Walker

Market Perspectives

An Investment Advisory Firm, Established in 1987

Summer 2004

Zemenick & Walker Investment Committee

Richard E. Zemenick
Chairman

James C. Walker
Vice Chairman

Chris G. Griesedieck
President

John M. Johnson
Executive Vice President

William C. Stude, III
Vice President

Bryan L. Schulz
Portfolio Manager

Jonathan A. Best
Portfolio Analyst

In This Issue

Rising Rates Dampen Bond Portfolio Returns	1
Focus on the Economy	1
Zemenick & Walker Launches New Website	2
Passive vs Active Investing	3
By the Numbers	4
Our Mission	4
Recommended Reading	4

Rising Rates Dampen Bond Portfolio Returns

By now the news is out...interest rates in the U.S. are well off their lowest levels and most mainstream analysts seem to agree that they could be heading significantly higher. We prefer to avoid speculating about the timing, magnitude, or even the direction of future movements in interest rates; however, in the current environment few people doubt that the long-term trend for yields will be upward. Even the Federal Reserve made it clear that its intention is to gradually guide rates upward (this is discussed in more detail in the article below, *Focus on the Economy*). Therefore, this is an opportune occasion to review with our clients the implications that rising interest rates have for their fixed income portfolios.

As the article's title indicates, rising interest rates do indeed "dampen" bond portfolio returns, at least in the short-term. However, long-term investors have nothing to fear. Each of their bonds will earn its original yield-to-maturity (YTM) as long as they are held until they mature and all of the coupons are reinvested at each bond's respective YTM. If the coupons are reinvested at rates higher than the original YTM, then the returns will be slightly higher and if they are reinvested at lower rates (or not at all), then the returns will be slightly lower than the original YTM.

Continued on Page 2

Focus on the Economy

After lowering the federal funds rate target 13 times between January 2001 and January 2003, reducing it from 6.50% to 1.00% in the process, the Federal Open Market Committee (FOMC) has finally reversed course. On June 30th Alan Greenspan and the rest of the FOMC raised the federal funds rate target by 25 basis points, from 1.00% to 1.25%. It was rather anticlimactic for such a significant event, as most market participants had been anticipating this move for some time.

The fact that the federal funds rate rose by a whopping 0.25% is not, in and of itself, particularly important. After all, at 1.25% the rate is still extremely low by historical standards. What is important is that the Fed acknowledged an intention to move the federal funds rate towards a neutral level "at a pace that is likely to be measured". Many experts presume a neutral rate to be somewhere in the neighborhood of four percent, a level that will certainly require many more incremental increases to reach. In the meantime, even with a bias towards tightening, America's monetary policy will remain quite expansionary.

The catalyst for this fundamental shift in monetary policy has been a steady flow of data releases indicating a robust U.S. economic expansion. In the three months prior to the Fed's decision the formerly lethargic labor market came roaring back to life, creating nearly 900,000 new nonfarm jobs. Moreover, at the time of the Fed's decision, all signs seemed to point to accelerating inflation. If an improved labor market indicated that the Fed *could* raise rates, then suddenly resurgent inflationary pressures meant that it *should*. It is appropriate to use low interest rates to attempt to revive a struggling economy, but once the economy resumes steady growth artificially low rates create an environment in which inflation thrives. However, several reports released subsequent to the June 30th meeting helped assuage fears of the imminent danger of soaring inflation and provided support for gradual rate increases rather than a speedier approach. The June jobs report was a big disappointment with "only" 112,000 jobs being created in contrast to the consensus forecast of 250,000. In addition the May core consumer price index increased by only 0.1%, the slowest pace this year ■

What is important is that the Fed acknowledged an intention to move the federal funds rate towards a neutral level "at a pace that is likely to be measured".

Rising Rates Dampen Bond Portfolio Returns

Continued from Page 1

However, between the purchase and maturity dates the fortunes of fixed income investors are subject to the implacable forces of the market. A bond's price is inversely related to the level of market interest rates. Therefore, assuming all else is constant, if market interest rates rise, then bond prices will fall. The opposite is also true. Thus, in a period of rising interest rates, a bond's total return will be reduced by its falling price, potentially even causing it to be negative. This is exactly what happened during the second quarter. In April rates rose sharply, causing many investors to have negative fixed income returns for the quarter. The graph below illustrates how this took place.

The black line represents the yield-to-maturity of a 4% coupon U.S. Treasury Note (UST) maturing 2/15/14 (roughly a 10-year investment at the beginning of the period shown on the graph). From the week of March 19th to the week of May 7th the bond's yield rose from 3.77% to 4.77%, a move of 100 basis points in less than two months (representing more than a 25% increase in yield). This was a very significant increase in rates for such a short period of time. As the red line on the graph demonstrates, this sharp rise in rates had a considerable impact on the UST's price. It fell from just under \$102 to \$94 over the same two-month period, a drop in price of nearly 8%! Since this time rates have fallen back from their highs, helping to mitigate the April losses suffered by fixed income investors. However, this still provides a good example of

the price volatility that even the highest quality fixed income securities can experience.

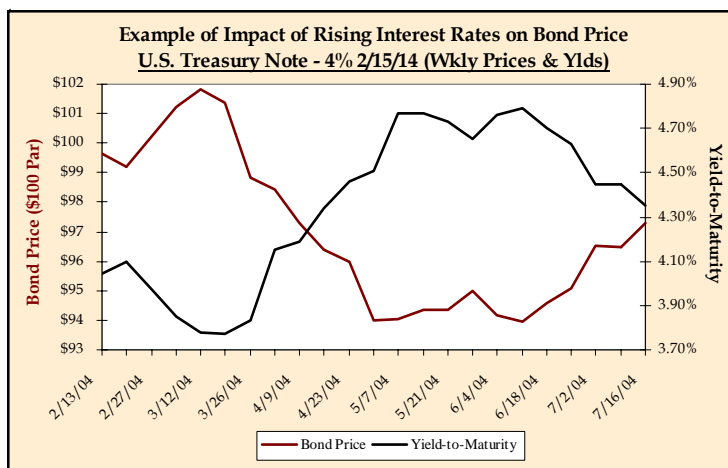
Some investors may wonder why they should be concerned that bond prices may fluctuate in the short-term given that they pay out their face value if held to maturity. Even buy-and-hold investors need to be aware of the impact rising interest rates can have on their portfolios, if nothing else but to simply adjust

This is exactly what happened during the second quarter. In April rates rose sharply causing many investors to have negative fixed income returns for the quarter.

their expectations for returns. Ever since the FOMC began lowering the federal funds rate in response to a weakening economy in 2001, interest rates have fallen markedly across the curve. This has helped enhance total returns (change in price + yield) despite the fact that lower yields reduced bond portfolio income (remember, falling interest rates mean higher bond prices).

As equities posted negative returns from 2000 through 2002, bonds helped to greatly reduce the overall volatility of diversified portfolios. Thus many investors did not see much of a drop in their overall portfolio values and may have even earned positive returns during one of the worst bear markets since the Depression for equities. Investors cannot always count on bonds to bail them out like this. In the next period of poor equity returns interest rates could very well be on their way up. This would produce a concurrent drop in equity and fixed income prices that would compound the losses for the total portfolio. Even though the losses on the bonds would eventually be offset, if they are held to maturity, this could make for some very high short-term volatility that diversified investors are not used to seeing in their portfolios.

Zemenick & Walker has always recommended clients structure their portfolios in such a way as to minimize the impact of rising interest rates on bond values. We recommend clients buy only high quality bonds (AA rated or higher), avoid bonds with maturities longer than ten years, and do not overload with zero-coupon bonds. This is because a bond's price volatility is higher the lower its credit quality, the longer its maturity, and the lower its coupon. Following this approach, of course, will not prevent bond prices from falling when rates rise, but it should help ease the pain ■



Zemenick & Walker Launches New Website

Good news for Internet users...Zemenick & Walker now has a presence in cyberspace. By September 30th www.zandw.com will officially be online. This new website will serve as an introduction to those who are not familiar with our firm - providing a history of Zemenick & Walker, bios of the principals, a detailed description of the services we provide to clients, contact information for further inquiries, and, for loyal *Market Perspectives* readers, an archive of previous newsletters.

[Visit Us Online
http://www.zandw.com](http://www.zandw.com)

We will provide current clients with passwords enabling them to login to the website. After logging in, clients will have the option to view their account holdings, which will be updated quarterly.

In addition, should they choose to do so, clients will be able to use the website as a central location for viewing all their financial statements. Bank statements, credit cards, and investment accounts can all be consolidated under their personal log in. More information about the website and the functionality it will offer to clients will be forthcoming ■

Passive vs Active Investing

Ever since Vanguard introduced the first index fund in 1975, investors have been debating the merits of passive versus active investing. Passive investing, more popularly referred to as indexing, has come a long way in just thirty years, garnering numerous highly respected proponents along the way. In fact, in the same year Vanguard unveiled the first index fund, Charles Ellis published his classic book *Winning the Loser's Game* (see *Recommended Reading* on page 4), in which he proclaimed that successful investing is more often a result of minimizing mistakes rather than maximizing winners. A recent convert to the school of indexing, Ellis believes most active fund managers are incapable of beating their benchmark indices over sustained periods of time.

His argument is not unfounded when one considers that for an active portfolio manager to outperform an index, he must beat the index's return by the amount of his management fee. For example, assume the S&P 500 returns 10.00% during a given year, and a portfolio manager charges 1.57% annually for his mutual fund, which is the average fee for actively managed U.S. diversified stock funds according to *Investor's Business Daily*. To simply break even with the S&P 500, that manager must generate a return of 11.57% before

We believe top-tier active management provides investors with a distinct opportunity to outperform the market...

fees. Given this scenario, the mutual fund would produce a net return to the investor of **10.00%** (11.57% - 1.57% expense ratio). In contrast, the Vanguard S&P 500 index fund charges investors roughly 0.18% annually. Thus, assuming the same returns as the example above, the index fund would provide a return after fees of **9.82%** (10.00% - 0.18% expense ratio).

Indeed, a case can be made for indexing, not only from a cost standpoint, but from a performance standpoint as well. Studies have proven that active portfolio managers struggle to beat their benchmark indices over extended periods of time. Tweedy, Browne & Co., a noted active portfolio manager based in New York reported that from 1982–1997, the S&P 500 outperformed over 90% of all surviving equity mutual funds. In fact, Tweedy, Browne admits, “Anyone in the investment management business who does not respect the challenge of low-fee index funds that rarely sell stocks and, therefore, rarely realize capital gains, is, as psychologists would say, in denial”. More recent studies, which include the volatile years just passed, are not quite as startling, but imposing nonetheless. The table below, based on a quarterly review conducted by Standard and Poor's, shows that over the past three years, only 34.46% of all large-cap blended mutual funds managed to beat the S&P 500 index. Surprisingly, according to the data, the strongest case for indexing can be made for small-cap stocks; the one area of the market in which steadfast indexers have historically believed active management could provide some benefit.

However, indexing does have its drawbacks. For one, how would you have felt about owning Enron, Global Crossing, or WorldCom as their corporate misdeeds surfaced? Index funds blindly held these positions because they were part of the indices being tracked. Active managers are paid to avoid such mistakes. Moreover, because most indices are capitalization based, as a stock price increases, it becomes a larger share of the index. This ignores the stock's intrinsic value. In other words, an index does not address the risk that a stock may be overpriced. In contrast, disciplined active managers can trim positions as their prices rise, minimizing the effect of sharp downturns.

Finally, despite all the studies orchestrated by the most astute indexers, the fact remains that an elite group of managers does consistently outperform the market. However, finding such managers requires access to resources and exorbitant amounts of time dedicated to in-depth analysis. Since we believe top-tier active management provides investors with a distinct opportunity to outperform the market, we undertake the research required to find them. As a result, our current active equity managers all have solid track records of outperforming their indices over extended periods of time. For a more detailed review of our current managers' long-term performance, please feel free to contact us directly.

We seek the following attributes in active equity managers, knowing these characteristics foster long-term success.

Low Turnover – Managers who trade positions frequently will incur higher trading costs, and a lower level of tax efficiency.

Low Fees – While it is understood that the research and analysis required for active management increases costs, fund managers should keep their fees low to provide higher net returns to investors.

Long-Term Focus – Focus should be on long-term performance with little regard to index composition. Managers who administer their portfolios around benchmark weightings become quasi-indexers.

Focus on Research – Managers should be willing to hold positions not in vogue with investors. The reason for paying active managers higher fees is to benefit from their research. If the research is not used to identify hidden treasures, there is no reason to pay for it.

Understandable Approach – Managers should have a clearly defined approach to investing, one that leads to a consistent strategy on both the buy and sell side.

Commitment – Managers should demonstrate commitment to success by investing their personal fortunes in the funds they administer ■

Percentage of Active Managers Who Outperformed Their Index

<u>Fund Category</u>	<u>Benchmark Index</u>	<u>1-Year</u>	<u>3-Year</u>	<u>5-Year</u>
All Large-Cap	S&P 500	41.04%	34.46%	47.70%
Large-Cap Growth	S&P/Barra 500 Growth	74.00%	14.29%	58.04%
Large-Cap Value	S&P/Barra 500 Value	15.96%	59.87%	43.92%
Small-Cap Growth	S&P/Barra 600 SCG	58.44%	11.58%	20.43%
Small-Cap Value	S&P/Barra 600 SCV	32.72%	52.32%	31.97%

Source: Standard & Poor's Indices vs. Active Funds Scorecard, First Quarter 2004

Our Mission

Zemenick & Walker is committed to providing superior investment advisory services to high net worth individuals, trusts, not-for-profit organizations, and retirement plans. As a fee-only, non-discretionary advisor, Zemenick & Walker eliminates potential conflicts of interest, giving clients a disciplined, business-like approach to the investment of their capital ■

Recommended Reading

We are happy to present a new feature in *Market Perspectives*...a forum for book reviews. We hope to not only let clients know what we have been reading, but also introduce them to investment-related books that we feel are particularly interesting and informative.

Winning the Loser's Game, by Charles D. Ellis

In his 4th edition of this remarkable investment classic, Ellis once again demonstrates keen insight as he explores concepts that are essential to both institutional and individual investors alike. We recommend it to all investors as a welcome refresher on many investing basics, such as the paramount importance of formulating written investment policies following comprehensive due diligence reviews. The book also stresses that taking a long-term perspective towards equities is essential to becoming a successful investor.

With his over 40 years of investment experience, Ellis' views on a host of other issues are also very interesting. Other topics discussed

at length are risk, returns, investment time horizons, building portfolios, performance management, and taking a balanced and realistic view towards the risks and rewards of investing. Ellis' 10 Commandments of Investing provide a clear and concise treatment of some of investing's most important principles:

- 1.) Don't speculate.
- 2.) Save.
- 3.) Don't do anything in investing primarily for "tax reasons".
- 4.) Don't think of your home as an investment.
- 5.) Never do commodities.
- 6.) Don't be confused about stockbrokers.
- 7.) Don't invest in new or "interesting" investments.
- 8.) Don't invest in bonds because you've heard that they are conservative or for safety of either income or capital.
- 9.) Write out your long-term goals, long-term investing program, and your estate plan and stay with them.
- 10.) Don't trust your emotions.

While we certainly do not agree with Ellis on everything (for example, index investing) his book is excellent and we recommend it to anyone looking to brush up on basic investment principles ■

By the Numbers

<u>Interest Rates</u> (Monthly since 1970)	<u>High</u>	<u>Date</u>	<u>Low</u>	<u>Date</u>	<u>June 2004</u>
Federal Funds Rate	20.00%	May-81	1.00%	Nov-03	1.25%
3-Month T-Bill	16.30%	May-81	0.92%	July-03	1.29%
10-Year Treasury	15.32%	Sept-81	3.33%	June-03	4.73%
30-Year Mortgage	14.67%	July-84	5.23%	June-03	6.29%
<u>Stock Indices</u> (Daily since 2000)	<u>High</u>	<u>Low</u>	<u>7/15/04</u>	<u>% from High</u>	<u>% from Low</u>
Dow Jones Industrial Avg	11,723	7,286	10,163	(13.31%)	39.49%
S&P 500	1,527	777	1,107	(27.53%)	42.43%
NASDAQ Composite	5,049	1,114	1,913	(62.12%)	71.70%
MSCI EAFE	1,774	857	1,308	(26.26%)	52.65%

This newsletter is for informative purposes only. Through this issue the publisher is not rendering investment advice. The information contained herein has been prepared from sources believed to be reliable, but its accuracy is not guaranteed. Opinions contained in this newsletter constitute the best judgement of Zemenick & Walker, Inc. but are subject to change without notice. Reproduction of this publication is prohibited without the express written consent of the publisher.