

Zemenick &
Walker, Inc.

Market Perspectives

An Investment Advisory Firm, Established in 1987

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Zemenick & Walker, Inc.

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The China Paradox

China seems to be everywhere of late. One can hardly open a newspaper or business periodical without seeing countless articles touting China's tremendous growth. The theme is recurring and popular - if not invested in China, an investor is missing a tremendous opportunity. In fact, veteran investor Jim Rogers went so far as to urge all Americans to teach their children Mandarin Chinese in anticipation of the future influence China will wield in global economic affairs.

Yet is the hype justified? Due to its size, location, population, and an abundance of raw materials and cheap labor, China has an edge on its neighbors. And economic growth has been rampant, as its economy has grown at a 9.5% annual rate for the past two decades. It is this growth in fact, that has tipped the scales of the global supply/demand equilibrium, as China's appetite for materials (particularly cement, oil, and steel) has far outpaced its own supply. *BusinessWeek* notes that since 1990, Shanghai has built enough high-rises to fill all of Manhattan. Add to this lax environmental regulation, a fiscally stimulative government, and a motivated population, and China would seem to be poised for economic growth for some time to come.

On a macro level, a strong case can be made to look closely at China as a potential investment. However, it may not be the paradise it is often described to be. As the table on the following page demonstrates, the Chinese stock market has not rewarded investors despite the country's impressive growth. Since the end of 2000, the SE Shang composite index has fallen at a *Continued on Page 2*

Focus on the Economy

September 20th marked the 11th consecutive meeting of the Federal Open Market Committee (FOMC) that ended with an increase in the federal funds target rate. After raising the target to 3.75%, the Fed is showing no intention of halting the string of rate increases. This announcement came at a time when various economists were uncertain of the path that the Fed would take in light of Hurricane Katrina. However, in their statement, the FOMC asserted that the disastrous events along the Gulf "do not pose a more persistent threat." Economists predict that the Fed will continue to raise rates to a neutral level, one that neither stimulates nor depresses the economy, a rate many predict to be around 4.50%.

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Most economists identify the balance between economic performance and inflation as a pressing short-term issue. It seems inevitable that the recent events in the Gulf of Mexico, in conjunction with the current status of oil prices, will slow the economy. To stimulate the economy the Fed would normally keep rates the same or lower them. Doing this increases borrowing, thus boosting spending and output. However, most post-Katrina projections show that the economy should only be affected in the very short term, and in fact, the 2006 projected growth rates have stayed the same. Therefore, the Fed would rather combat potential rising inflation by sticking to its original plan to raise interest rates. Still in question, again, is just how high the FOMC will raise rates in the future.

Whereas short-term worries appear to be fairly tame, longer-term concerns continue to mount. High gas and oil prices are predicted to level off, but keep climbing slowly. The *Continued on Page 3*

The China Paradox

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rate of 10.6% annually, underperforming every other index shown on the table, representing the European, U.S., and selected Asian markets. Yet a struggling stock market is just one of the many challenges facing investors in China. Remember communism? Well, China is still a communist country. Its major corporations are state-owned. *The Economist* reported in February 2005 that when the government launched the Shanghai exchange in 1990, only minority interests in poorly run state firms were sold to investors, with the government retaining upwards of 70% of most companies. Due to this high level of government ownership, only about \$150 billion of the \$500 billion Chinese market is even open to foreign investment. On top of this, the best government-owned companies in China have thus far not been privatized.

Richard Chenevix-Trench of the London investment firm Sloane Robinson LLP recently stated at a Greenwich Roundtable Symposium that the Chinese government often fattens the earnings of state-owned companies prior to public listing. Company shares are then sold to unsuspecting investors at a premium to their actual worth. This cash is then frequently diverted to other areas of the economy and businesses in order to help them look better for the next IPO. In other words, the government (the majority shareholder) views equity as free money, readily dispensable for any purpose. This obviously represents a major challenge for investors, as the interests of management and the majority shareholder are rarely aligned with their own. Moreover, corporate governance in China is virtually non-existent. While we have experienced our own problems with corporate governance in the U.S., China's predominantly state-owned companies are audited by the government itself. This is certainly a glaring conflict of interest that leaves doubt as to the accuracy of corporate financials.

Investing directly in China should certainly give one pause. But how successful have multi-national corporations been in their ventures into the country? Might it make sense to purchase a large multi-national doing direct business there? Surprisingly, multi-national corporations are actually struggling in China. Jean-Baptiste Nadal (international equity manager for Kayne Anderson Rudnick) states that only a few companies are just now beginning to make money in China, despite years of operation. Bruce Veaco of Pacific Financial Research (advisor to the Clipper Fund) substantiated this by noting recently that Altria, long known to have a highly successful overseas cigarette operation, has only recently begun to earn profits in China. One of the major problems is that start-up costs are high, as multi-nationals are often required to make substantial infrastructure investments. Perhaps of greater concern to companies desiring to do business there is that the government still pressures foreign companies to share technology as a price for entering the market. Compounding the problem, adds Veaco, is the fact that foreign products have yet to gain a great deal of market acceptance. The result is an environment in which success is limited and difficult to attain.

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So we arrive at the paradox. If direct and indirect investment in China appears too risky, how can individual investors benefit from one of the hottest economies in the world? We have spoken with several equity managers recently regarding the China question, and the underlying theme has been one and the same. Direct investment by individual investors should be avoided. The risks are too high. Yet, China's appetite for materials and equipment is undeniable. It has driven many commodity prices to all-time highs. Thus, most equity managers focus their attentions and investments

in companies that are benefiting from the sale of materials, equipment, and services to the rapidly growing economy. Regional companies based in surrounding nations such as Australia, Singapore, and Taiwan were mentioned frequently as being best equipped to meet the demands of and profit from China's growth. Thus, when evaluating an international mutual fund, one should not simply look at the fund's weighting in China as a benchmark for its exposure to that country. Instead, it is more likely that fund managers, cognizant of China's growth, are supplementing their China exposure by purchasing export-driven companies from neighboring countries ■

Worst of The Bunch: Chinese Stock Market Not Keeping Pace

Index	Region	2001	2002	2003	2004	2005*	Annual
SE Shang Comp.	China	-20.6%	-17.5%	10.3%	-15.4%	-4.0%	-10.6%
Hang Seng	Hong Kong	-22.4%	-15.6%	41.8%	17.0%	12.0%	4.2%
Nikkei 225	Japan	-32.7%	-9.1%	39.2%	12.8%	8.2%	0.8%
S&P Europe 350	Europe	-21.3%	-19.7%	33.9%	20.8%	7.8%	2.0%
S&P 500	USA	-11.9%	-22.1%	28.7%	10.9%	2.8%	0.1%
Wilshire 5000	USA	-11.0%	-20.9%	31.6%	12.6%	3.9%	1.7%

*Through 9/30/05

** All returns are in U.S. dollars

Zemenick & Walker Again Recognized in Bloomberg Survey

For the fifth year in a row, Bloomberg Wealth Manager magazine surveyed and ranked independent investment advisory firms across the country. The 2005 survey saw a significant increase in respondents, with Bloomberg ranking the top 500 firms by average client relationship of which Zemenick & Walker, Inc. ranked 34th nationally and 1st in Missouri with an average relationship of \$7.2 million. Not included in the survey are banks, broker-dealers, and trust companies. We thank all of our clients and friends of the firm whose support has made this possible through their engagement of the firm and by their continued referral of new accounts ■

Focus on the Economy

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effects of oil price levels and volatility on the economy are certainly something of debate for economists. The fact is that eight of the nine post-war recessions were accompanied by sharp increases in the price of oil. History would suggest that oil shocks lead to higher inflation, a contraction in output, and higher unemployment. Production costs are surely affected as well as consumer spending across the board. However, in today's environment, due to enhanced research, technology, and communication, markets are able to respond much more rapidly than in the past. Most economists cite these advances, in conjunction with federal spending, as stabilizing factors that will keep the U.S. economy growing. Again, raising the federal funds rate demonstrates that

the Fed has significant confidence that the economy will be resilient in the long run.

Concerns about federal government spending also persist. National public debt continues to rise as costs skyrocket for financing the ongoing conflict in Iraq and the relief effort in the Gulf. The enormous trade deficit and rising consumer debt merely compound the issue. Increased spending will certainly help boost the economy, however economists and politicians alike question how Congress plans to cover its mounting, enormous debt. Certainly any tax-cut aspirations will be ignored, in fact, many politicians speculate that previous tax-cuts could be repealed. Either way, the question of how the nation will finance its debt is more and more in need of answers ■

Real Estate: Too High To Buy?

The financial press has twisted itself in knots as it debates whether or not the United States is experiencing a real estate bubble. Investors should note that the term "real estate bubble" is rather imprecise and can be misleading. It implies that the many types of real estate - that clearly differ according to use and location - somehow compose a homogenous market. Obviously they do not and, therefore, one should take care before making general conclusions about real estate. Further, even if one could comfortably conclude that many real estate investments are currently carrying relatively unattractive valuations, this would not justify excluding the asset class from a well-diversified, long-term investment portfolio.

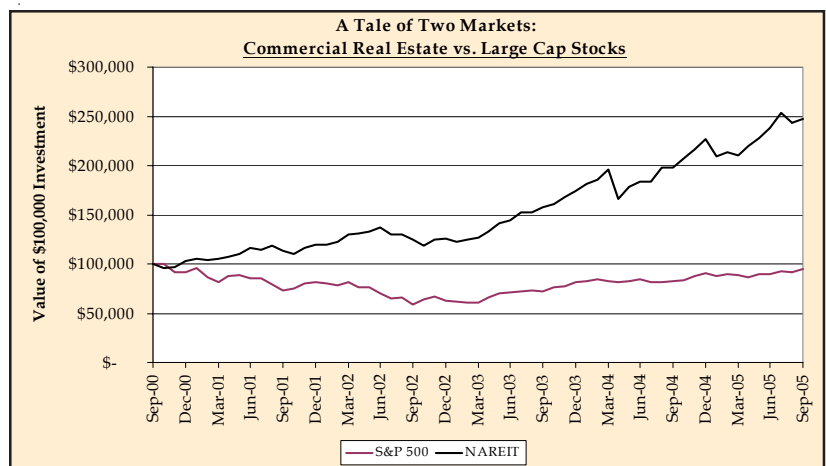
When people refer today to a "real estate bubble" they are most likely discussing residential real estate. As indicated above, it is a fractious market that is more influenced by local factors than national aggregate supply and demand. For example, a farmhouse in Kansas does not serve as a substitute for a condo in Miami. That said, many regions of the country (particularly the coasts) have experienced an incredible boom in home prices that has been fueled by a period of historically low interest rates, rampant investor speculation, and the maturation of the baby boom generation.

Arguing that homes in many regions of the U.S. are selling at unreasonable levels, *The Economist* noted that in the past five years the ratio of home prices to rents has risen 35% above its average level from 1975 to 2000. The implication of this is that price growth must eventually tail off to allow rents to catch up and restore the ratio to "some sort of fair value". In the regions that have experienced the most dramatic boom this may even require housing prices to fall. There is no way to tell when this process of fair value adjustment will begin; in fact, prices could continue their dramatic rise in the short-term. However, as it relates to speculating on the price of one's own home, a recent column in *The New York Times* was probably correct when it advised, "in the long run, sleep at home and invest in the stock market".

Likewise, commercial real estate has had an excellent, although less publicized, run of its own over the past five years. Individual investors can gain exposure to this sector through individual REITs (real estate investment trusts) or REIT mutual funds. As measured by the NAREIT index, the sector has compounded at 19.89% annually from 9/30/00 through 9/30/05 compared to -.95% for the S&P 500. The graph below illustrates the impact of this dramatic difference in returns on a hypothetical investment of \$100,000. This fact has not gone unnoticed by investors. Jonathan Litt a REIT analyst at Smith Barney commented in *Barron's* that "a wall of money continues to chase the sector and the entire U.S. commercial property market". This flow of money into the commercial real estate market has put further upward pressure on prices.

Clearly after such an extended period of outperformance, commercial REITs are no longer the bargains that they once were. Several years ago many REITs offered relatively attractive dividend yields of as high as 8.50%, but today the average dividend yield is closer to 4.50%. By comparison the current yield for a five-year U.S. Treasury Note is 4.18% as of September 30th. Given that one of the most commonly referenced advantages of investing in REITs is the cash flow that they provide, this is a discouraging development.

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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 and offers clients a disciplined, business-like approach to the investment of their capital ■

By the Numbers

<u>Interest Rates</u> (Monthly data from 1970)	<u>High</u>	<u>Date</u>	<u>Low</u>	<u>Date</u>	<u>9/30/05</u>
Federal Funds Target	20.00%	May-81	1.00%	Nov-03	3.75%
3-Month T-Bill	16.30%	May-81	0.92%	July-03	3.40%
10-Year Treasury	15.32%	Sept-81	3.33%	June-03	4.25%
30-Year Mortgage	14.67%	July-84	5.23%	June-03	5.80%
<u>Stock Indices</u> (Daily data from 2000)	<u>High</u>	<u>Low</u>	<u>9/30/05</u>	<u>% from High</u>	<u>% from Low</u>
DJIA	11,723	7,286	10,568	(9.85%)	45.05%
S&P 500	1,527	777	1,228	(19.58%)	58.04%
NASDAQ	5,049	1,114	2,151	(57.39%)	93.09%
Wilshire 5000	14,752	7,343	12,289	(16.70%)	67.36%
MSCI EAFE	1,774	857	1,619	(8.74%)	88.91%

Real Estate: Too High to Buy?

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According to Jellison, a “more optimistic scenario is priced into REITs than stocks or bonds”. If this optimistic scenario plays out, with interest rates remaining at reasonable levels and growth rates remaining strong, then REITs should hold their own.

On the other hand, if the scenario underpinning REIT valuations proves to be overly optimistic, the sector could suffer a much steeper decline than many investors might expect. Evidence of this came in April 2004 when the yield for the ten-year U.S. Treasury Note shot up 70 basis points, from 3.84% to 4.54%, triggering the NAREIT index to plummet by 15.26% in that month alone. Fortunately for REIT investors, mid and long-term interest rates soon fell and the sector recovered its losses.

The next time they may not be so lucky - the higher the sector valuations climb, the more susceptible REITs will be to future negative news in the marketplace.

Does this mean investors should steer clear of REITs? Absolutely not. They can be an important part of a diversified portfolio. In our opinion investors are far more likely to be successful with a long-term commitment to REITs than by trying to time the market. However, given their high valuations, it is prudent to adopt a conservative position to help mitigate the damage to one’s portfolio should they take a downturn. Along with potentially reducing one’s allocation to REITs, this also means investing with a talented active money manager rather than in a passively managed REIT index. With an index fund one is forced to own all of the companies and sectors covered by the index regardless of their valuations and relative attractiveness. An active money manager can create a more defensive portfolio if he believes the market is nearing a peak by avoiding overpriced names and sectors and allowing cash to accumulate. As a perfect example of this, Jellison recently noted that he was avoiding the residential sector entirely and that lodging (hotels) and office REITs appeared to be less overvalued than the retail and industrial sectors. This conservative approach should help protect investors if the market takes a negative turn while enabling them to stay diversified by maintaining some exposure to real estate ■

Even industry insiders are beginning to be concerned with commercial REIT valuations. David Jellison, the portfolio manager for the Columbia Real Estate Fund, says that based on historical relationships REITs appear to be richly priced relative to stocks and bonds.

“A wall of money continues to chase the sector [REITs] and the entire U.S. commercial property market.”

-Jonathan Litt, Smith Barney REIT analyst

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