

Zemenick &
Walker, Inc.

Market Perspectives

An Investment Advisory Firm, Established in 1987

Fall 2006

Zemenick & Walker, Inc.

Richard E. Zemenick
Director

James C. Walker
Director

Chris G. Griesedieck
Chairman

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President

William C. Stude, III
Executive Vice President

Bryan L. Schulz
Vice President

Jonathan A. Best
Assistant Vice President

Nicholas A. DeCenso
Portfolio Analyst

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Shining a Light on Hedge Funds

Remember Long-Term Capital Management, the hedge fund founded in 1994 by John Meriwether, former vice-chairman and head of bond trading at Salomon Brothers? Board members included not one, but two, 1997 Nobel Prize winners in Economics. Yet while initially successful, the fund folded in 1998, losing \$4.6 billion in less than four months. Nevertheless, over the following eight years, the hedge fund industry quadrupled, growing from \$240 billion to more than \$1.2 trillion! So the LTCM story must be an aberration, you say. One might reasonably assume such growth to be an indication of high investment performance and reflective of a desirable investment arena. Think again.

The Wall Street Journal headlines are again filled with stories similar to LTCM. A September 19th article tells the story of Amaranth Advisors, a hedge fund that was up \$2 billion through August of this year, then promptly down by \$5 billion! Key to the fund's meltdown was a 32-year old energy trader named Brian Hunter, who worked thousands of miles from the home office with, it would appear, very little oversight. Two days earlier, the paper highlighted the story of another, albeit successful, Connecticut based hedge fund manager, Steven Cohen. He was only down \$150 million. Then again, that was only for one day of trading! Why is it happening? Is the worst over? Is it time to invest? We think not.

Hedge funds can offer outstanding returns. They can diversify an investment portfolio. They can even make sense for some investors—but not likely for most. On the surface, *Continued on Page 2*

Focus on the Economy

After a string of 17 consecutive rate hikes that lifted the federal funds target rate from 1.00% to 5.25%, the Fed decided to leave rates alone at both its August and September meetings. Though this came as no surprise, it certainly marks an important decision in the new Ben Bernanke era. Economists had been speculating for quite some time about the possible end to the increases. Rate hikes in the near future are certainly still a possibility, but this decision reveals that the Fed is willing to take action against current economic issues.

While concerns over high energy prices, the slowing housing market, and the potential for recession continue to hassle policymakers, many economists agree that inflation remains to be the core economic issue. When dealing with inflation, one problem seems to be that the economy typically slows before inflation comes down. Another reason why inflation can be difficult to deal with, as cited by Dallas Federal Reserve Bank President Richard Fischer, is that increased globalization can have quite an impact. He believes the lags “may become longer, increasing the time it takes for the consequences of the Fed tightening measures to take hold.” Whereas core inflation figures exclude energy and food, gasoline prices continue to worry overall inflation observers. Core inflation rose just 0.2% in July, while gas prices continued to increase, 5.3% in that month.

Many economists would also note, however, that a cooling economy isn't necessarily all bad. Not only should it eventually bring inflation into check, as stated above, but it can provide a type of economic survival of the fittest. Weaker companies tend to be pushed out and those remaining are forced to improve. This would ideally leave strong companies poised to provide slow and steady growth for investors. Although this would be the desired scenario for the Fed, it seems as if inflation worries will still take center stage for the upcoming meetings and any rate decision will stem from the future inflation outlook ■

Shining a Light on Hedge Funds

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potential fat returns often blind the investor and block out the four largest industry “warts”: excessively high fee structures, poor liquidity, a lack of transparency, and lax regulatory oversight.

The common fee structure is “2 and 20”, which is to say, an investor pays 2% annually on the amount invested, and 20% of any profits made. In Cohen’s case, he regards his skills so highly that he charges 3% and 50% of profits! This means that for an investor to simply break even with the long-term return of the stock market (10%), Cohen would have to generate a return of 23% before his 3% fee, and before his 50% cut. Now, he is either twice as smart as everyone else, and no one else can find those 20% investments, or he borrows money (i.e. uses leverage) to double up his bet when he earns the same 10% as the rest of us. The only problem is, when the market falls, he falls faster. So, why pay these managers, in general, so much more for taking even greater risks with your money?

Next, we come to liquidity. Traditional investments such as stocks, bonds, and mutual funds typically can be sold for their cash value quickly and easily. Hedge Funds, on the other hand, are notorious for a feature known as a “lock-up”, which is simply a period of time in which the investor has no access to his investment. Recently, the SEC enacted a provision requiring investment partnerships with more than 14 private equity investors to register. One exemption to this requirement is if the fund has a two-year lock-up period. Not surprisingly, many hedge funds have embraced this exemption in an effort to remain “unregulated”.

This leads us to the final issues of transparency and regulation. Due to their specialized strategies, hedge fund managers typically do not allow anyone to see what it is they do, as they might lose their edge. As a result, they rarely disclose to investors the amount of leverage, risk, or the real value of their assets. In some cases, they determine the value of those assets themselves. For example, many hedge funds own illiquid exchange-traded securities. In a 2001 study entitled *Do Hedge Funds Hedge*, Clifford Asness, Robert Krail, and John Liew concluded that “the absence of good prices may provide hedge funds flexibility in how they mark these positions for month-end reporting”. This allows the opportunity to price those securities up to improve performance. Such flexibility may also allow managers to smooth out fluctuations in pricing, which could in turn “lower estimates of volatility and correlation

to traditional indices”. The authors, after adjusting for these irregularities, further concluded that hedge funds as a group exhibit a beta of 0.84, meaning that 84% of their movements in price could be explained by movements in the S&P 500. Given the fact that hedge funds often tout their low correlation to the market, a 0.84 beta might come as a surprise to many investors.

Yet even with all of these issues permeating the hedge fund industry, many investors still cling to the belief that they provide superior returns to traditional investments. However, a recent study by Burton Malkiel and Atanu Saha published in the *Financial Analysts Journal*

“of the 331 hedge funds reporting data in 1996, only 25% still existed in 2004”

questions the general performance success of the industry. The authors point to three biases in reported hedge fund performance that are often overlooked. One bias is the practice of voluntary reporting. Because of lax regulation, hedge fund managers are not required to report audited returns to regulators, or the databases that publish index data. This affords poorly performing hedge funds the flexibility of not reporting their returns, which could inflate index performance.

The second bias concerns a hedge fund’s ability to “back-fill” performance data. Managers often seed hedge funds with capital, only to begin reporting performance at a later date. If the performance from the time period prior to the first reporting date is favorable, managers might then “back-fill” their fund’s performance by adding that data to the databases. Obviously, unfavorable data is not provided, giving unwary investors no knowledge of the fund’s early struggles. The final and perhaps most staggering bias concerns the low survivorship rate of hedge funds. Malkiel and Saha point out that of the 331 hedge funds reporting data in 1996, only 25% still existed in 2004. Because performance databases typically drop defunct hedge funds from their indexes, results can be heavily skewed upward. For example, their study showed that between 1996 and 2003, “live-only” funds returned a 13.31% annual return. However, when defunct funds were added back into this group, the annual return dropped to just 8.91%, which trailed the S&P 500’s 9.37% annual return over the same time period.

So what can we learn from this? While any single hedge fund may provide the superior returns and lower volatility advocates claim, it seems apparent that the hedge fund industry as a whole might fail to meet investor expectations■

Zemenick & Walker Recognized in Financial Publications

In its inaugural survey, Financial Advisor Magazine ranked registered investment advisory firms across the nation. The study looked at various aspects including total assets, services provided, and average relationship size. The survey then grouped over 400 firms by asset size and ranked them by asset growth in 2005. Zemenick & Walker, with \$993 million under management, ranked 20th out of firms with assets between \$500 million and \$1 billion. Of all firms surveyed, the firm ranked 16th in assets per client relationship. Zemenick & Walker was also recognized this year by Wealth Manager magazine. In its annual survey, the magazine ranked the top 439 investment advisors by average client relationship. Zemenick & Walker ranked 38th nationally and once again, 1st in Missouri with an average relationship of \$6.6 million. Thank you again to our clients and friends whose support has made our success possible■

Does Market Capitalization Matter?

The terms “large cap” and “small cap” are so ubiquitous in conversations about the stock market that we often assume everyone has a solid understanding of the concepts. Because of their importance in diversified equity portfolios, we felt it worthwhile to present an introductory discussion.

Simply put, stocks are often classified according to their size or market capitalization (stock price x number of shares outstanding). Thus, capitalization is the current price of an entire company according to the stock market.

Different groups use different methods to categorize stocks by market cap. For instance, Morningstar classifies stocks as giant, large, mid, small, or micro. However, not everyone agrees on the market cap levels that separate the different categories. Zemenick & Walker, Inc. uses a broader approach, defining companies as large or small based on the market capitalization characteristics of the Russell 3000 Index. The Russell 3000 is comprised of 3,000 securities that represent nearly 99% of the total capitalization of U.S equity markets. The Russell 1000 is a subset of this index that encompasses its largest 1,000 stocks. Similarly, the Russell 2000 represents the smallest 2,000 stocks in the Russell 3000. Currently, the largest market cap in the Russell 2000 is roughly \$2.5 billion, thus we consider stocks with capitalizations below that level to be small caps.

The table to the right provides examples of some well-known companies with different market caps. One immediately recognizes

the difference between the global giants like Exxon and Microsoft and smaller companies like Four Seasons and Cheesecake Factory. These are just some examples of companies with which most people are familiar. However, a defining characteristic of many small companies is that most people have never heard of them.

Small cap stocks are generally considered to be riskier than large cap stocks. They are typically not as well established as their large cap counterparts and often find it more difficult to raise capital, particularly in times of crisis. Moreover, many small caps are thinly traded, meaning they have low daily trading volumes. This can make it difficult to establish and exit large

positions in a timely fashion. Using standard deviation, a measure of the variability of returns about their mean, as a proxy for risk, the historical record seems to support the idea of higher risk for small caps. Ibbotson Associates reports in its 2006 Yearbook that small cap stock returns had an annual standard deviation of 32.9% from 1926 to 2005 compared to 20.2% for large caps. In return for this additional risk, small cap stocks have historically offered a higher return than large cap stocks. *Continued on Page 4*

Market Caps for Selected Companies
As of September 12, 2006

Exxon Mobil	\$384.6 billion
Microsoft	\$254.5 billion
FedEx	\$32.1 billion
Harley Davidson	\$16.1 billion
Four Seasons Hotels	\$2.4 billion
Cheesecake Factory	\$2.2 billion

Book Review: Family Wealth - Keeping It In The Family

A review of the largest private fortunes amassed over the past few centuries reveals how surprisingly few of these fortunes have survived multiple generations. In his book *Family Wealth – Keeping It in the Family*, author James E. Hughes, Jr. points out that despite the enormous wealth created by the “first” generation, rarely do families succeed in managing and growing their capital base beyond the second or third generation. Many times, rather than providing opportunity, the success of the “first” generation results in personal and financial dependency for future generations. Often, families fall victim to the adage “shirtsleeves to shirtsleeves in three generations.”

Facing obstacles as varied as natural disasters, poor investment decisions, overspending, divorce, illness, etc., it is easy to see how a family’s wealth can dissipate over time. Hughes notes that many declines in a family’s financial capital base result from an earlier deterioration in the family’s human and intellectual capital. Focusing on financial goals without addressing the state of the family’s human and intellectual capital can be self-destructive.

To overcome the aforementioned hurdles, Hughes suggests that families develop a “Family Mission Statement”, a social compact between all family members. This compact is based on a family’s history, shared values, and common vision for the future. Once a

Family Mission Statement is developed, the family should take an inventory of the assets available to pursue the mission. This exercise involves a gathering of family members and a review of the family’s financial holdings as well as each family member’s personal résumé. Families should embrace each family member’s unique role in the family regardless of the talents and expertise they bring to the “business”. Hughes stresses that success should not be measured solely in “dollars and cents”. Many well-to-do families view their financial situation as an opportunity to advance social causes (e.g., education, community service, personal development and religious awareness). In these situations, schoolteachers, religious leaders and social workers may contribute as much to a family’s success as lawyers and bankers.

Our nation’s infatuation with wealth accumulation is evidenced by the “bestseller” status of so many “how to” books on wealth accumulation. Given our obsession with acquiring wealth, shouldn’t we plan for how our wealth will eventually be spent? *Family Wealth – Keeping It in the Family* addresses how to thoughtfully plan for the transfer of wealth to successive generations. A well laid-out estate plan addresses not only financial capital but also seeks to ensure the transfer of human and intellectual capital needed to maintain the family’s position and advance the family mission statement ■

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>	<u>9/20/2006</u>	<u>9/20/2005</u>	<u>Change</u>	<u>Exchange Rates</u>	<u>9/20/2006</u>	<u>9/20/2005</u>	<u>Change in \$</u>
Federal Funds Target	5.25%	3.75%	+1.50%	USD/EUR	1.2686	1.2115	-4.50%
3-Month T-Bill	4.81%	3.54%	+1.27%	JPY/USD	117.46	111.96	+4.91%
10-Year Treasury	4.73%	4.26%	+0.47%	USD/GBP	1.8886	1.7983	-4.78%
30-Year Mortgage	6.43%	5.74%	+0.69%	USD Index ¹	85.81	88.60	-3.15%
<u>Stock Indices</u>	<u>9/20/2006</u>	<u>Change From High²</u>	<u>Change From Low²</u>	<u>Economic Data</u>	<u>Aug-06</u>	<u>Aug-05</u>	<u>Change³</u>
DJIA	11,613	-0.94%	+59.38%	Unemployment Rate	4.70%	4.90%	-0.20%
S&P 500	1,325	-13.24%	+70.60%	CPI (Trailing 1-Year)	3.82%	3.64%	+0.18%
NASDAQ	2,253	-55.38%	+102.21%	Retail Sales	\$368 b	\$345 b	+6.67%
Russell 2000	734	+21.18%	+124.58%	Housing Starts	1.67 m	2.08 m	-19.71%
MSCI EAFE	1,864	+3.27%	+126.50%	Real GDP (2nd Qtr)	\$11.40 t	\$11.00 t	+3.64%

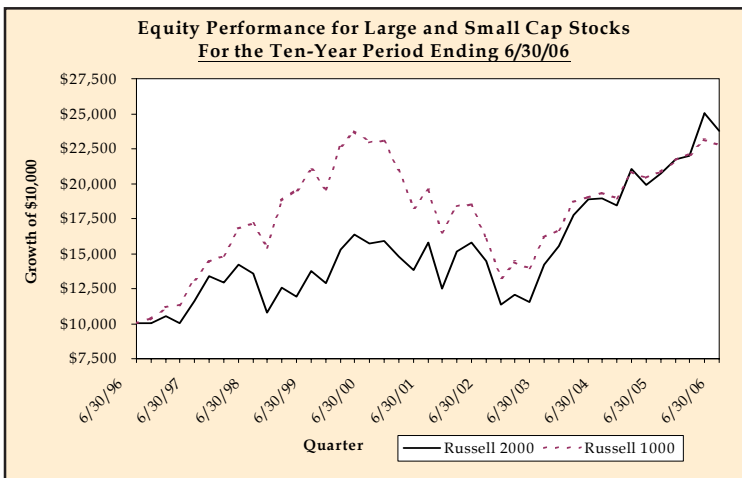
¹ Represents the wgt avg exchange value of the U.S. Dollar against 6 currencies: Canada, Japan, Sweden, Switzerland, the U.K., and Euro.
² High and Low points for each index come from their year 2000 peaks and subsequent bear market lows; represents cumulative price appreciation.
³ This represents absolute change for unemployment and CPI, but it is the percentage change for retail sales, housing starts, and real GDP.

Does Market Capitalization Matter?

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Ibbotson reports that small cap stocks had an annualized return of 12.6% from 1926 to 2005 while large cap stocks returned 10.4%. Common sense seems to indicate that smaller companies have more room for rapid sales and earnings growth than larger firms and, at least theoretically, the potential for greater stock price appreciation. For example, Microsoft would likely find it challenging to grow its annual sales (currently \$44 billion) at 25% for an extended period of time, but a relatively small software company might accomplish this simply by introducing a new product.

Large and small cap stock returns, though positively correlated, often go through cycles of relative over and under-performance.



Looking at the ten-year graph of the cumulative returns for the Russell 1000 (large cap) and 2000 (small cap) one can see that during the tech boom of the late 1990s, large cap stocks significantly outperformed small caps. However, once the tech bubble burst in the year 2000 small caps began a six year run of outperformance versus large caps. As a result, small caps have gone from attractive valuations in the late 1990s to being more fully valued today. In fact, large caps now appear to carry much lower P/E multiples than small caps. To support this claim, we split the Russell 3000 Index membership into quintiles by market capitalization (companies with positive earnings only) and calculated a simple average P/E for each. We found that the bottom three quintiles carried significantly higher P/Es than the top two. This certainly seems to indicate that the days of small cap stock market leadership may be numbered ■

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