

# March 31, 2006 Market Commentary and Outlook

*You can observe a lot just by watching.*

-Yogi Berra

Can we apply baseball great Yogi Berra's maxim to the "game" of investing?

Table 1 compares the annual returns of six major asset classes to the rate of **inflation**, which is defined as the general upward movement of prices over time. While opinions differ as to exactly how inflation should best be measured, all investors agree on one thing: ***If your portfolio isn't beating inflation, it's losing real value.***

By viewing investment performance on an after-inflation basis, a portfolio's real growth in purchasing power can be measured. For example, during the 1970s, the S&P returned 5.9% on average each year. However, after adjusting for an average inflation rate of 7.4%, the Index actually lost 1.9% annually of purchasing power.<sup>1</sup>

Compared to the 1970s, last year's 3.5% inflation rate may seem well-contained. Yet, the outlook for inflation is uncertain. The U.S. economy faces difficult trade, budget, and geopolitical challenges that could trigger a sharp move, either up or down, in the level of inflation. *Is there one asset class that is better than another for creating a hedge against inflation?*

**Cash equivalents** offer some protection against inflation. Unfortunately, while cash has tracked inflation reasonably well over time, it has failed to achieve a meaningful positive real return during the past six years. Cash yields are strongly influenced by the Federal Reserve, the regulator of the U.S. money supply. During 2002-2004, the Federal Reserve forced short-term yields to historic lows in order to stimulate the economy. Lately, however, the Fed has been pushing yields higher in order to remove its earlier stimulus. With cash yields in the 4-5% range, the prospect for cash to beat inflation has greatly improved.

**Bonds** traditionally offer higher returns than cash, and thus, could offer better inflation adjusted returns than cash—and did so in years 2000 through 2004. But since 2005, bonds have been in a slump given the effect of the Fed's increase in interest rates.

(1) Benchmark indices: Large Cap Stock: S&P 500, Mid Cap Stock: S&P 400 Mid Cap, Small Cap Stock: Russell 2000, International Stock: MSCI EAFE, Bonds: LB Aggregate, Cash: US 30 Day Tbill, Inflation: CPI. Source: Ibbotson Associates.

**Table 1: Relative Performance of Asset Classes**

2000		2001		2002		2003		2004		2005		Average	
						Small	Int'l						
						47.3%	20.7%						
						Int'l	Small	Int'l	Int'l	Mid			
						39.2%	18.3%	14.0%		10.0%			
Mid	Bonds					Mid	Mid	Mid	Mid	Bonds			
17.5%	8.4%					35.6%	16.5%	12.6%		6.8%			
Bonds	Cash					Large	Large	Large	Large	Small			
11.6%	3.8%					28.7%	10.9%	4.9%		6.3%			
Cash	Small	Bonds				Bonds	Bonds	Small		Cash			
5.9%	2.5%	10.3%				4.1%	4.3%	4.6%		2.7%			
<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>	<b>Inflation</b>
<b>3.4%</b>	<b>1.6%</b>	<b>2.4%</b>	<b>1.9%</b>	<b>3.3%</b>	<b>3.5%</b>	<b>2.7%</b>							
Small	Mid	Cash	Cash	Cash	Cash	Int'l							
-3.0%	-0.6%	1.7%	1.0%	1.2%	3.0%	1.5%							
Large	Large	Mid			Bonds	Large							
-9.1%	-11.9%	-14.5%			2.4%	-1.1%							
Int'l	Int'l	Int'l											
-14.0%	-21.2%	-15.7%											
		Small											
		-20.5%											
		Large											
		-22.1%											

Today, there is a possibility that bonds could enjoy a brief rally similar to the one experienced during 2000-2002. However, sustained high returns from fixed rate bonds are simply not possible, as high prices and low yields put a tight ceiling on the level of return that can be sustained.

If inflation were to rise, fixed-rate bonds could lose some of their future purchasing power and come under serious price pressure. If, however, inflation were to retreat, fixed income investments might appear increasingly attractive.

*Over the very long-term*, stocks have proved to be the best hedge against inflation. However, **large cap stocks**, the darlings of the late 1990s, fell sharply during 2000-2002, underscoring the fact that the opportunity to earn high rates of return comes at the price of significant investment risk.



Investors, concerned that large companies might be at a competitive disadvantage due to underfunded employee benefit plans and rising energy prices, have been slow as of late to reenter the large cap arena. While these concerns have some merit, we note that the S&P 500's price-earnings ratio has fallen to the middle of its historical range, possibly indicating the return of opportunity to the asset class.

**Stocks of small- and mid-size companies** performed extremely well during the rebound of 2003-2004. During this period, the Federal Reserve held interest rates low, providing low-cost capital to those who were willing to borrow. The availability of easy and cheap money helped many small- and mid-sized companies realize growth and good profitability—all of which was reflected in their stock prices.

By 2005, however, the rally showed signs of fading, as rising short-term interest rates slowed the flow of capital. If the Fed's tightening continues, it is possible that prices of some of the more speculative companies may pull back as markets adapt to a tougher financing environment.

Like small stocks, **international stocks** have rocketed in recent years. Competitive labor and natural resources have enabled foreign-based companies to reap the benefits of U.S. economic stimulus.

In the short term, there is a significant risk that a retrenchment of the U.S. economy could deal international stocks a setback. However, looking beyond such an event, the global economy is likely to become increasingly self-sufficient and independent of the U.S. economy over the long term.

### How to achieve the best hedge against inflation?

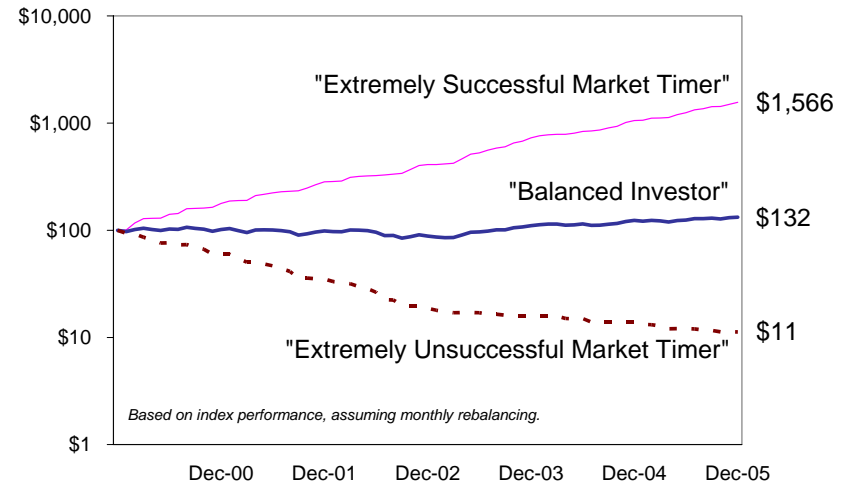
While each asset class at times proved to be an excellent hedge against inflation, at other times, that same asset class proved undesirable. *Is market timing the answer?*

A hypothetical “extremely successful market timer” who somehow managed to put 100% of his or her money in the best-returning asset class each month over the past six years would have gained on average over 58% per year. A \$100 initial investment would have grown to \$1,566. Conversely, an “extremely unsuccessful market timer” who somehow managed to put 100% of his or her money in the worst-returning asset class each month would have lost on average 31% per year over the six-year period, shrinking the \$100 initial investment to \$11.

*Is the potential upside of market timing worth the downside risks?* The chances of consistently choosing either the best or worst-performing investment each month are slim. We believe the data supports Mr. Berra's observation: *If you don't know where you are going, you will wind up somewhere else.* We think a diversified portfolio is a better approach.

A hypothetical “balanced investor” who simply combined all six asset classes in equal weights would have had an average annualized return of 4.8% over the six-year period, growing a \$100 initial investment to \$132, providing \$15 in additional purchasing power after inflation. While this approach to investing may seem somewhat boring, it beats the alternative of being an “extremely unsuccessful market timer”.

### Hypothetical Growth of \$100 Invested December 31, 1999



Our approach to diversification is more sophisticated than splitting up a portfolio equally among all asset classes. Employing modern portfolio theory, we make available to plan participants professionally constructed, diversified portfolios which we believe long-term will create an effective hedge against inflation. We believe it's a good strategy for winning the investment game.

Investment Committee  
Northwest Capital Management, Inc.  
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