Cp's Quarterly Investment Perspective

Comprehensive Planning Associates, Inc. Third Quarter 2005

Our research team conducted a detailed study of a range of possible economic scenarios and looked at how these would impact our portfolios. Contemplated portfolio changes are based on this analysis. We can't fully protect against all risk without significant opportunity cost from excessive conservatism. But we are confident that our balance of risk and return is sensible under a broad range of economic scenarios.

Stocks are at the undervalued end of our fair-value range, but given the risks that exist we are not comfortable overweighting stocks.

We own fixed income specifically to hedge against the risk of declines in the equity market. Our return outlook for bonds is not great, but it is better than what we expect from cash, and bonds additionally provide important diversification. For this reason we are generally reducing cash positions.

We continue to believe the large current-account deficit increases the risk of a decline in the dollar. But this decline is likely to come against the currencies of our largest trading partners. For this reason we are contemplating the replacement of a some our foreign bond positions with PIMCO Developing Local Markets Fund.

The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our investment team's more interesting views and research with our clients. It is not intended as a recommendation for any specific action.

Quarterly Investment Commentary

Equities have seen tepid returns year-to-date, but did relatively well in the third quarter. The S&P 500 rose 3.6% and the small-cap Russell 2000 gained 4.7%. REITs picked up 3.8% on top of a very strong prior two quarters. Foreign stocks did very well, gaining 11.7%, as did commodity futures (up almost 17%) due in large part to soaring energy prices. Investment-grade bonds were slightly in the red, while foreign bonds did slightly worse due to appreciation in the U.S. dollar.

Market Overview

Stocks — There is plenty to worry about these days: hurricanes, housing prices, massive current-account and federal-budget deficits, strife in Iraq, rising inflation, and others. We share these concerns, and spend much of our time evaluating how these risks could impact the U.S. economy and markets in the near and long term. It's tempting to give in to these fears and assume a conservative investment posture, but this would ignore another—and perhaps more important—variable, which is valuations. Valuations matter because they provide insight into what the market expects to happen, and sometimes those expectations are overly optimistic or overly pessimistic. When these situations occur, we can take advantage of these opportunities and reposition our portfolios to potentially enhance our long-term returns, without increasing overall portfolio risk. In fact, in some instances, such as when there is a fat-pitch opportunity, overall portfolio risk may be reduced.

Looking at the current market and using several different valuation methodologies, it appears that the S&P 500 is at the low end of what we considered to be a fair-value range. These valuation approaches assume an average level of risk relative to history. So if there are no major blow-ups or there is no major cyclical downturn, we'd expect average annual returns somewhere in the high single-digit range over the next five years. The market always prices in risk to some degree, but it seems likely that the market is presently pricing in a somewhat greater-than-average level of risk.

We too believe that there is a higher-than-average level of risk right now, but this valuation buffer gives us some comfort that investors are not ignoring these risks. In the short-run, valuations seldom come into play as a backstop against losses; investors get scared and head for the exits, valuations be damned. However, the trade-off for that short-term pain would be that it would create an opportunity for better-than-average long-term gains.

Within the equity universe, we aren't seeing any attractive tactical opportunities. International equities have several things going for them: improving fundamentals in some areas such as Japan and emerging markets, and higher dividend yields and slightly better valuations than in the U.S. But we see risks as well: poor decision-making by government policy makers, sluggish progress on structural reforms, dependence on U.S. demand for exports, etc. The continued strong upward move in commodity futures prices has probably reduced some of their return potential (at least over the short term). However, the primary structural elements of total return for the commodity futures index remain, and there are many plausible scenarios where commodity futures will perform either as well as or much better than the 60/40 mix of stocks and bonds. Commodity futures would likely do poorly in a deflationary environment, but over the long-term we still believe this investment will add value.

Fixed Income — Investments in the fixed-income world can be very tricky. For example, rising oil prices stoke fears of inflation, which is bad for bond prices, but at the same time there are concerns that high oil prices in conjunction with other factors (such as a slowing housing market) could slow economic growth, which is good for bond prices. While economic forecasting is difficult, and calling turning points is even tougher, we don't have to be able to forecast that environment to intelligently factor fixed income into our portfolio weightings.

In deciding how to allocate to bonds it is important to think about their purpose. Is it to provide income? Provide big returns to the portfolios when tactical opportunities present themselves? Our view is that most of the time bonds' most important function is to help offset equity losses when the markets are in flux. Obviously we are aware of—and sensitive to—the return prospects for different bond sectors, and this plays into our decision-making process, but the key driver is in assessing how they can help us "play defense" when times are tough for stocks. Right now, real yields on investment-grade bonds are very low, which suggests to us that they may be overvalued on a long-term basis. There are several scenarios where, over the short term, rising rates could result in cash outperforming bonds (and TIPS and Floating-rate bonds help hedge against this). But if we experience a significant economic slowdown, bonds would experience some appreciation at a time when equity markets wouldn't be performing well (in which case investment grade bonds would perform better).

So bonds are an important diversifier that help us manage risk. Even with their relatively low yields we expect them to generate returns in the 4% to 5% range, which would equal or outperform cash returns over the long run in most scenarios, including a "steady-state" environment in which we don't see any huge changes in economic conditions. Our thinking on this has evolved recently, and is discussed more below. We also continue to believe foreign-currency denominated bonds are a prudent investment, although we are making some changes in these positions as well (also discussed below).

Fine-tuning Foreign and Domestic Bonds

PIMCO Developing Local Markets (DLM) is something we've been considering for several months. Since we originally established our foreign bond positions, several important factors have changed. The relative yield advantage we once enjoyed overseas is no more. Also, the difference in real (inflation-adjusted) yields has narrowed, suggesting that foreign bonds no longer have a valuation advantage over U.S. bonds. Additionally, the dollar may not be as overvalued as it once was in relation to several developed regions, Europe in particular. However, because of the unprecedented magnitude of our current account deficit, we continue to believe a dollar depreciation versus the currencies of some of our larger trading partners is probable over the long run, and there is a small risk of an outright dollar crash at some point if overseas investors unexpectedly decide to diversify or reduce their U.S. holdings, sparking a "rush for the exit."

A few months ago, PIMCO launched the DLM fund, (the first public mutual fund of its kind) which invests primarily in ultra-short-term bonds in a wide range of emerging markets. These countries offer yields which are attractive in both nominal and real terms relative to the U.S. and developed markets; this fund's benchmark, the JPMorgan ELMI+ Index, currently yields roughly 5.5%. Also, the long-term economic fundamentals in many emerging markets have improved markedly (lower debt levels and higher foreign currency reserves, for example), and given this improvement, along with trade flows, we believe that over a period of years the dollar is more likely to experience material declines against these countries' currencies than against more developed markets' currencies. (These improved fundamentals also contribute to the attractiveness of the ELMI universe, although this in and of itself would not be a sufficient reason to invest there—it's just one of several factors that we view as a positive.)

Because of the fund's very short duration—it is almost like a money market—there is no significant interest rate risk, although there is still the currency risk. The currency risk should not be ignored as a very real source of volatility, but the fund is extremely diversified with a wide range of emerging markets, and in the past this diversification has been surprisingly effective at mitigating downside risk. That doesn't mean there isn't risk—even in emerging markets yields are quite a bit lower than they were a few years ago and this means less cushion against capital losses, for example—but as noted the fundamentals are also markedly better. Finally, PIMCO's DLM fund in particular offers an advantage versus their developed market bond funds in that it has considerably more flexibility to make moves away from its benchmark. Ordinarily, this is not something we look for when making tactical asset allocation decisions, but in the case of emerging markets—where meaningful risks can come from a small number of countries—we think PIMCO's proven track record could add a meaningful amount of value; their Emerging Markets Bond Fund has a great record over the eight years since its inception. We are, however, waiting for their minimum initial investment requirement of $100,000 to drop by at least 75% before moving forward.

Traditional Investment Grade Bonds — Cash yields have been on the rise, while bond yields have moved comparatively less, which on its face suggests that cash is even more attractive now than it was when we first established these positions two years ago. However, in actually penciling through a wide range of scenarios—factoring in other investments we hold—we came to two conclusions: First, over a five-year time horizon, it's very unlikely that cash will outperform bonds.

Second, in looking at our overall positioning, we would like to have more recession/deflation protection than what is currently present in our portfolios. In the event of a bad recession, commodity futures and the Industrial Materials sector, TIPS, Floating-rate bonds, and cash are all likely to provide less ballast than a more conventional bond fund like iSHARES Lehman Aggregate Bond (AGG). Furthermore, the shift from developed market bonds to emerging markets cash contributes even more to this imbalance. Effectively we're making a bet against a recession/deflation scenario in the near term that is stronger than what we believe is called for given our overall long-term market views.

In looking at our options, we believe reducing some of our TIP and Floating-rate positions in favor of traditional intermediate-term bonds modestly reduces this implicit bias. The biggest risk to making this move right now is that short-term interest rates continue to rise, causing bond prices to drop. The good news is that the performance differential is not likely to be huge either way, and we're positioning our portfolios in a way that protects them better in the event of a sudden recessionary shock, which poses a more material downside risk.

In carefully assessing a range of possible economic scenarios, we recognize that in a worst-case scenario, we would violate our loss thresholds. The problem is that the only way to completely hedge this risk is to have very low allocations to volatile investments such as equities. But even bonds are not a perfect solution (we can imagine bonds losing 5% or more in a dollar crash or stagflation scenario, and they could even lose money if the economy did unexpectedly well). That leaves few options other than cash, which under any circumstance does not offer attractive long-term returns. So trying to protect against all possible risks would result in a permanent, ultra-conservative asset allocation. That level of excessive pessimism can be just as detrimental to long-term returns as market disruptions: missing big up-moves can seriously reduce long-term average returns. We own things like bonds, commodity futures or Industrial Materials, and foreign bonds to help us in the event that some of these risks come to pass, but we have always been willing to accept a small chance that risk thresholds could be violated by what we believe would be a small amount in certain very severe scenarios. As always it is very important to make sure you are in the right type of portfolio for your level of risk tolerance.

We thank you for your confidence and trust.

Best Regards,

Cp's Investment Team