

January 2005

As 2005 gets under way, we'd like to take just a moment or two to look back at the last year and review the performance of the capital markets. In addition, we look forward and try to put a frame on what we see for the coming year.

In the end, 2004 proved to be a pretty good year by any measure. For the record, economic growth, corporate profits and job growth all came in strong, while inflation and interest rates remained low despite a gentle rise for each. A late year surge boosted the returns of U.S. stocks and their peers around the globe. The S&P 500's 9.2% fourth quarter gain provided most of its 10.9% return for the year - close to its long-term average.

The large-cap U.S. stocks were outdone by some spectacular returns around the globe. In particular, small company stocks from the U.S. extended their winning streak over their larger brethren to five years - coming in with an 18.3% return. For the five years ending 2004, small company stocks compounded at 6.6% per year, while large company stocks are still shaking off the hangover from the bubble market of the 90's. Large company stocks have a negative annualized return for the five years ending 2004 (-2.3%), but still boast a 12% compound rate of return for the last ten years.

Returns on international stocks were outstanding for both large and small companies. For dollar-based investors, overseas investments were generally enhanced by local currency appreciation relative to the U.S. dollar. For the year, international stocks returned 20.7%.

The real star for the year was REITs, which again performed spectacularly with a 33% return - despite suffering its worst one-month loss since October 1987 (the Wilshire REIT Index was down 14.6% in April). REITs have not only provided fine returns in the face of less than robust stock and bond markets (annualized at 23.4% over the past three years versus 3.6% for large-cap U.S. stocks and 6.1% for U.S. bonds), but have behaved differently in the short run - giving investors much needed diversification.

Perhaps the biggest surprise of 2004 was the behavior of interest rates. At the beginning of the year, many bond investors and most Wall Street experts feared that rising interest rates would bring losses. In fact, in spite of five increases in short-term rates by the Federal Reserve in 2004, intermediate bonds not only posted gains, but they significantly outperformed money market investments.

Short-term rates did rise, as much as 1.5% for one-year Treasuries, but yields on the ten-year Treasury notes ended the year at 4.3%, slightly below where they started the year. For the year, taxable bonds posted a 3.2% return and tax-exempts earned a 2.7% return.

The good news, going into 2005 and still expecting that rise in interest rates, we can remain at the shorter end of intermediate bonds and capture the now higher yields. We expect this to add to returns, while providing the very important protection of principal that bonds afford.

The profitability of U.S. companies neared record levels in 2004 and should continue to rise in 2005. Even more important, corporate free cash flow has risen to almost double the previous peak in the 1990s. However, spending on equipment and software has lagged far behind. By conserving their cash or using it to pay down debt or buy back stock rather than reinvesting in their businesses, company managements are displaying a marked conservatism that appears to reflect concern about the durability of the economic recovery. But in our view, lower oil prices in the near term and the decline in the U.S. dollar will likely lead to robust economic growth in 2005, with acceleration in capital spending expected to follow.

Stocks from overseas nearly doubled the return of U.S. stocks in 2004, the third year in a row they bested U.S. stocks. Prospects for overseas stocks remain positive as valuations are cheaper in aggregate than those of U.S. stocks, and the falling U.S. dollar is expected to add to returns from international stocks. We expect the U.S. dollar to continue to decline in order to bring global trade and money flows into better balance.

Finally, no discussion of economics and capital markets would be complete today without a mention of China. The emergence of China as a global industrial power clearly constitutes a transformative trend with profound influences on corporate performance across multiple sectors.

The increase in economic freedom in China has created consumers with more disposable income than ever before. China is now one of the largest markets for consumer products such as TVs, personal computers, refrigerators and air conditioners. Today, companies in the U.S. and elsewhere are profiting handsomely by selling to China.

China's maturing markets are also creating strong Chinese firms that are building brands, learning new management techniques, and challenging established multinationals both in China and around the world. As always, we will monitor the opportunities this creates to enhance returns and reduce risk, be it in China or the derived benefits to companies around the globe. It's important for us to remind you that economic growth doesn't automatically translate to positive capital market returns in the short-run. While China's economy grew at a 9.5% pace in 2004, China's stocks declined -4.9%.

This communication gives us the opportunity to encourage you to communicate with us or your advisor about changes in your situation that may require us to revisit your allocation of assets. As always, we advocate a balanced diversified approach combined with disciplined rebalancing to provide stability during volatile markets, while participating in the returns of the global capital markets.

Sources: Standard & Poor's, Wilshire Associates Incorporated, Frank Russell Company, Morgan Stanley Capital International, China Daily, Dimensional Fund Advisors, Bloomberg and One Capital Management, LLC. Benchmarks used in this article: U.S. Large Company Stocks - Standard & Poor's S&P 500, U.S. Small Company Stocks - Russell 2000 Index, International Stocks - Morgan Stanley Capital International EAFE Index, Bonds - 5 Year U.S. Treasury Notes, REITs - Wilshire All REIT Index, Tax-exempt Bonds - Standard & Poor's/Investortools Municipal Bond Indices