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Style and Class Matters

Bonds Beat Equities

Given the dismal performance of the U.S. stock market over the last three years, most investors have become acutely aware that diversification across different asset classes (i.e. stocks, bonds, and cash) is a key determinant of investment returns. Having all or a disproportionate share of your eggs in one basket can bring you fortunes if your eggs turn to gold, but can also deliver a devastating result if your basket falls apart.

As the findings from a well-known study published by Brinson and colleagues concluded, over 90% of the variability of returns in a portfolio can be explained by the asset allocation selection.

Since March of 2000, investors that allocated a majority of their portfolios to U.S. equities took it on the chin (technology investors took it somewhere else). Investors mostly in bonds and cash have been smiling on the sidelines while those with balanced portfolios consisting of both stocks and bonds have taken solace knowing that things could have been much worse.

Even though the U.S. bond market solidly out performed stocks during the five-year period ending Dec. 31, 2002 (7.55% annual return for the Lehman Aggregate Bond Index versus a -0.61% annual return for the S&P 500), not all equity investors faired equally bad during this turbulent period. As Table I illustrates, investment style in addition to asset allocation across multiple asset classes does, in fact, make a difference.

Growth Stocks Crater

Investors that favored growth stocks faired significantly worse (in some cases over 10% worse) than those investing in small and mid-cap value as well as blended funds during the five-year time frame.

Table I: Five-Year Annualized Returns Ending Dec. 31, 2002*

	Value	Blend	Growth
Large Cap	.55	-.26	-7.43
Mid Cap	3.05	2.24	-4.73
Small Cap	3.35	5.52	-7.89

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When looking at the three-year returns, the differential among investment styles is even more pronounced. Table II illustrates how value stocks handily beat growth stocks over the three-year period. Of course, much of growth stock's decline can be attributed to the tech sector's meltdown. Had it not been for a stellar 4th quarter of 2002 where the telecom and technology sectors gained 34.9% and 22.7% respectively, growth stocks performance would have been quite a bit worse.

Table II: Three Year Annualized Returns Ending Dec. 31, 2002*

	Value	Blend	Growth
Large Cap	-4.64	-12.06	-31.94
Mid Cap	5.61	2.15	-22.23
Small Cap	8.89	6.62	-21.53

*These tables are constructed using data provided by Morningstar

Learning the Hard Way

The lesson learned is that investors should not only diversify across different asset classes but should also diversify within asset classes.

Over extended periods of time and through varying economic business cycles, different investment styles will go in and out of favor. It's inevitable that even the best managers' comparative returns will suffer if their investment style is currently on the outs. For example, during the tech boom, many renowned managers (including Warren Buffet) appeared to have lost their touch when they were outgunned by the stellar returns of growth and tech fund managers.

Since many of the world's most successful fund managers invest according to certain styles (i.e. some excel in small cap growth stocks while others stick to large cap value stocks), investors will need to utilize multiple managers to gain adequate portfolio diversification.

What To Do Now

SMS believes that stocks will begin to reestablish themselves as a better performing asset class as compared to bonds. Furthermore, it is likely that growth stocks, in particular, will outshine value stocks once the U.S. economy shows signs of sustained improvement.

Disciplined, long-term investors should view the current environment as an excellent opportunity to gradually (over a 12 month period) move funds from cash and bonds and rebalance their portfolios by adding more growth oriented funds. The old adage "buy low, sell high" certainly pertains to this market.

So what's keeping you from investing some of your hard earned dollars in growth-oriented mutual funds that treated you so well during the 1990's? For starters, growth stocks are getting trounced for some very good reasons. Pending war with Iraq, a nuclear standoff with North Korea, massive layoffs, corporate fraud, and disappointing corporate earnings are just a few of the daily reminders of why stock prices having been heading south.

So why not hoard all your money in cash? If you need your money for a particular reason in the next few years, you probably should. Short-term, risk-averse investors should stick to cash and very short duration government and corporate bonds. However, long-term investors desiring to grow their wealth would be ill advised to follow such a conservative strategy.

One important point that long-term investors should always bear in mind when contemplating eradicating anything that remotely resembles a stock from your portfolio is that YOU DON'T WANT TO BET ON THE END OF THE WORLD BECAUSE YOU WON'T BE AROUND TO COLLECT THE PAYOFF. Most investors tend to lose sight of their long-term goals and objectives when news is bad. If you're a long-term investor and believe that the U.S. and other industrialized economies in the world will continue to grow, then you should maintain a reasonable portion (greater than 30%) of your portfolio in equities (U.S. and global). A more significant allocation to equities will depend on your particular circumstances. The chances are that you will live to see better days and should invest some of your portfolio in stocks.

How SMS Can Help

SMS Capital Management works with its clients to develop a personalized investment strategy and develop an asset allocation mix that meets each client's particular goals and objectives. Through its independence and disciplined approach, SMS researches and identifies proven fund managers with various investment styles. In addition, SMS monitors portfolios and fund managers for deviations from targeted objectives or other changes might expose clients to unanticipated risks.