StraightTalk

StraightLine Advisors
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It's Time for a Change

Equity market risks have increased significantly. A more conservative investment posture is now appropriate

Over eighteen months ago, we executed a dynamic allocation in our client portfolios to participate in a favorable equity market environment while avoiding the risks of potential increases in long-term interest rates.

Client portfolios have benefited during that time from the rapid rise in equity valuations in the fourth quarter of 2004, rising dividend yields from the sectors in which we are most heavily positioned, and increased current yield in short-term fixed income funds.

Over the next few pages, we will outline the case that equity market risks have increased significantly. This does not mean a change in our long-term strategic allocation for your portfolios, but it does mean that a more conservative posture is now appropriate in this environment.

We will address the reasons we feel it prudent to reduce our overall equity exposure, then discuss our fixed income strategy for the balance of 2005. Throughout, we'll answer what we think will be the most common questions we will receive concerning our decision.

Historical perspective on investment returns

The last decade or two provide an incomplete perspective on historical investment returns

For most investors and investment professionals, the experience of the last ten to fifteen years provides the entire historical perspective. For example, if you have owned an S&P 500 index fund for the last fifteen years, your investment has enjoyed a compound annual return approaching 13% per year. A fixed income fund has probably generated returns in excess of 7% over the last ten years. A moderate allocation portfolio, using stocks and bonds, probably has exceeded 9% investment growth since 1994.

The last decade or two, however, provide an incomplete perspective on investments and investment returns. One of the more popular data compilations[1] reaches back to 1926. Others utilize return data back to 1871, when earnings data became somewhat reliable, or farther back to 1802[2].

These longer-term analyses paint a different picture of returns expectations. Fixed income returns have been closer to 5%-5½% historically, while stock returns have been closer to 8%-9%. A 60%/40% mix of stocks and bonds has averaged 7%-7½%, not the 9-10% to which we have become accustomed.

[1] Ibbotson Associates Stocks, Bonds, Bills and Inflation®
[2] Stocks for the Long Run, Jeremy Siegel, McGraw-Hill, 2002

The challenge for investors is to decide whether the price you pay for investments is too high or low.

How much longer will we insist on paying higher prices for equities?

When you purchase a common stock, or an equity mutual fund, you are purchasing the earnings power of the company and the stream of dividends that company will generate for shareholders. The price you pay is determined by the market, and is measured in a large variety of ways (price/earnings, price/sales, price/dividends, etc.).

The challenge for investors is to decide whether that price is too high, too low, or just right for the investment you are making. In one sense, the decision is no different than the decision to buy a car, a loaf of bread, or a new house. What we have seen recently is that investors have consistently been willing to pay a much higher price for stocks and bonds than their counterparts from decades past.

We took historical earnings and valuation data compiled by Robert Shiller (www.econ.yale.edu/~shiller/) and looked for time periods where common stock investors have been willing to pay 25x earnings (or $25 for every dollar of corporate earnings). Since 1881, there have been ten such periods:

Year End	Price/Earnings	Year End	Price/Earnings
1928	25.30x	1999	44.19x
1995	25.03x	2000	37.28x
1996	27.73x	2001	30.50x
1997	33.03x	2003	26.63x
1998	38.82x	2004	27.14x

Over 130 separate time periods, and only ten times have we paid this much for stocks, and nine of the ten have happened the last ten years!

What will make investors finally change their mind?

While hundreds, if not thousands of variables enter into an investor's mind when make choices, one consistent variable has been the level of inflation and changes in that level over periods of time[3]. The best stock markets in the past have come when valuation levels (the price we are willing to pay for stocks) are low, inflation is low and, most importantly, the inflation level is stable.

A review of the same historical valuation data provides an interesting picture of periods when valuations are high and levels of inflation are changing. There have been seven time periods since 1871 where the price we were willing to pay for corporate earnings was more than $20 per $1 of earnings and where the rate of inflation (as measured by the Consumer Price Index) changed by more than 1%:

[3] A thorough and straightforward discussion of the impact of inflation and other factors on the stock market can be found in "Unexpected Returns, Ed Easterling, Cypress House, 2005.

Year End	Price/ Earnings	Beginning CPI	Ending CPI	S&P Return Following Year
1928	25.30x	-2.26%	-1.16%	-7.56%
1929	22.01x	-1.16%	0.58%	-12.67%
1968	22.28x	3.04%	4.72%	-6.91%
1997	33.03x	3.32%	1.70%	23.66%
1999	44.19x	1.61%	2.68%	-6.84%
2001	30.50x	3.39%	1.55%	-11.43%
2004	27.14x	1.88%	3.26%	???

Changes in the rate of inflation appear to impact investors' view of the right price

As you can see, with the exception of 1997, investors appear to have reacted to the change in inflation by either reducing their view of how much corporations are going to earn (the E in P/E), or by reducing the price they will pay for the earnings of a corporation.

One thing is fairly certain in today's environment. It is very difficult to expect that common stock investors will continue to be willing to pay even more for corporate earnings over the next three to five years than they are paying currently.

Fixed income investment can provide capital protection in this environment

Fixed income investors in the nineties and the early 2000s were able to generate high absolute returns by owning bonds or bond funds. In the most recent past, yields in bond funds have fallen to the 3-4% range, making absolute returns a little more difficult to achieve.

Remember, however, that the additional benefit of fixed income investing is the stability bonds and cash can bring to a portfolio when the equity markets are going down.

For example, of the seven down markets we referred to in the above chart, only in 1969 did a portfolio of intermediate-term government securities generate negative returns (and that was less than 1%). In each of the other time periods, conservative fixed income investments served to offset the declines in the equity markets for balanced fund investors.

Significant fixed income returns are generated during periods of falling interest rates, a scenario we find highly unlikely over the next 18-24 months. However, a prudent level of bond investment in most portfolios makes sense for the purpose of generating absolute positive returns during an anticipated difficult equity market environment.

If things are going to be so tough, why not sell all of my stock funds?

For each StraightLine client, we have structured a strategic asset allocation that makes sense for long periods of time, five or ten years or even further. That allocation is based on your long-term financial goals, your tolerance for fluctuating returns, and other factors.

That strategic allocation will generally not change unless your goals and objectives change. However, our evaluations of the markets allow us to make dynamic, or shorter-term, shifts to reflect our views of the economy and the markets. These views tend to look forward eighteen to twenty four months. For example, our last dynamic allocation shift (adding to common stock portfolios in general and emphasizing value type funds in particular), took place in February 2004.

Dynamic allocation shifts do not change the long-term strategic plan for investor portfolios

We do not feel that major variations from a strategic allocation make sense for investors. All markets have proven unpredictable; large bets in one direction or another are more guesswork than anything. We know your best interests lie in a long-term strategy that includes consistent commitments to a wide variety of asset classes.

Year to Date Performance Review (Through September 30th)

Domestic Equities

Standard & Poor's 500 Index 2.77%
Large Cap Value (Russell 1000 Value) 5.72%
Small Cap Value (Russell 2000 Value) 4.02%
Large Cap Growth (Russell 1000 Growth) 2.22%
Small Cap Growth (Russell 2000 Growth) 2.51%

The S&P 500 Index hit a four-year high at the market close on Friday, July 15th. Strength has come from all sectors, but value stocks and large-cap stocks in particular.

Standard and Poor's expects that dividend payouts for 2005 may exceed $200 billion, an increase in excess of 12% over 2004. With 34% of the S&P 500 held directly by individual investors, the net tax savings from the 2003 dividend tax rate change is estimated at $30 billion for 2005, and will probably exceed $100 billion through 2008, when sunset provisions may change back the tax rate.

Dividend payouts by large companies may exceed $200 billion in 2005

Even with the rapid rise in dividend payouts, the return from the dividend portion of common stocks remains near historical lows. We feel the continued push to return capital to shareholders by companies will be the driving force behind any continued equity gains in 2005 and beyond.

International Equities

Average International Stock Fund 6.29%
Foreign Large Blend Funds 9.69%
Foreign Large Value Funds 9.20%
Foreign Large Growth Funds 9.40%
Diversified Emerging Market Funds 23.18%

Funds which concentrate on smaller, higher risk markets (such as South Africa, South Korea, Brazil, Taiwan, Mexico, etc.), foreign equities have led the outperformance of foreign equity markets this calendar year.

Fixed Income Markets

Average Intermediate-Term Bond Fund 1.36%
Average Intermediate-Term Government Fund 1.46%
Average Long-Term Bond Fund... 1.85%
Average Long-Term Government Fund 3.51%

While short-term interest rates have risen (two year Treasury yields have risen from 3.07% to 4.16% in 2005), long-term rates, particularly on high quality bonds, have fallen (30 year Treasuries now yield 4.57%, versus 4.83% at the beginning of the year). A variety of phenomena have contributed to this move, but the bottom line is that investors now have a difficult time gaining additional current yield by increasing the risk of their fixed income portfolio.

Our strategy for the fixed income portion of the portfolio remains the same. The use of conservative bond portfolios, funds that maintain high quality and shorter maturities, make more sense than ever in today's fixed income environment.

Conclusion

In our last StraightTalk piece, we commented that it may be more difficult to find the double-digit returns many investors experienced in 2003 and 2004 going forward. We now feel the risks of market declines have increase significantly for the balance of this year and into 2006. Even if the economy continues to expand and the Federal Reserve continues to flood the market with new capital, investors may now be ready to reevaluate the prices they pay for the investments they own.

Proper asset diversification and an emphasis on quality mutual funds in your retirement account remains key. In conditions like the present, this means a higher weighting on more stable asset classes, like fixed income and cash equivalents, and slightly less exposure to growth-oriented stock mutual funds.

We will continue to evaluate the funds available in your account to make sure that expense ratios, manager tenure and consistent returns provide you with an advantage. Meanwhile, maintaining or increasing contribution levels to provide retirement asset growth when returns are not significant will be important.