COMSTOCK

Paul Comstock Partners

Your partner in investment decision making...

MARCH 2007

Market Commentary

Both the market and the economic outlook started strong this year, but faded over the course of February and March. Annualized real GDP growth fell to between 2.0% and 2.5% this quarter from its prior three-year average of 3.7%. The S&P 500 returned 0.64% for the quarter. Mid Cap US stocks, led by continued outperformance of Real Estate Investment Trusts, were the strongest performer for the quarter with the Russell Midcap returning 4.38%. Small Cap US stocks also outperformed large caps with the Russell 2000 delivering a 1.95% return year to date. Non-US stocks continued to perform well. The MSCI EAFE index returned 4.15% for the quarter and the MSCI Emerging Market index delivered a more subdued 2.35%. Oil increased to over $65 per barrel driven in part by the Iranian capture of the British sailors and the delayed February onset of winter weather across the Northeast. The inversion of the yield curve moderated as yields fell shorter term bonds with little change in 10+ year maturities. Yields on two-year Treasuries fell 24 basis points from 4.82% at December 31, 2006 to 4.58% at the end of March. Low quality fixed income continued to be the strongest performer with CCC rated bonds leading with a 4.17% return for the quarter.

Housing is the main culprit behind slowing GDP growth, but weakness in auto and disappointing capital spending also contributed. Headlines about poor housing data and imploding sub-prime lenders have been the main focus of the financial press this quarter. The real concern at this point is how the exit of the marginal sub-prime buyer from the housing market will affect the industry as a whole. Economists are divided over whether the housing decline will perhaps trigger a recession or if the impact will be isolated and of limited consequence for the US and global economy. If a soft landing in the housing market occurs, the larger and better financed companies in the home-building and mortgage lending industries will likely benefit with growing market share at the expense of weaker competitors. A hard landing may trigger a recession that could have a severe impact on all cyclical stocks as well as commodities.

A significant factor in this equation is growth outside the United States. As consumption in the US has been the primary driver of global GDP growth in recent years, it is important that other economies can step into the void if US growth stalls. There are some encouraging signs on this front. Both European and Japanese GDP growth have increased from the 1.5% average of the past few years to around 2.5%. A shift in consumption and economic growth away from the US may bode poorly for many small cap US companies with limited overseas sales, while large cap and multinational US stocks will likely benefit.

A recent conference we attended sported the intriguing title *Endowment Envy: exploring how the "Yale Model" is affecting the interests of the institutional investor*[1]. Referring of course to the phenomenal performance of the Yale Endowment under the leadership of David Swenson, the conference promised to address the question of whether Yale's performance can now be enjoyed by anyone with the will and the money to invest similarly. Is Yale's past performance replicable by most large investors in the current market environment? Or was it a result of Swenson being the "first to the party" in a group of investment strategies now broadly labeled "alternative" that may at this point in time have too much money chasing too few opportunities? This is the key question of today's financial markets. Given that the marketing and product development machine known as Wall Street is emphatically answering the first question in the affirmative, we suspect that a "yes" on the second question better reflects reality.

To be sure, the performance and asset allocation of top US college endowments is impressive. According to the presentation given by Leslie Keifer at Cambridge Associates, the top endowments had a ten year annualized total return of 14.6% as of June 30, 2006. Not only does this outstrip the 8.32% performance of the S&P 500, it beats any single major equity index, domestic or international. The average asset allocation had 14% in US equity, 20% in non-US equity and 11% in bonds and cash, leaving 55% of their portfolios in the various categories of alternative investments. US equity averaged over 25% of top endowment portfolios through the late 1990s and declined over

the course of the present decade whereas allocations to international stocks increased dramatically over the ten year period. Allocations to real estate and non-marketable alternatives (i.e. private equity) were relatively constant but allocations to hedge funds increased substantially in 2002, from 12-13% to over 20% where they remained until present.

What does a thoughtful investor make of all this? Do they reallocate their portfolios to match the mix provided above? Or out of knee-jerk contrarianism do they load up on large cap US stocks and investment grade bonds, now that there is no asset class that has not been embraced by the masses? The example set by the performance of top endowments certainly has demonstrated the power of diversification and eliminated biases against investing outside of US stocks and bonds. When David Swenson took over the Yale Endowment in the 1980's, most Endowments conservatively invested in large cap US stocks and investment grade bonds. They were stymied by the Prudent Man rule, which in essence said that you could only invest in what everyone else thought was acceptable. If the bulk of assets in the financial markets are managed under rigid conventions of propriety, there are bound to be opportunities for those willing to step outside of those bounds. For example, Michael Milken showed in the early 1980's that high yield (junk) bonds had delivered outsized returns for the risk taken. After the investment world followed Milken's research and loaded up on high yield, the bonds delivered outsized risk and poor returns. Prior to the wide popularity of hedge funds, exotic trading strategies like convertible arbitrage were treated by the bulk of investors with skepticism perhaps ensuring that the strategies would continue to work for the few who ventured to employ them. Now we are in an environment where the motto seems to be "invest first, ask questions later". Is it reasonable to believe that outsized returns remain readily available for all?

We continue to believe that the best practice is to evaluate investments based on an analysis of the future opportunities rather than the past. Given that history is certain while the future is not, it is understandable that many investors focus an inordinate amount of time looking at it. There is a great deal to be learned following the thoughts of the top endowments; they are some of the most sophisticated investors in the world. However they have minimal liquidity requirements and are exempt from taxes – two important factors that separate them from the majority of investors.

Very likely there is too much money chasing private equity and hedge funds these days. In this environment, the best players are flush with more capital than they can employ and are, therefore, mostly closed to new investors. As money flows in, managers are increasing fees as opportunities diminish. The cardinal rule in making excess returns is to be a provider of scarce capital. David Swenson provided scarce capital to the alternative strategies he funded throughout his career and benefited as abundant capital was available to come in behind him. Can any investor today giving money to a multi-billion dollar hedge fund of funds believe that his dollar of capital is a scarce commodity? Although it is perhaps uniquely challenging today, we continue to look for places where our client's capital is scarce and will be treated with outsized returns.

[1] Note in the interest of full disclosure I did not actually attend the conference, an invitation-only event hosted by Research Affiliates over a weekend in San Diego with such financial luminaries as Harry Markowitz and Burton Malkiel. The day before I was to leave I broke my ankle but fortunately Paul was more than willing to take my place at the conference.

Questions? Please feel free to contact us at (713) 977 2694.

Steve Browne,CFA
CIO
Paul Comstock Partners

Copyright © 2007 Paul Comstock Partners. All Rights Reserved.