

C A M B R I D G E A S S O C I A T E S L L C

U.S. MARKET COMMENT

BEAR MARKETS, CONTINUED

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“Only the elderly who have not understood the changes in the nation’s financial markets, or who are unable to adjust to them, are sticking with stocks.”—“The Death of Equities,” Business Week, August 13, 1979.

Bear markets, it has been said, are a process of confidence destruction. Indeed, secular bear markets are dangerous not because they go straight down, but because they tend to stage periodic, violent rallies that look, for all intents and purposes, like a new bull market, sucking many investors in right before reversing course and plunging to new lows. Thus, by the time the market finally *does* hit bottom, most investors have long since thrown in the towel and sworn off equities forever. While we are clearly nowhere near this point today, we thought it might be helpful to review exactly where we are in the secular bear market that began in March 2000, and what this portends for future returns.

The most recent example of a secular bear market bottom in the United States occurred in 1982, when the S&P 500 was trading around 100 (the same level as 14 years earlier), valuations had sunk to a post-Depression low (Table A), investor sentiment showed extreme levels of pessimism (Table B), and mutual fund managers were holding roughly 12% of assets in cash (Table B). Long-term Treasuries, meanwhile (often referred to at the time as “certificates of confiscation” due to the ravaging effects of inflation), offered rates in the low teens (with real rates briefly spiking up to 6%), while gold traded at around \$500 an ounce, up from less than \$200 three years earlier. In retrospect, of course, this represented a tremendous buying opportunity for U.S. financial assets.

Certainly, both economic conditions and market statistics today are far different from those of 1982, and few would make the argument that we are currently at a market bottom. Yet considering the S&P 500’s 54.72% return since October 2002, along with the Nasdaq’s 85.61% rise, it seems relevant to ask whether this represents (as we believe) just a garden-variety bear market rally, or instead the first leg of a new secular bull.¹

One reason we believe this to be a bear rally is that markets never came close to the conditions seen at previous bear market bottoms. As we have noted in earlier papers, even at the October 2002 and March 2003 low points, investors were not unduly pessimistic, while valuations remained at levels more reminiscent of prior market peaks than troughs. In simple terms, while the 49.15% drop in the S&P 500 from March 2000 to October 2002 (and 77.93% drop in the Nasdaq) purged many of the most egregious excesses built up during the bubble, and sent most speculative day traders and stock jockeys packing, the subsequent rally has bolstered most “investors”’ belief that they are right to “stay the course” in equities. As stated above, this is typical bear market action: it generally takes years of failed rally attempts to disabuse investors of their love for equities after a major bull run.

For example, while it is easy in hindsight to view 1982’s single-digit P/E ratios as a bargain, Table A shows that the market multiple had been mired below 10 for several years; in other words, investors had already been burned buying “cheap” equities and watching them go nowhere. Inflation, meanwhile, averaged 7.4% a year in the 1970s, playing havoc with nominal returns. As of June 30, 1982, for example, investors

¹ We have been periodically exploring this issue over the past few years. For more details, please see our *Asset Allocation in the Current Environment* series at www.cambridgeassociates.com.

who had bought the S&P 500 when valuations touched a low of 8.1 in September 1974 (in other words, got the timing just right) had seen their *nominal* average annual compound return of 10.7% reduced to a mere 1.7% in real terms. And this represented the *best-case* scenario. It is easy to see, therefore, why *Business Week* ran their infamous “Death of Equities” cover story—a fascinating piece of history that documents investors’ flight from stocks in the 1970s.

Of course, while history is a useful guide to future events, we must also consider the possibility that today’s market will bottom in ways significantly different from those seen in past bear markets (or that it has already done so). The market could, for example, simply go sideways for ten to 20 years, with rising earnings eventually bringing multiples to more attractive levels. While we do not expect this, and such an outcome would differ significantly from that of past bear markets, investors should remember that the number of bear markets on which we have data is quite limited. Indeed, while we feel the 1982 bottom is representative of the conditions one would expect at a market trough, it is the *only* example of a major U.S. market bottom for which we have reliable data. In other words, we recognize that there are significant differences between the economic backdrops then and now, but are stymied by lack of data on other market troughs.

It could be argued, for example, that as conditions today are different from those of the past, markets do not need to “bottom” as they have in prior bear markets. Some observers, for example, believe the quick monetary and policy actions by the Federal Reserve and the Bush Administration managed to short circuit the typical adjustment process, and that markets can thus rise from current levels in line with real earnings growth. Certainly this argument has some appeal: corporate earnings have been spectacular over the past year, and valuations measured on trailing 12-month earnings, while still high, look far more reasonable than during the bubble. In addition, it seems logical that equities would sport higher valuations in an era of low inflation and low interest rates, both real and nominal. Even further, the market has done quite well despite a raft of negative news over the past year (oil and commodity price rises, stagnant employment numbers, and extremely low capital expenditures, to name just a few), and thus positive news could easily send equities flying.

The main problem with such reasoning is a short-term focus that fails to take into account the legacy of the bubble. (Also, as we have noted in the past, we believe normalized earnings are a better gauge of valuations than those based on past year earnings, and normalized P/E’s are currently one standard deviation above their long-term mean.) While we would agree, for example, that a sharp drop in oil prices could push equity prices higher, such a development would be unlikely to resolve the systematic overvaluation of U.S. markets. In other words, equities are currently priced to return very little over the medium- to long-term unless one is willing to make some *extremely* optimistic assumptions.

Table C shows that unless investors are willing to maintain today’s far higher-than-average normalized P/E multiples, or companies able to deliver truly astounding earnings growth, five-year returns must be less than the long-term historical average. If, for example, multiples and earnings growth reverted to their post-1960 means (hardly an overly pessimistic assumption), the average annual price change for the S&P 500 over the next five years would be 3.3%, barely enough to offset CPI inflation at current levels. (Puny dividend yields of 1.6% will not help much, either.) Further, if multiples contract and/or earnings growth slows markedly—not all that unlikely considering both have been well above their historical averages

for quite some time—risks to the downside are significant. For example, if multiples were to drop to one standard deviation *below* their long-term mean, as they have in previous secular bears, the S&P 500 would fall 2.3% on an annual basis *even if* companies were somehow able to meet analysts' rosy-eyed forecasts of 12% annual earnings growth for the next five years. In short, while we cannot predict what the S&P 500 will do for the next week, let alone the coming five years, we can say that everything must go right for five-year nominal returns to merely equal long-term averages. Considering the risks outlined above, such an outcome seems highly unlikely, suggesting that future returns are likely to prove relatively low by historical standards.

Risky Business

Our base assumption therefore remains that we are in the early to middle stages of a secular bear market, with significant down legs yet to come. The most likely proximate cause of an equity market sell-off remains an accelerated, destabilizing decline in the US\$. This is not to say we expect a crash; rather, we expect that *if* there were a sharp, self-reinforcing sell-off in the US\$, this would exert considerable strain in the global economy, causing a commensurate rise in investors' risk aversion. A dollar swoon could be caused by a number of factors, chief among them a decision by Asian central banks to either sell U.S. Treasuries or simply scale back purchases of new issues. With non-U.S. investors now holding more than 43% of outstanding Treasuries, up from 30% at the end of 2000, they appear to hold the key not only to currency markets, but also to U.S. interest rates.

Indeed, while a sharp decline in the US\$ would be damaging in and of itself, the bigger danger is that a falling dollar could set off a chain reaction of negative events: rising U.S. interest rates, with all that entails for highly levered U.S. consumers and homeowners; rising prices for goods and services; a general drop-off in global economic activity; and, in a worst case scenario, some sort of global financial crisis. Such crises, it should be noted, are an endemic feature of the fiat monetary regime the world has relied upon since the United States cut the link between the dollar and gold in 1971. Since that time, there has been a steady increase in cross-border financial crises, nearly all of which can be laid, at least to some degree, at the feet of currency markets.

Again, we are not predicting a dollar crash—we did not even know how much probability to assign this scenario over the next several years. Our point is merely that risk aversion and volatility are both unusually subdued, and market stability unusually high, at a time when there are certainly risks out there about which the market seems (on the evidence of equity valuations and bond credit spreads) rather complacent. As regards the dollar, indeed, we would be more inclined to predict a rally in the short term, since everyone seems now to expect a further decline. After all, markets relish proving the consensus wrong, and the chorus of dollar bears has become so deafening in recent months it is reminiscent of the widespread bearishness on Treasury bonds at the beginning of 2004 (and we know how that turned out). The point, of course, is that when everyone “knows” something is about to happen, it may be a good time to consider the other side of the trade.

That said, a bounce in the buck would not cure what ails the currency: namely, the yawning U.S. current account and budget deficits. In simple terms, the United States is now a massive debtor country, and the easiest way to alleviate debts (particularly when one's currency also functions as the preferred global store of value) is to inflate them away.

In this context, there are those (including some at Cambridge Associates) who believe that equities are being artificially supported by the Fed's continuing (and misguided) efforts to reflate the debt-laden and distended U.S. economy—efforts that will only postpone the eventual (and necessary) day of reckoning. Put simply, this school of thought holds that the Fed's aggressively stimulative monetary policy laid the groundwork for an unsustainable boom built on debt and that higher rates are necessary to clear the excesses of the bubble and pave the way for a new economic expansion. Continuing to hold rates too low, they say, will simply delay the inevitable adjustment, allow excesses to become more extreme, and inflict greater pain in the end. As James Grant, editor of *Grant's Interest Rate Observer* (and a firm believer in this line of reasoning) once put it: “no proper boom can be built on the uncleared debris of a preceding boom.” For those subscribing to this view of central bank perfidy—or gross incompetence—gold is the logical hedge against a debasement of the currency.

How Bad Do You Want It?

If current equity prices seem to reflect a good deal of complacency, credit pricing reflects unsullied optimism. Indeed, spreads of high-yield and emerging markets debt over Treasuries are now so tight that the risk of an outlier event is essentially priced at zero; thus, even a minor upset is likely to trigger a rise in risk aversion. The current appetite for yield puts us in mind of the old Don Henley lyric: “How bad do you want it? Not bad enough.” For example, the high-yield Treasury bond yield spread has shrunk to the narrowest margin since our data series began in 1987, even as U.S. economic growth has showed signs of softening. As of December 31, high-yield debt yielded only 250 basis points more than ten-year Treasuries, which are themselves at historically low levels. As with equities, high-yield debt is now priced so dear that absolutely everything needs to go perfectly for the economy, interest rates, and corporate earnings in order for investors to just earn historically average returns. The risk-reward equation, in other words, seems badly skewed: investors are incurring considerable risks with little or no chance of earning outsized returns.

More worrisome still are the trends in high-yield issuance, which show the worst credits making up an ever-greater share of new issues. In the first three quarters of 2004, CCC-rated credits made up a whopping 18.7% of high-yield issuance, on track for the highest percentage since our data series began in 1983, and up sharply from 2002 and 2003, when CCC debt made up 3.2% and 7.3% of issuance. Obviously, investors have been willing to overlook the fact that one-year default rates for C- and lower-rated issues average nearly 20%.²

Emerging markets debt spreads are also at historically tight levels, which has sparked rationalizations as to why recent developments make such debt more palatable than in the past. While we do

² Source: Historical Default Rates of Corporate Bond Issuers, 1920-1999, Moody's Investors Service, January 2000.

not consider such arguments spurious, they almost always appear (as in this case) after the fact, and often have little to do with reasons for investing in the asset class *today*. In other words, while one could have made the argument five years ago that increased liberalization of markets and business-friendly governments would bring risk levels down and thus make emerging debt more attractive, to use that line of reasoning today is to cite yesterday's good news as a justification for today's high valuations—never a particularly good idea.

In general, one of the underappreciated stories of 2004 was how the re-embrace of risk that began in 2003 never really ended, but in many ways became more extreme. The strong returns of high-quality stocks in the third quarter—a fact noted by us, among others, as a potentially positive sign for the rally—dissipated in fourth quarter, and appear to have been more of a blip than a trend reversal (Table D). Indeed, many of the best performers in 2004, particularly late in the year, were highly speculative “story stocks” reminiscent of the halcyon days of 1999-2000. TheStreet.com Internet Index, for example, soared 41.53% after bottoming on August 13, while the Philadelphia Semiconductor Index jumped 23.08% from September 8 through the end of the year.

As if to underscore investors' love affair with all things risky, the long-awaited rise in U.S. dividends remains just that—awaited.³ Indeed, the still-puny dividend yield of U.S. markets is yet another argument that future returns will lag historical averages, as dividends have made up 65% of investors' total returns on U.S. stocks since 1973.

Conclusion

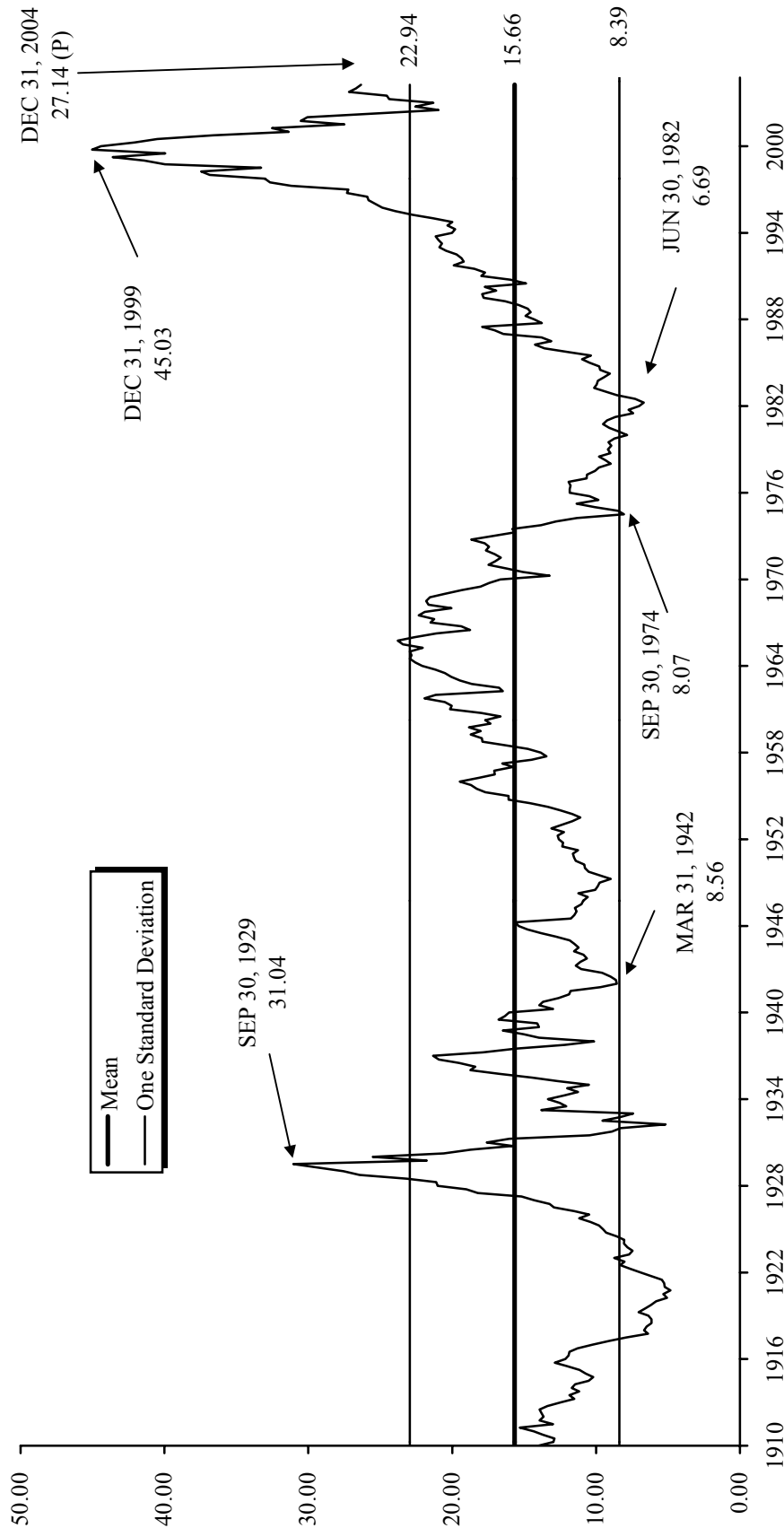
It is perhaps worth reiterating that economic growth is a necessary but not a sufficient condition for good equity market returns. That growth must be at least as robust (and as sustained) as the market has already anticipated and its beneficent effects may be offset at any time by exogenous events that result in rising risk aversion and a consequent re-rating of the market multiple. Consequently, we set little store by economic predictions—even if we thought them likely to prove reliable, which has rarely been the case. In fact, we continue to expect that before this bear market runs its course, we will see a period when economic growth is robust, but equity markets puzzlingly weak.

Overall, we still believe we are somewhere in the midst of a secular bear market and somewhat skeptical of the market's ability to mount a sustained advance from current levels. While the recent rally has been impressive in many ways, it has not differed significantly from similar rallies during previous secular bear markets (Tables E and F), and the speculative elements discussed above make us leery of succumbing to its momentum. Nevertheless, we would caution that bear market rallies can prove far stronger and more durable than most expect, and so we continue to preach diversification and rebalancing as opposed to underweighting equities, and advise investors *with the capability to do so* to pursue incremental returns through managers who seem best able to add alpha in this uncertain environment.

³ For more details, see our September 2004 U.S. Market Comment: *Dividends: Are Companies Willing and Able?*

Table A

S&P 500 NORMALIZED REAL PRICE-EARNINGS RATIOS SINCE 1910



Sources: Calculated from data provided by Bureau of Labor Statistics, *Irrational Exuberance* (Robert J. Shiller), Standard & Poor's Compustat, and *The Wall Street Journal*.

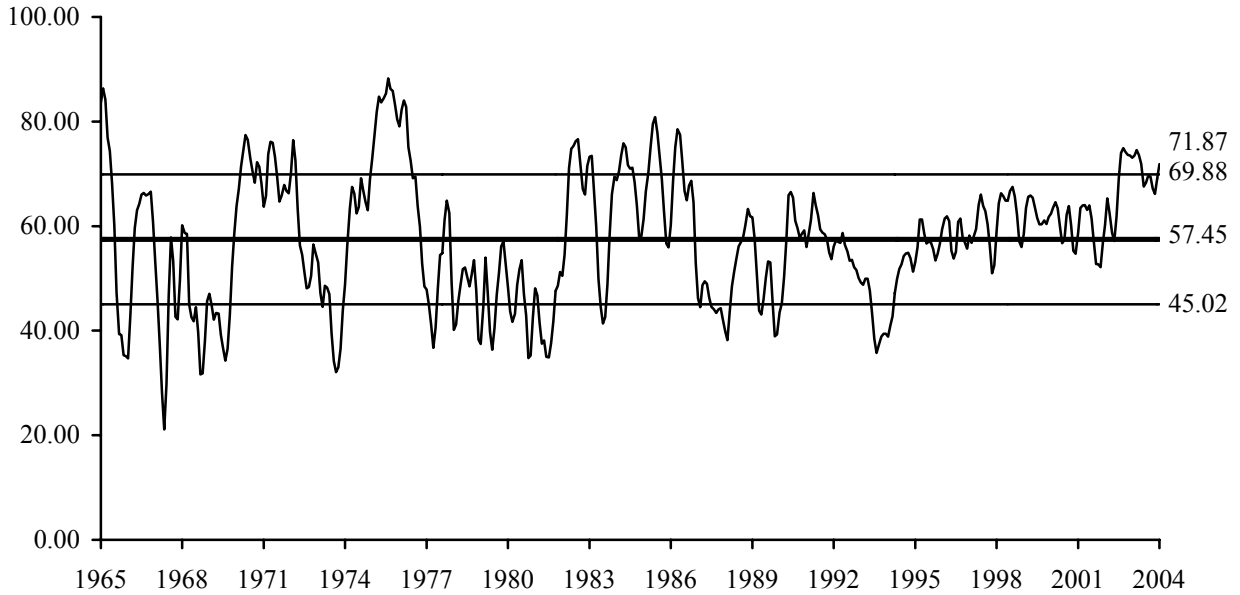
Notes: (P) Preliminary. Normalized real price-earnings ratios for the S&P 500 are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. The graph represents quarterly data through December 31, 2004, however that data point is based upon the CPI-U as of November 30, 2004.

Table B

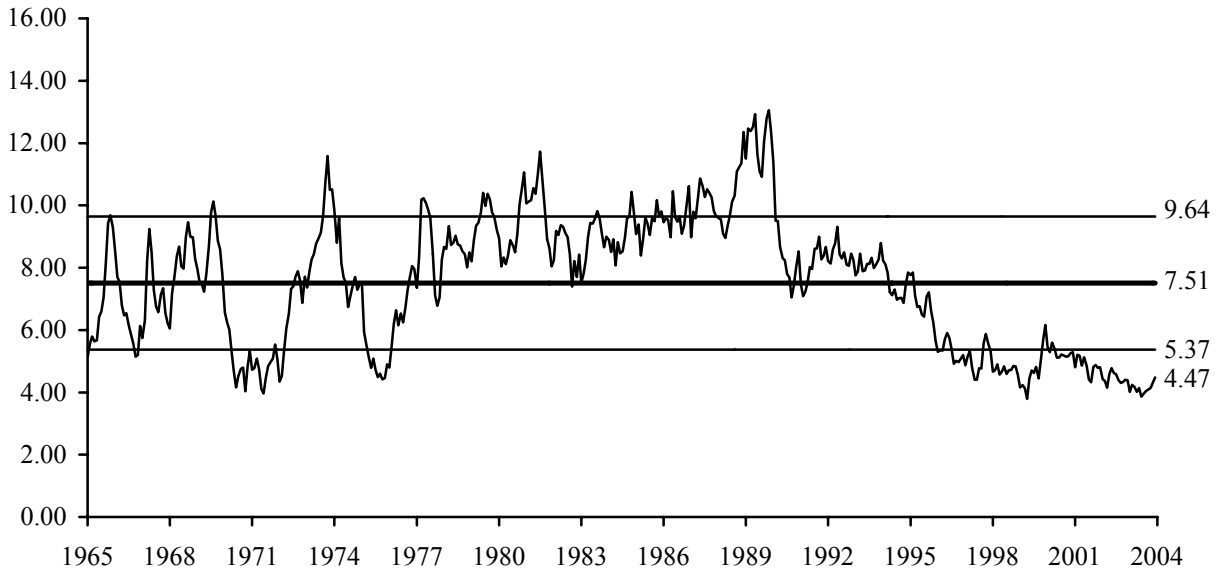
MEASURES OF INVESTOR SENTIMENT/ACTIVITY

December 31, 1965 - December 31, 2004

Advisory Service Sentiment



Stock Mutual Fund Cash/Assets Ratio



Source: Ned Davis Research.

Note: The Stock Mutual Fund Cash/Assets Ratio is through November 30, 2004.

Table C

**HOW MUCH WOULD THE S&P 500 APPRECIATE UNDER THE FOLLOWING
EARNINGS GROWTH AND P/E ASSUMPTIONS?**

As of December 31, 2004

		Five-Year Average Annual Earnings Growth Rate Assumptions		
		Average Earnings Growth (1960-2004) 6.6%	Forward Estimate 12.1%	Average of Previous Five Years 4.3%
<u>P/E at the End of Five Years</u>		<u>Five-Year Average Annual Compound Price Appreciation (%)</u>		
Current Normalized P/E Ratio	27.1	12.8	18.6	10.4
Current P/E	20.4	6.6	12.1	4.3
12-month forward P/E estimate	16.5	2.1	7.4	-0.1
Average P/E Ratio (1960-12/31/2004)	17.5	3.3	8.6	1.1
Average plus one Standard Deviation	24.6	10.7	16.4	8.3
Average minus one Standard Deviation	10.3	-7.1	-2.3	-9.1

Sample Interpretation:

Given a particular earnings growth assumption and price-earnings ratio, this exhibit illustrates the expected average annual price change for the S&P 500. For example, if earnings grew by 12.1% over the next five years (current I/B/E/S consensus estimate), and the price-earnings ratio at the end of five years is equivalent to the current normalized price-earnings of 27.1, then the price of the S&P 500 would increase by 18.6% annually over the next five years.

Sources: Calculated from data provided by Bureau of Labor Statistics, Puglisi & Co., Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal*.

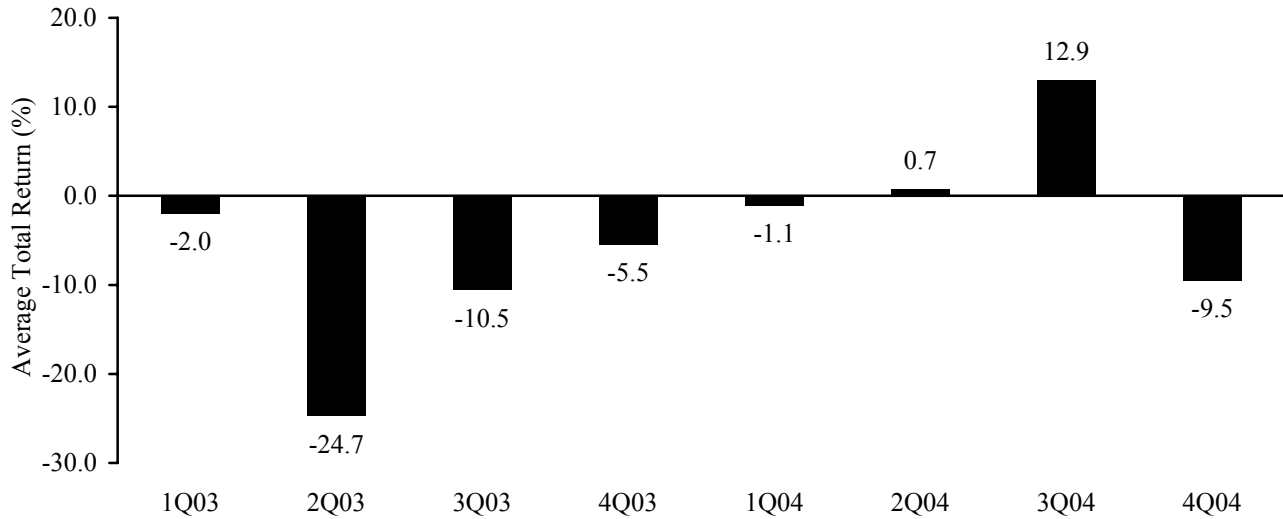
Notes: Based on December 31, 2004, S&P 500 price of \$1,212 and preliminary S&P 500 earnings per share of \$59. The price-earnings ratio using normalized earnings is the real price divided by the trailing ten-year average of real earnings. I/B/E/S earnings estimates have historically been twice as high as actual earnings.

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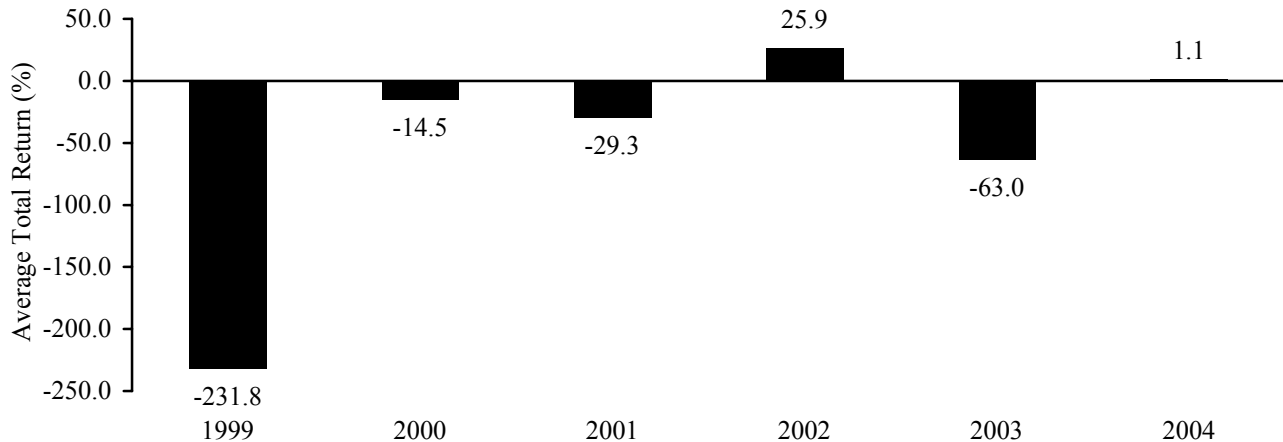
Table D

**PERFORMANCE BY QUALITY:
RUSSELL 1000® INDEX RETURNS OF HIGH-QUALITY LESS LOW-QUALITY STOCKS**

January 1, 2003 - December 31, 2004



January 1, 1999 - December 31, 2004



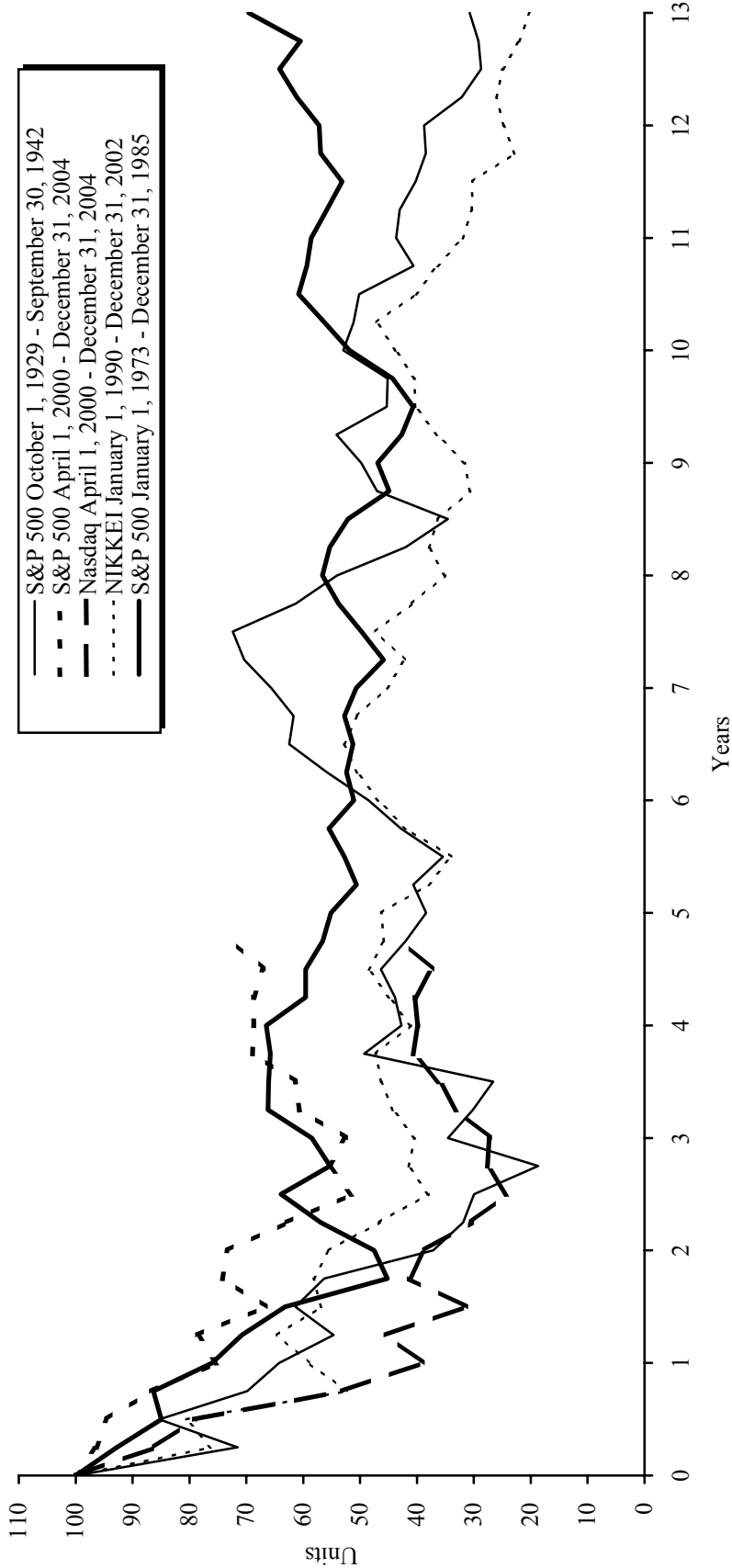
Source: Frank Russell Company.

Notes: "Quality" is measured by the average total return spread between A+ and C companies, as rated by Standard & Poor's. Calculations are based on constituents and rankings as of the end of the periods that were given a rating in that specific period; constituent numbers range from 634 companies in 1999 to 793 companies in 2004. "S&P Common Stock Rankings" are determined by appraising the past performance of a stock's earnings and dividends, as well as its relative standing at the time of the company's current fiscal year-end. Growth and stability of earnings and dividends are key elements in establishing S&P's earnings and dividends rankings.

Table E

CUMULATIVE WEALTH DURING VARIOUS BEAR MARKETS FOR THE S&P 500, NASDAQ AND NIKKEI INDICES

In Real Terms
(Base Value = 100)



Sources: Global Financial Data, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal*.

Notes: All units are in local currency unless otherwise noted. The December 31, 2004 data points are calculated based upon CPI-U data through November 30, 2004.

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Table F
15 BEAR MARKET RALLIES
1926-2004

Equity Market Peaks & Troughs				Bear Market Statistics		Performance From Bear Market Low												
Date of Market Peak	Market Peak Level	Peak P/E	Date of Market Trough	Market Trough Level	Trough P/E	Peak to Trough Perf (%)	Duration of Bear Mkt (mos)	1 Year Later			2 Years Later			3 Years Later				
								Perf. (%)	P/E	Earnings Growth (%)	Perf. (%)	P/E	Earnings Growth (%)	Perf. (%)	P/E	Earnings Growth (%)		
09/07/1929	31.92	20.8	07/08/1932	4.41	8.6	-86.2	34.0	172.0	24.4	-16.7	124.0	21.4	-8.8	141.0	12.5	58.8		
07/18/1933	12.20	28.5	03/14/1935	8.06	12.4	-33.9	20.0	81.0	18.7	20.0	127.0	16.8	66.2	34.0	10.8	57.4		
03/10/1937	18.68	17.3	03/31/1938	8.50	8.8	-54.5	12.5	29.0	17.5	-26.8	44.0	12.3	2.1	17.0	9.4	9.3		
11/09/1938	13.79	22.0	04/28/1942	7.47	7.3	-45.8	41.5	54.0	10.6	5.9	59.0	12.8	-9.2	98.0	14.7	-4.6		
05/29/1946	19.25	22.4	06/13/1949	13.55	5.7	-29.6	36.5	42.0	7.4	3.8	59.0	8.0	15.2	80.0	10.1	-1.4		
08/02/1956	49.75	14.0	10/22/1957	38.98	11.3	-21.6	14.5	31.0	17.7	-16.1	44.0	16.7	-0.6	37.0	16.4	-4.8		
12/12/1961	72.64	23.1	06/26/1962	52.32	15.1	-28.0	6.5	33.0	18.3	10.7	56.0	18.5	24.8	59.0	17.6	39.5		
02/09/1966	94.06	18.0	10/07/1966	73.20	13.3	-22.2	8.0	33.0	18.1	-3.8	42.0	17.9	2.7	27.0	16.0	6.9		
11/29/1968	108.37	18.9	05/26/1970	69.29	12.5	-36.1	18.0	44.0	19.2	-4.9	60.0	18.2	6.5	56.0	15.1	27.5		
01/11/1973	120.24	18.7	10/03/1974	62.28	6.8	-48.2	20.5	38.0	10.9	-14.8	67.0	11.0	4.8	55.0	9.0	17.6		
09/21/1976	107.83	11.3	03/06/1978	86.90	8.0	-19.4	17.5	13.0	7.6	18.9	25.0	7.6	38.8	49.0	8.8	34.4		
11/28/1980	140.52	9.5	08/12/1982	102.42	7.3	-27.1	20.5	58.0	13.0	-8.2	62.0	9.3	16.8	83.0	12.4	10.9		
08/25/1987	336.77	21.9	12/04/1987	223.92	13.2	-33.5	3.5	21.0	11.6	38.1	57.0	14.7	36.6	46.0	14.7	26.7		
07/16/1990	368.95	17.2	10/11/1990	295.46	13.6	-19.9	3.0	29.0	21.7	-18.0	36.0	23.2	-17.0	56.0	22.5	-6.1		
03/24/2000	1527.46	30.0	10/09/2002	776.76	25.6	-49.1	30.5	33.7	26.4	27.2	44.5	19.9	85.1	---	---	---		
							Average			1.0			15.2			17.6		
							Median			-3.8			16.7			6.5		

Sources: The Leuthold Group and Robert J. Shiller.

Notes: The price-earnings valuation data represent the market peak/trough price divided by beginning of month earnings for performance dated 1st through 15th and end-of-month earnings for performance dated 16th through 31st. For one-, two-, and three-year P/E levels, the price is month end, based on the rounding convention used with earnings (1st through 15th/16th through 31st).