



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

LOOKING FOR THEMES IN A RANGE- BOUND MARKET

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Looking for Themes in a Range-Bound Market

What has driven the performance of large-cap equities this year? The fact that they have been stuck in a trading range implies the absence of prevailing themes, which is particularly notable compared to 2003 which suffered no shortage of thematic drivers, as poor-quality, low-profitability, high-leverage, high-volatility, and high-beta stocks outperformed. We looked at a cross-section of potential contributing factors, and found striking sector dynamics as well as a modest tilt to value. However, in contrast to 2003, quality has been the overriding force behind the year-to-date performance of mid- to large-cap stocks, as represented by the Russell 1000® Index.

Sectors. It has been a year of two sectors, and two sectors only: energy and technology. Energy has been the Russell 1000® Index's best-performing sector, returning 39.7% through July. Despite its paltry 5.4% market cap weight in the index, energy has contributed 1.0 percentage points to the index's year-to-date return (including both "integrated oils" and "other energy"). On the other end of the performance spectrum, IT has been the worst performing, returning -8.3% year-to-date, and slashing the index's returns by 1.2 percentage points. Year-to-date performance contributions of the other sectors remained in a tight -0.3% to 0.3% range (see Table A).

Market Capitalization. The market cap effect went AWOL after the first quarter (Table B). Companies with the largest market capitalization in the Russell 1000® returned -1.4% year-to-date, comparable to those with the smallest market cap, -0.9%. The stocks in the second largest group by market cap quintile performed the best, returning 0.7%, while those in the third quintile were the worst performing, with a -2.8% return.

Dividend Yield. Thus far this year, investors have made little or no distinction among stocks by the size of their dividend yield. First, roughly 35% of Russell 1000® constituents do not pay dividends, and their year-to-date returns have ranged from -76% to 70%. Second, within the dividend-paying universe, stocks with the largest yield posted a similar return to those with the smallest yield, 0.9% and 1.0%, respectively (Table C).

Valuations. *Within* the Russell 1000® Index, investors have shown a slight bias toward value, as shown by the performance spread between stocks with the highest and lowest price-to-earnings, price-to-book, and price-to-cash flow ratios (Table D). Indeed, the Russell 1000® Value Index, which returned 2.5% through July 31, has outperformed the Russell 1000® Growth Index by 5.5 percentage points this year.

The mid- to large-cap Russell 1000® Index, while overvalued, is considerably cheaper than its small- and mid-cap indices, and fairly expensive compared to the mega-cap Russell Top 200® Index (Table E). Despite these relatively attractive valuations, large caps have only managed to squeak by small caps, while mid caps have outperformed; the Russell 1000®, Midcap®, and 2000® indices have returned -0.3%, 2.0%, and -0.4%, respectively.

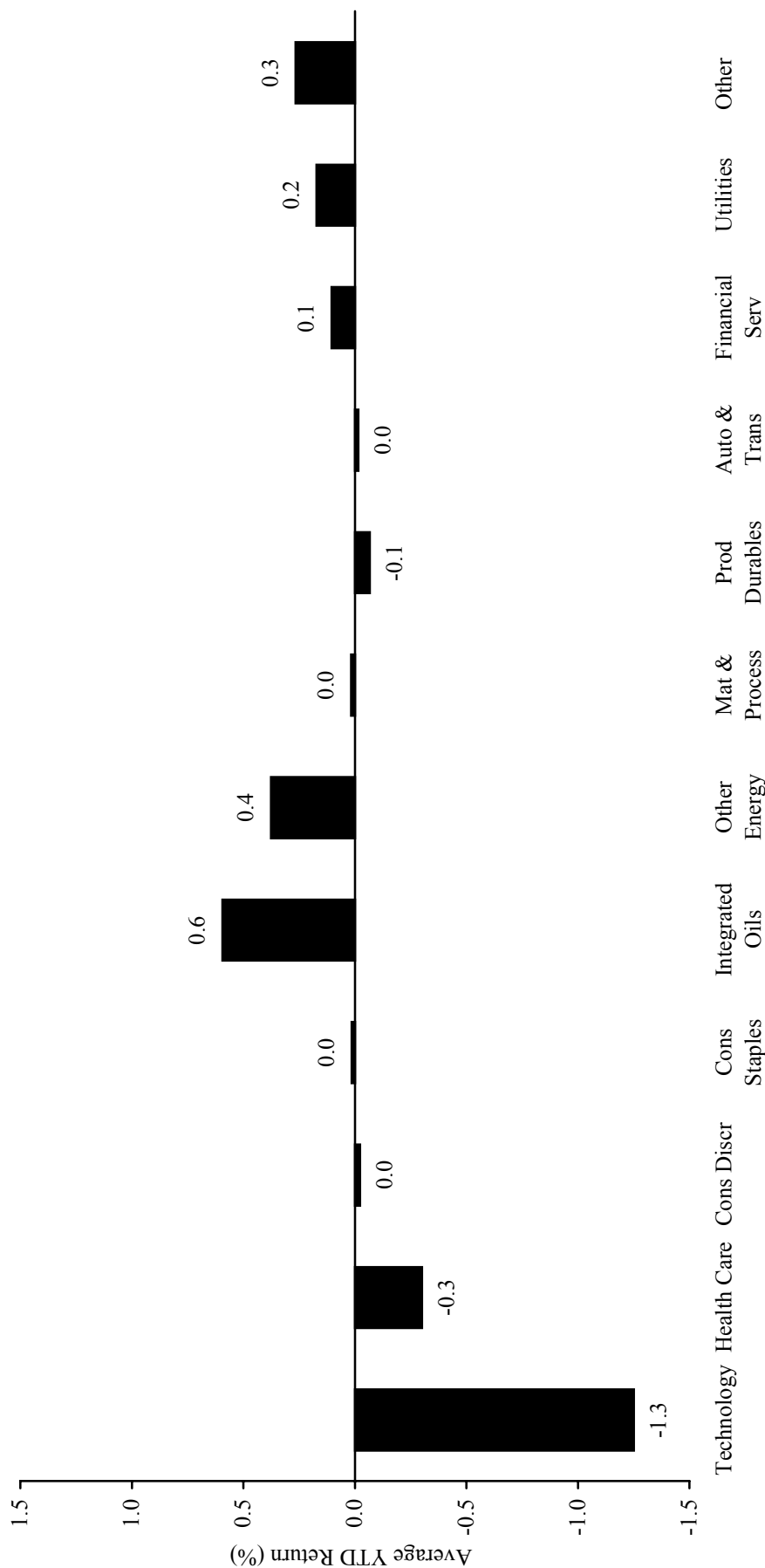
Quality. Investors have clearly preferred high-quality equities this year—quality as defined in the S&P Common Stock Rankings, which rates stocks by the consistency and growth of companies’ earnings and dividends. Table F, which charts the performance spread between the average performance of A+ and C securities, shows that, while low-quality stocks outperformed high-quality stocks from the second quarter 2003 to the first quarter 2004, the disparity steadily diminished until, by the second quarter 2004, high quality has topped low quality.

Similarly, through 2003 companies with low returns on equity (ROEs) bested those with high ROEs, but the tables turned in 2004 and high profitability has since outperformed by a solid margin (Table G).

As argued in our June U.S. Market Comment, we would expect market capitalization to continue to play second fiddle to quality as long as the market remains range-bound or resumes its bear market trajectory.¹ Therefore, investors should review total portfolio characteristics to ensure that the aggregate of individual manager bets have not resulted in an underweight to high-quality securities relative to the market, and adjust portfolio weights accordingly.

¹ For an in-depth discussion, please see our June 2004 U.S. Market Comment: *Underweight U.S. Small Caps? Not So Fast.*

Table A
PERFORMANCE CONTRIBUTION OF THE RUSSELL 1000® INDEX BY SECTOR

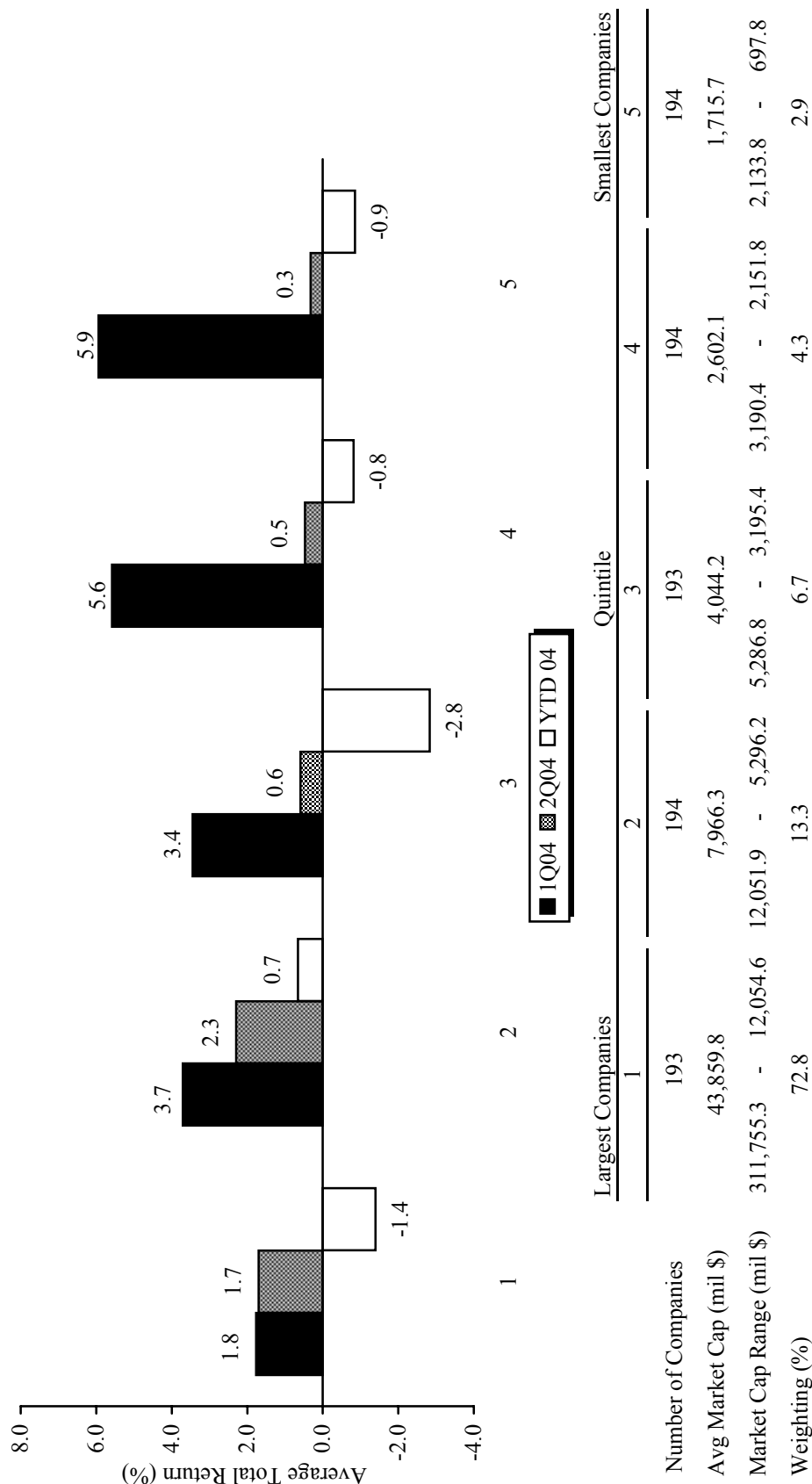


Sources: Factset and Frank Russell Company.

Notes: The performance contribution is calculated by multiplying the year-to-date return for each sector by its weight within the entire index. Returns are year-to-date through July 31, 2004. Market values are as of December 31, 2003.

Table B

RUSSELL 1000® INDEX TOTAL RETURNS BY MARKET CAPITALIZATION QUINTILE

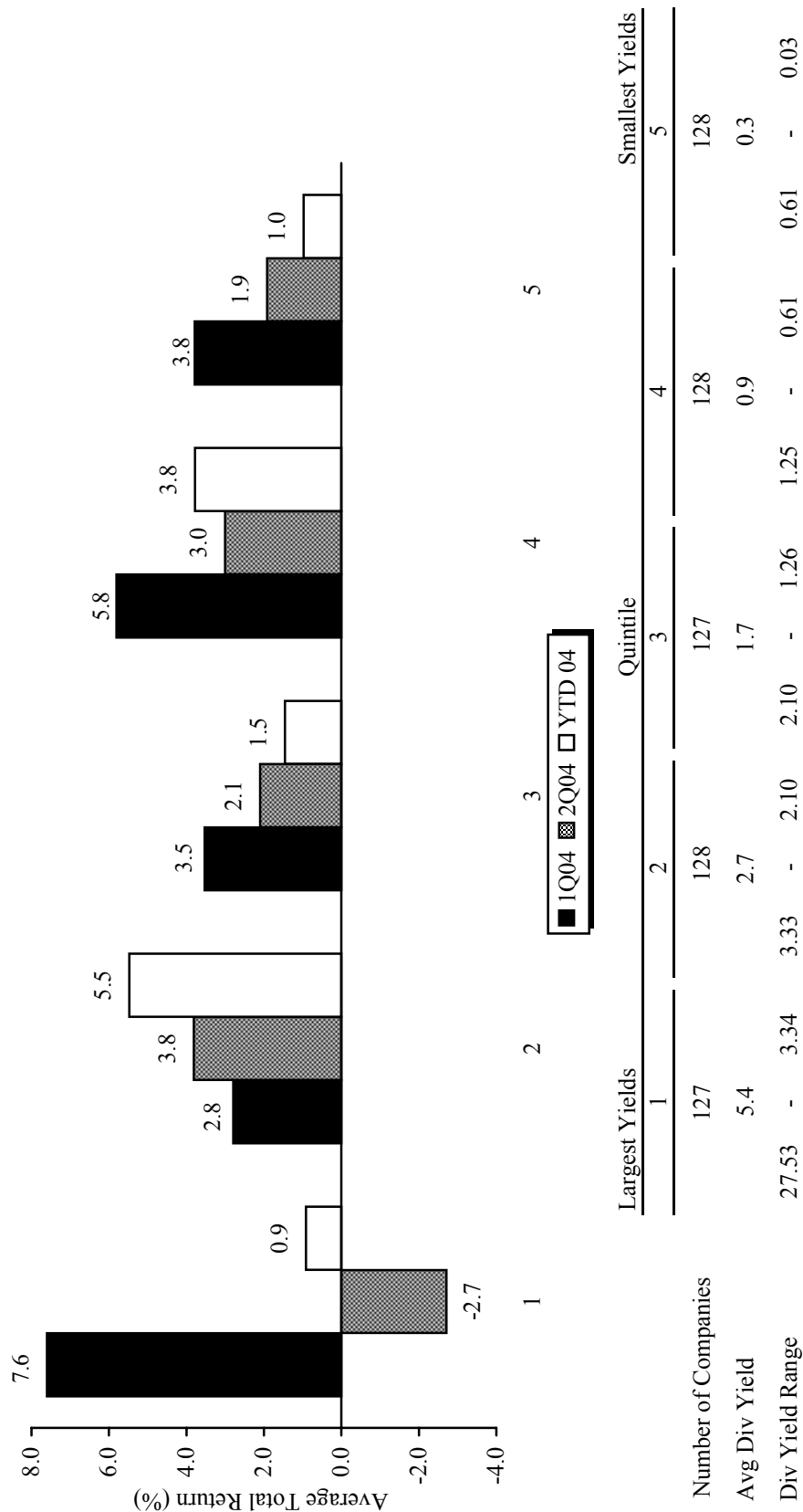


Sources: Factset and Frank Russell Company.

Notes: Year-to-date returns are through July 31, 2004. Calculations based on constituents that had a reported market value for year-end 2003.

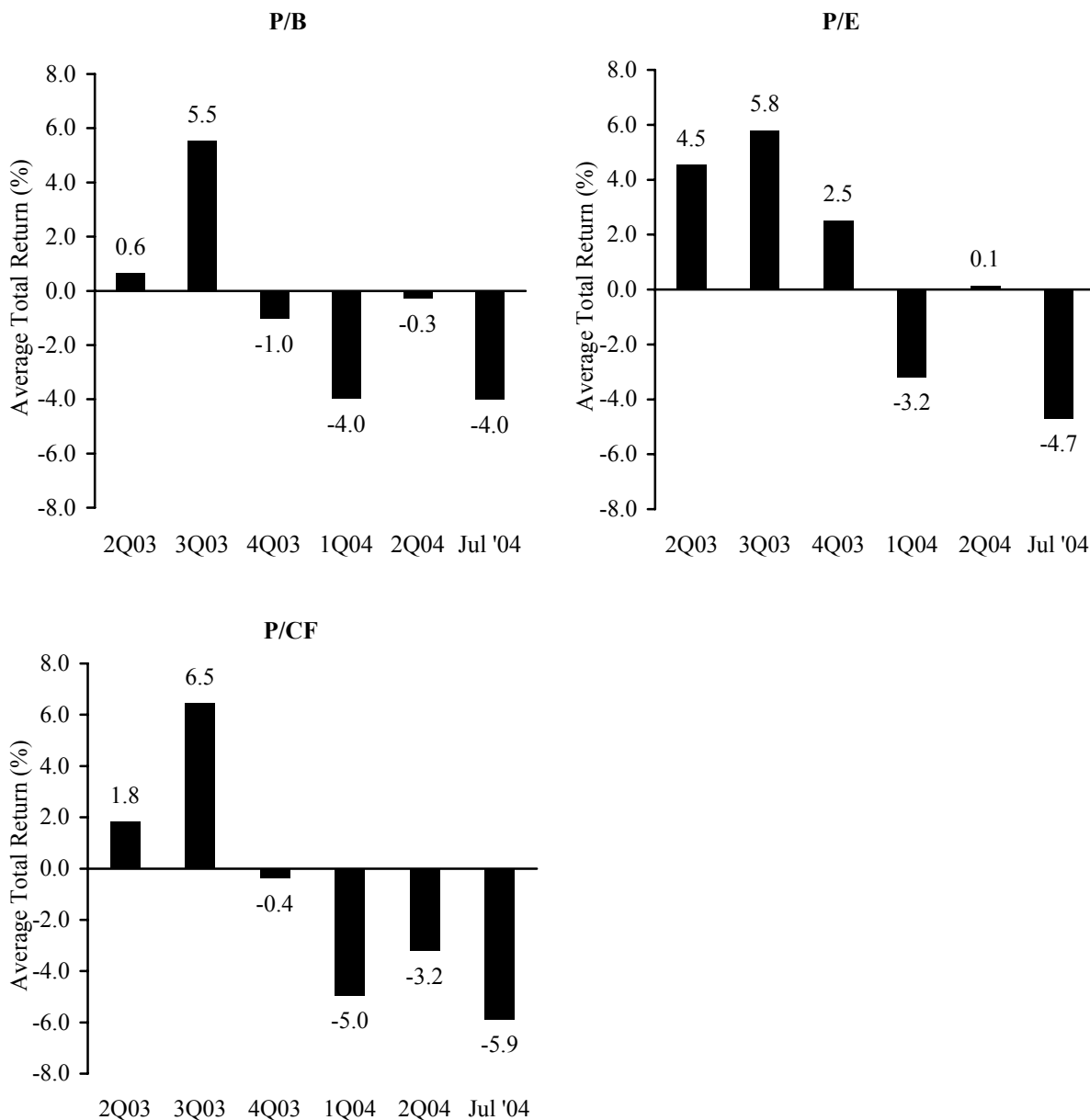
Table C

RUSSELL 1000® INDEX TOTAL RETURNS BY DIVIDEND YIELD QUINTILE



Sources: Factset and Frank Russell Company.

Notes: Year-to-date returns are through July 31, 2004. Calculations based on constituents that had a reported dividend yield greater than 0.03 for year-end 2003. Excluded from the calculations were 345 companies as they had a dividend yield less than 0.02.

Table D**PERFORMANCE OF RUSSELL 1000® BASED ON VARIOUS VALUATION MEASURES****April 1, 2003 - July 31, 2004**

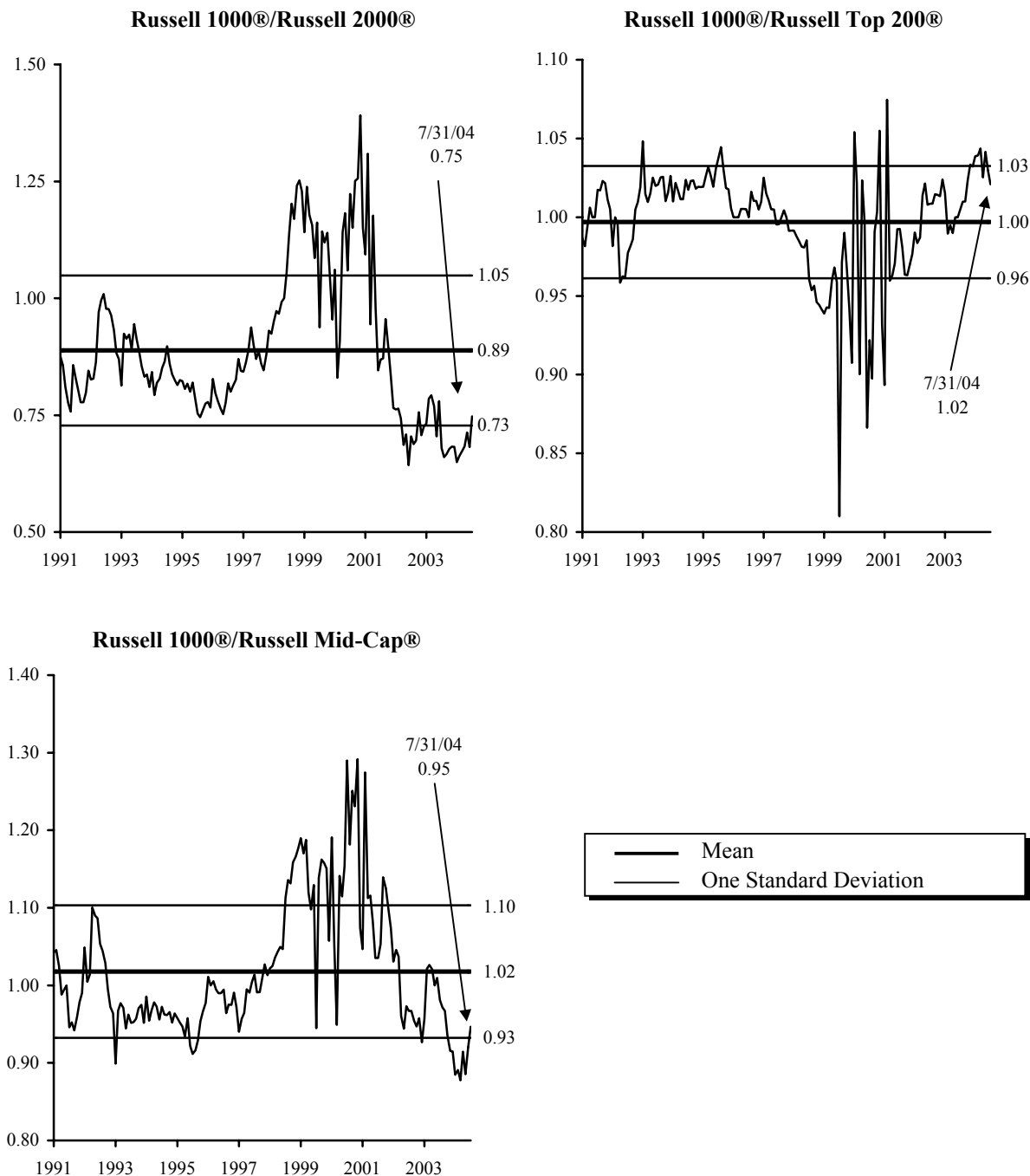
Sources: Factset and Frank Russell Company.

Notes: Calculations are based on quintile rankings with each measure. "Performance" represents the difference between the average return for the constituents in the top quintile and the average return in the bottom quartile. To be included, constituents must have a valuation (each done separately) as of December 31, 2003.

Table E

**PRICE-TO-EARNINGS RATIO OF THE RUSSELL 1000® INDEX RELATIVE TO OTHER
RUSSELL INDICES**

January 31, 1991 - July 31, 2004

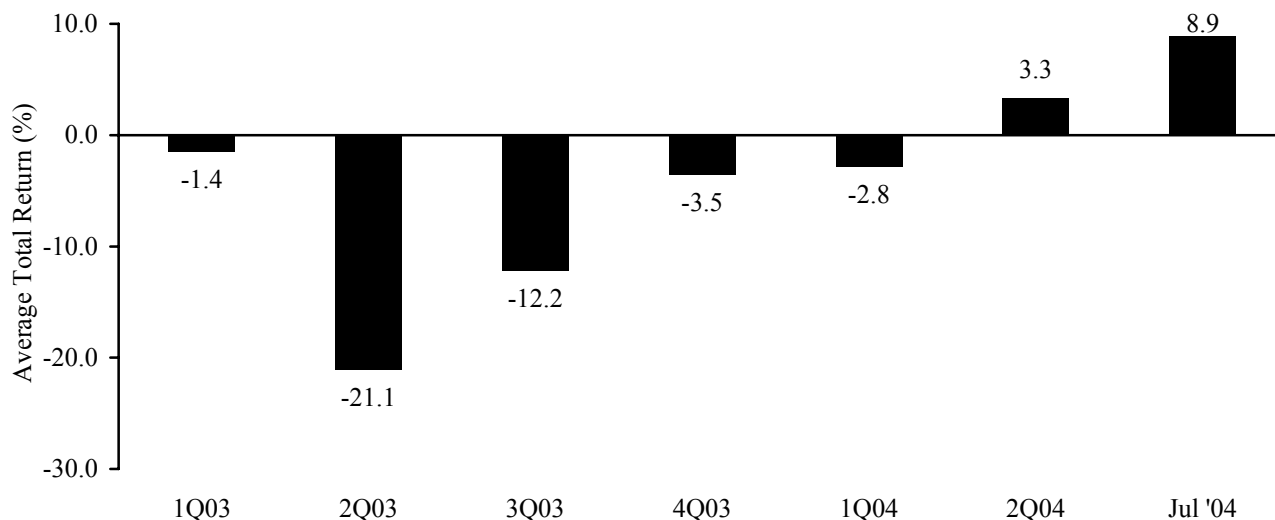


Sources: Frank Russell Company and Thomson Datastream.

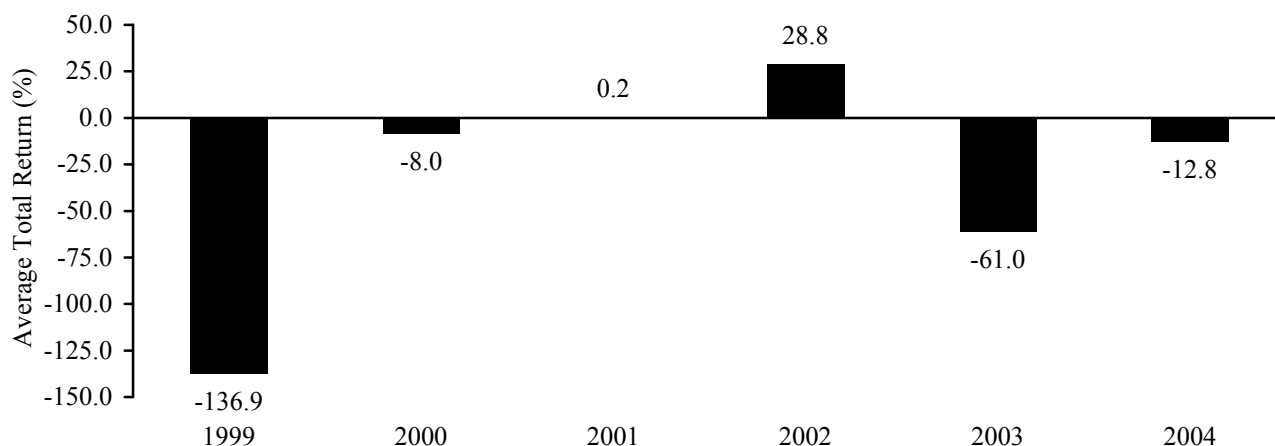
Table F

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

January 1, 2003 - July 31, 2004



January 1, 1999 - July 31, 2004



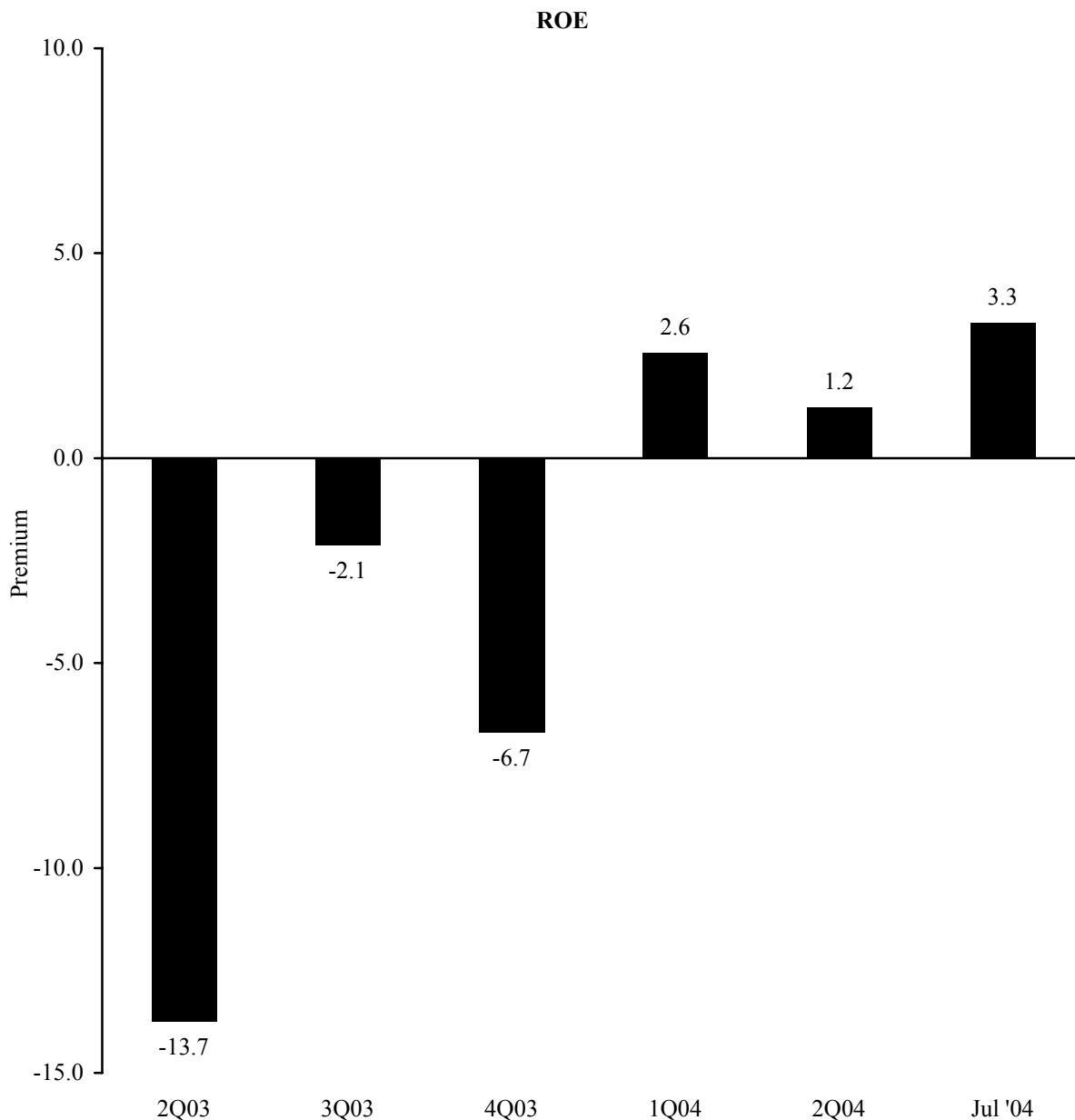
Source: Frank Russell Company.

Notes: "Quality" is measured by the total return spread between A+ and C, D companies, as rated by Standard & Poor's. Enron is the sole D-rated company. Calculations are based on constituents that were given a rating in that specific time period; constituent numbers range from 645 companies in 1999 to 775 companies in 2004. Constituents, quality ratings, and total returns are all period specific. "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 G

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

April 1, 2003 - July 31, 2004



Sources: Factset and Frank Russell Company.

Notes: Calculations are based on quintile rankings of ROE. "Performance" represents the difference between the average return for the constituents in the top quintile and the average return in the bottom quintile. To be included, constituents must have a ROE as of December 31, 2003. ROE is earnings per share divided by book value per share.