



# MANCHESTER CAPITAL MANAGEMENT LLC

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volatile year.*

## **Market Outlook**

Long-term stock investors were rewarded as the market finished 2003 strongly, fulfilling our expectations and bearing witness to the strength of the economic rebound. The S&P 500 Index of stocks was up over 28%, with even stronger performance in the small company sectors of the market. International developed markets, emerging markets, and real estate investment trusts all had stellar years. Some of the best returns came from the most speculative sectors, but the rally was broad.

The bond market was decidedly more subdued, returning only about 4% as measured by the Lehman Aggregate Bond Index. After enjoying declining interest rates for the past twenty years, it appears rates have bottomed and will begin to increase along with the economic rebound. When interest rates do increase, it will have a negative impact on bond valuations, although bonds will continue to provide a stabilizing role for any investor who wants to mitigate risk.

Indeed, the stock market could be in for a volatile year as it is pulled back and forth between strong economic growth with excellent corporate earnings versus growing government deficits, an unresolved war in the Middle East, and political parties on both sides complaining, promising, and threatening.

In our judgment, the financial landscape is neither as dire nor as bright as the different candidates would portray. The job recovery is slow, but it is improving. Increases in productivity and problems with measuring the job market affect the reported numbers more than a widespread exportation of jobs to India and China. America's job losses are cyclical in nature, not structural, and will rebound in the coming quarters.

Both parties are pandering to protectionist fears that would have America retreat from its trade agreements and economic leadership. Isolationism is a greater threat to our economy and markets than outsourcing. The globalization of information technology

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is here and can't be stopped by tariffs or trade agreements. Some American industries are benefiting even while others suffer, but the net economic rewards are substantial.

The deficit is alarming, primarily because the current administration hasn't proven its ability to control spending despite its claims that it will in the future. The deficit is still in-line with the median level of inflation-adjusted deficits that the government has historically run, but the trend of spending increases needs to be changed to make the capital markets comfortable. The Republicans have shown no reluctance to spend, while the Democrats are promising more programs than we can afford with the tax cut.

Further, neither party is willing to address what really is perhaps the major issue in our economic future, the untenable burden of entitlements. Sometime between today and the retirement of the final baby boomers, the system will be changed or it will run out of money. Federal Reserve Chairman Greenspan recently spoke out on the issue, cautioning that we must change Social Security and Medicaid benefits sooner rather than later, but every political candidate trying to secure votes quickly denounced his independent voice.

Meanwhile, we are concerned about excesses in parts of the markets. Perhaps the best example is the excitement about the growth of China, which has sent their stock valuations soaring, commodity prices hitting multi-year highs, and strains on the currency and bond markets. There seems to be a general consensus that it is a "sure bet", which is usually a strong signal that we are reaching an extreme. All the buyers have bought, and they are trying to convince each other they are right.

We are very pleased with the recent success of our portfolio designs, and are watching developments closely to make adjustments as necessary. Our view is to remain calm and focused in this year when there is likely to be more rhetoric than usual because of the upcoming elections.

## ***Selecting Specialty Managers***

As our clients know, our investment process involves selecting specialty investment managers in certain asset classes and investment styles. While we often purchase individual securities and arrange separate account managers for some portfolio designs, in many instances we enjoy the ease and liquidity of accessing great managers through mutual fund shares.

There are thousands of specialty investment managers here and abroad. With the help of Callan Associates, Morningstar, and PEP Software, Manchester Capital has the resources to comprehensively evaluate the universe of managers and only select the best for our clients. Manchester Capital only selects the managers that exhibit consistent performance, reasonable levels of risk for given returns, style purity, organizational stability, and investment team skills and depth.

In order for a particular manager to be considered for client assets, it must pass the following minimum criteria:

- Open to new investments
- Assets of \$100 million
- Manager tenure of at least 3 years in same prospectus objective

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- Have no abusive fee loads (*front loads, back-end loads, or 12-b-1 fees*)
- Expense ratio (*mgmt fee*) below the top quartile of peer group
- Rolling five-year performance ranked in the top quartile of its peer group

*Many managers exist merely because of a sales effort.*

Surprisingly, these minimum requirements eliminate most candidates and give us a working list to continue our search. The next step is more stringent and requires a detailed examination of the manager's performance, risk temperament and investment process. The following quantitative and qualitative measures are evaluated before earning MCM's approval:

- Rolling 3-year performance vs. style group and benchmark
- Three-year Sharpe Ratio vs. style group and benchmark
- Position on the risk/return scatter plot over a rolling 3-yr period
- Consistency and trueness to prospectus objective
- Benchmark- and risk-related ratios
- Investment team credentials and turnover
- Industry and/or geographical distribution
- Individual stock representation and breadth of portfolio
- Stock selection process and sell discipline

We take note of any managers that have excess out- or under-performance. We are particularly interested in the risk employed to achieve excess returns to insure that the out-performance is not being achieved by merely assuming more leverage or disproportionate concentrations.

Typically, we are left with only a few managers in each specialty category. It is always surprising how many managers have inferior performance or attributes and exist merely because of a sales effort.

*Selecting a manager is not the end of the job.*

Manchester Capital will then fulfill all required due diligence screening before officially approving a manager for client assets. This involves, but is not limited to, analyzing their Prospectus, examining their ADV, reviewing their Statement of Additional Information (SAI), and visiting the manager at his/her office.

We also know that selecting a manager is not the end of the job. Once a manager is approved for client assets, we closely track performance, participate in the periodic conference calls, monitor portfolio characteristics, and evaluate market sentiment towards the asset class. Moreover, the Investment Committee meets each month to complete a comprehensive review of each fund's overall performance and key statistics.

Manchester Capital makes a point of visiting the managers on an annual basis. This gives us a chance to ask questions that are pertinent to the future outlook of a specific fund. Our steadfast belief is that personal relationships are what make business possible. We take great pride in being involved with not only our clients but our investment vehicles as well.

## *Investment Committee Meeting Highlights*

**Optimal Allocations** – The Committee re-evaluated the optimal portfolio allocations in view of Callan’s 2004 capital market projections. The expected returns and projected risk characteristics were suitable and well within MCM’s comfort ranges. The Chief Investment Officer, Ted Cronin, did not want to make any changes to the preferred allocations and remains cautious on REITs and high yield bonds in 2004. The Committee also decided to maintain its emerging market allocations – currently at the top of their strategic allocation range.

**Year-to-Date Manager Performance** - The Committee evaluated each manager compared to his or her appropriate benchmark and peer group. The Committee was impressed with their year-to-date performance and comfortable with their current risk profile. The Committee had noted the relative out-performance of MCM’s small and mid cap value managers. Small capitalization stocks historically outperform during recovery phases and small and mid cap value led domestic equities during the sophomore year of the 1992 economic recovery. The Committee is optimistic about 2004 – the sophomore year of the 2003 recovery.

**Year-to-Date Stock Performance** – The Committee reviewed their client’s individual stock positions and industry group allocations. It appears the strength this year is coming from the 2003 laggards. More specifically, consumer staples, oil services, and telecom services are driving performance so far in 2004. The industrials, technology, and basic materials are the laggards so far this year. The Committee noted the S&P 500 is bumping into some resistance at 1160.



**More SEC Investigations** – The Committee was pleased that the SEC charges of manager conflicts-of-interest (late trading, etc.) have not involved any of MCM’s preferred equity managers. The Committee did note the SEC’s inquiries into Callan and PimCo Bond Funds. It appears a marketing group within PimCO was responsible for the violation, and did not directly involve any of the PimCO money managers. David Brigham, Senior Investment Strategist, voiced his concern that the problems demonstrated a management failure at PimCo and will distract Bill Gross, the head at PimCO, from his primary responsibility to shareholders, which is managing its core bond portfolios.