



# MANCHESTER CAPITAL MANAGEMENT LLC

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## **Market Outlook**

**By Ted Cronin, CIO**

*Market fluctuations are  
a buying opportunity  
for long-term investors.*

In 1994, Jeremy Siegel's historic book, Stocks for the Long Run was published, arguing that over time, stock returns surpassed those of bonds, and did so with lower risk when inflation was taken into account. He documented the case for making large holdings of stocks the cornerstone of any portfolio. His thesis coincided with a sharp run up in equity markets that saw extraordinary stock returns through the end of the decade. He became one of the leading, and most celebrated, gurus of the 1990's bull market.

Then the bubble burst. Stock portfolios suffered at the beginning of the new century, and so did Dr. Siegel's reputation. There seemed to be plenty of risk and limited returns in stocks for several years. Some market seers began to suggest that there might be fundamental problems with stock ownership. Investors were advised to favor bonds, hedge funds, commodity pools, gold or silver, real estate, almost anything but equities. A recent newspaper headline quoted a real estate maven as promising that "no one ever lost money" by owning residential property.

New rationales were proposed to undermine stock ownership. First, there was the added risk suffered by stocks from global terrorism. Further, stock prices could suffer if inflation accelerates due to the demands of high growth countries like China. In addition, US corporate profits appear under pressure from globalization and outsourcing.

And there is a growing demographic problem. Low birth rates in the US, Europe, and Japan are resulting in an aging population that faces debilitating debt from unfunded pension liabilities and escalating medical responsibilities. Demand for goods by retirees could outstrip the dwindling supply produced by a decreasing number of workers.

Thankfully, Dr. Siegel has just come out with a new book, The Future for Investors, which reviews the data of the recent bear market, and analyzes stock performance in a more comprehensive manner than undertaken before. His findings support the merits of proportionate stock ownership. A key conclusion, which MCM endorses, is that the fluctuations in the market, instead of being a source of alarm, give

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investors a buying opportunity to establish long-term stock positions.

*The future of the  
global economy  
is bright.*

Dr. Siegel agrees that the fundamental demographic and economic forces are moving the global economy eastward toward Asia. By the middle of this century, the combined economies of India and China will be larger than those of the developed world. Importantly, the rapid growth of developing countries will have a significantly positive impact on our maturing economy, mitigating the negative consequences of the age wave.

As our aging population imports the goods and services we need, we will finance our purchases by selling our stocks, bonds, and brands to investors in the developing world. Stock prices should appreciate as the young investors of China, India, and other emerging markets work to buy majority ownership in most large global companies, something they will achieve by the middle of the century. There will be a massive exchange of goods for assets. There will be a recurring pattern of sales by companies such as Tetley Tea being purchased by an Indian conglomerate or IBM PC division selling to a Chinese computer company.

The future of the global economy is bright. For the first time in recorded history, information is practically free and anyone anywhere has access to the world's knowledge. This will drive productivity, entrepreneurship, and economic growth throughout the world. We believe that over the next several decades, stocks will outperform bonds and typical inflation hedges such as precious metals and other commodities. Successful investors will be those who continue to allocate portioned amounts to diverse asset classes, investing for the long-term trends rather than short-term fears.

## ***Hedge Fund Primer***

***By Rick Johnston, Managing Director, Burlington***

*Hedge funds strive for  
high risk-adjusted  
rates of return.*

Some investors are seeking to complement the traditional asset classes such as stocks and bonds with alternative investments in order to increase the risk-adjusted return potential of their portfolios through investments that offer further diversification and low correlation to traditional financial assets. Over the past decade, hedge funds and funds of hedge funds have performed at attractive levels when compared to both the broad equity markets on a risk-adjusted basis and to the broad fixed income markets on an absolute basis.

Hedge funds are predominantly private investment entities that are typically unregistered, meaning that the Securities and Exchange Commission (SEC) and other regulatory bodies do not oversee them. As a result, they do not provide many of the investor protections that apply to registered investment products. Nevertheless, hedge funds strive for high risk-adjusted rates of return while minimizing correlation to traditional stock and bond markets. While their structures may vary, hedge funds typically include a performance fee and a management fee, both of which are intended to incentivize hedge fund managers to achieve high absolute returns.

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*Hedge funds use sophisticated and, at times, high risk investment strategies.*

Funds of hedge funds (FoHFs), as the name implies, pool multiple hedge fund strategies into one fund with the hopes of offering investors greater diversification and access to multiple and diverse hedge fund strategies. This enables more small investors to participate in hedge funds. Hedge funds and FoHFs have some common characteristics that differentiate them from mutual funds including:

**Absolute returns** - Most hedge funds and FoHFs seek to achieve positive, or absolute, returns in any market. It is important to note that in seeking absolute returns, hedge funds and FoHFs use sophisticated and, at times, high-risk investment strategies such as arbitraging single issuer securities or investing in volatile international markets.

**Low correlation to traditional asset classes** - Hedge funds and FoHFs also attempt to use these sophisticated high-risk investment strategies to provide returns independent of traditional asset classes. Hence, they may provide diversification because you are invested in a fund that is not tied to the markets like traditional assets are (e.g., most mutual funds). This may provide some portfolio stabilization depending upon the hedge fund or FoHFs and market conditions.

**Potentially lower volatility** - Many hedge funds actually strive to "hedge" risk. Since hedge funds generally have low correlations to traditional investments like stocks and bonds, including hedge funds along with traditional asset allocation in a portfolio may improve returns while reducing overall volatility. To the extent that they succeed, the portfolio's overall risk-adjusted return can be substantial.

There are multiple and diverse hedge fund strategies that span the risk/return spectrum. Although rigorous discussion of each would fall outside the scope of this primer a few of the most widely used strategies include:

*There are multiple and diverse hedge fund strategies spanning the risk/return spectrum.*

**Tactical strategies** that strive to take advantage of global market trends as they relate to items such as currency, exchange rates, interest rates and other factors. These strategies may include long/short equity, global macro and managed futures.

**Event driven strategies** that aim to profit from price imbalances upon the completion of a specific event or transaction, such as a merger, hostile takeover, reorganization or leveraged buyout. These strategies may include merger arbitrage, distressed securities and special situations.

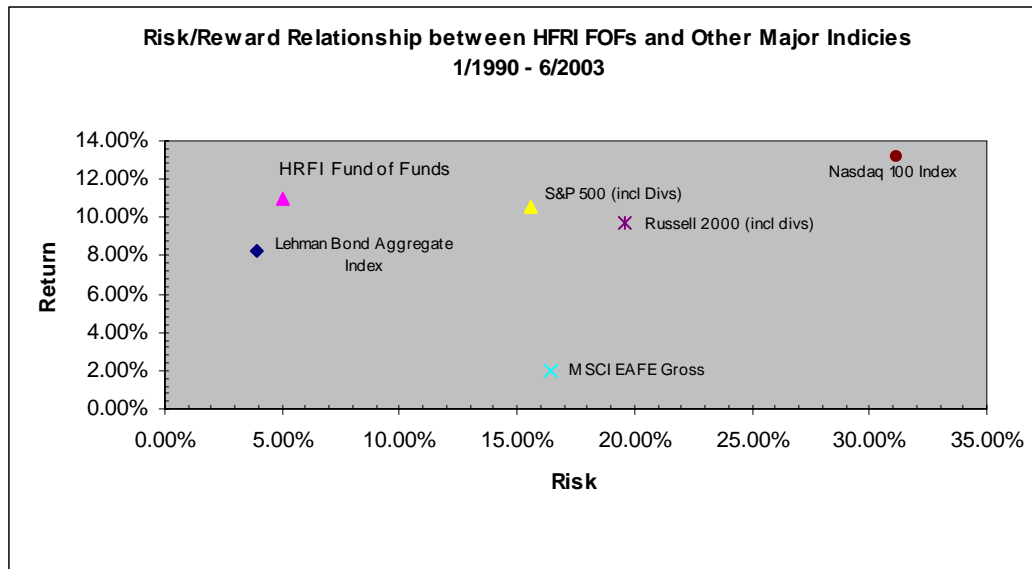
**Arbitrage strategies** that exploit pricing discrepancies between closely related securities. These may include convertible arbitrage, equity market neutral arbitrage and fixed income arbitrage.

For the right investor, hedge funds may provide a viable alternative investment to low yielding bonds and a struggling equity market. They also may reduce the volatility of a broad-based portfolio via increased diversification and low correlation.

One can see from the chart below that the HFRI FOFs Onshore Index

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has lower risk and higher return potential compared to many other major indices. Consequently, portfolio gains from holding FoHFs can be significantly greater than gains earned by holding only stocks or bonds. While past performance is no guarantee of future results, the following chart reveals that FoHFs could offer something that some traditional investments may not.



***Past performance is no guarantee of future results.***

*Source: Pertrac, Hedge Fund Research, Strategic Financial Solutions, LLC*

*The HFRI Monthly Indices (HFRI) are performance indices that are equally weighted by strategy.*

Like any investment, hedge funds are not without their risks. In evaluating hedge funds, investors will want to be sure to weigh all of these risks in light of the potential rewards. These risks include non-regulation risk, managerial risk, illiquidity, limited transparency, and tax consequences.

In general, hedge fund managers employ sophisticated, risky investment strategies. These risks may lead to investors losing a substantial portion of their investment. Investors not willing to accept this risk may want to avoid investing in hedge funds.

There is no denying that hedge funds have become part of the alternative investment landscape, but not all hedge funds are created equal, and that's where your financial advisor can help in understanding the nuances and 'hidden' risks, as well as advise you on suitability and fit.



*We are pleased to announce the addition of a beautiful baby girl to the Mirenda family. Jim, Holly, and big brother Teddy welcomed Sofia Catherine Mirenda on May 27, 2005. Congratulations, Jim and Family!*

