



# MANCHESTER CAPITAL MANAGEMENT LLC

September 2, 2004

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## **Market Outlook**

If, as they say, the stock market has to climb a wall of worry to gain ground, today we are facing a Mount Everest of concerns. Maybe it's the election hullabaloo, but there is an abundance of hand wringing over potential inflation, the price of oil, the direction of interest rates, the possible slowdown of the US economy, the twin deficits, the war in Iraq, unemployment, terrorism at the NYC convention, and so on.

It is no wonder that bonds have out-performed stocks so far this year as investors seek the safety of fixed income securities. The surprise is that the stock market has shown such remarkable resiliency in the face of so many potential problems. If it hasn't crashed under the weight of current pessimism, it could well advance through year-end to provide positive returns for the second year in a row. Valuations, interest rates, and corporate profits are all in line to enable a modest rally.

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The price of a barrel of oil at \$48 is alarming, given that a year ago everyone thought oil would be priced under \$30/barrel. Rebounding economies are driving prices higher while supply is threatened by war and politics. But keep in mind that in the 1980s oil was above \$80/barrel when adjusted for 2004 dollars. At that time, oil consumption was a much greater share of everyone's budget. Wal-Mart has estimated that every \$10 increase in the price of oil costs only \$7 a week out of a consumer's wallet.

Fear also distorts our view of the economy, which appears to be either weaker or stronger depending on the latest unemployment report. In fact, the economy is remarkably strong given that it suffered a stock market crash after a bubble and then an 8-week shutdown after 9/11. Most of today's economic numbers are better than those of 1996, with a stronger GDP, higher productivity, higher disposable income, and declining unemployment. Corporate profits will likely increase by 7% next year. While there are several economic measures that are distressing, the Federal Reserve is correct in describing the current economy as enjoying a "sustainable" recovery.

3657 Main Street  
Manchester, VT 05254  
(802) 362-4410

30 Main Street  
Burlington, VT 05401  
(802) 951-2512

1155 Coast Village Road  
Montecito, CA 93108  
(805) 969-5670

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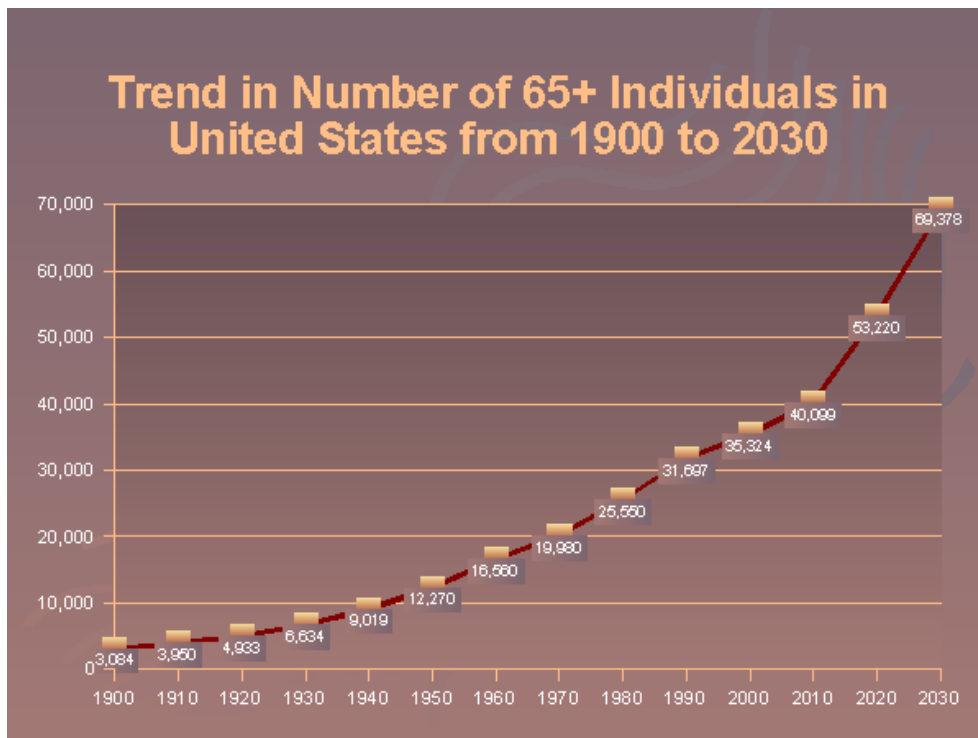
Perhaps the current general trepidation about our future relates to a deeper anxiety about the fundamental changes that are taking place, which we are powerless to stop. The financial markets are entering a new era when interest rates will trend higher, rather than lower, for the next decade or beyond. What will happen to stock and bond markets in a scenario of rising rates and inflation? What happens to the residential real estate market, which has seen a 50% appreciation in the last 5 years, when mortgage rates increase rather than decrease? Who is in control when there is no global balance of power?

The US economy is continuing a radical, structural shift from a manufacturing economy to a service-oriented, entrepreneurial one in the midst of an ever more competitive global job environment. Entire industries are undergoing dramatic changes that no trade policy or tax break can prevent. When the world wants word processors, typewriter companies suffer.

Going forward, an aging US population will place greater demands on government entitlements. The benefits being promised by Social Security, Medicare, and Medicaid cannot be met in their current form, and represent unfunded liabilities without comfortable solutions. As Alan Greenspan has pointed out, neither political party nor corporate leaders appear willing to address these issues and provide leadership in helping us manage solutions.

This year is turning out to be good training for investors in the new and old realities of the markets. The heyday of big returns from either the stock or bond market is behind us, but a future of modest returns and trading ranges offers opportunities to make normalized rates of return. It is never certain in which area of the markets or when, but today's economic growth promises suitable rewards. The more things change the more they stay the same.

**Ted Cronin**



Source: Ageworks.com, Chapter 2:1: Demographics of an aging population



## ***The Erosion of Fiduciary Responsibility***

***By David Brigham***

The dictionary defines fiduciary as “one who holds something in trust, a person who stands in special relation of trust, confidence or responsibility in his obligation to others as agent or principal.” In my lexicon, after forty years as a fiduciary, such terms as prudence, balancing risk and return, and acting as if your client’s assets were your own, shape the concept as it applies to investment management. A successful investment management firm has an undivided loyalty to its clients, one in which the interest of both client and manager are directly aligned without competing influences.

The primary focus should be the achievement of investment results that are consistent with an agreed upon risk profile. Compensation to the fiduciary comes only from a percentage fee based on the market value of the assets under management: good results in both up and down markets contain fair rewards for both client and manager.

The purity of this endeavor can be subtly or quickly eroded depending upon the architectural structure of the investment management firm. Historically, in the 1950’s, 60’s and well into the 70’s, the investment business was a cottage industry comprised of relatively small, independent, and individually owned firms, and a few large bank trust departments whose total contribution to overall bank profits was relatively insignificant. By far the ownership and direction of those firms was in the hands of those who did the investing. These owners did not report to a corporate senior management nor were they subject to influence by boards of directors representing public stockholders. In short, there was nobody to report to except the client. In reality, the client was the senior partner of the firm.

The erosion of this structure started to occur in the late 70’s and galloped forward into the 80’s and 90’s with the formation of large financial services firms (many with public stockholders) aided by favorable developments in our capital markets along with a significant increase in individual stock ownership.

The attraction of the non-transactional nature of investment management revenue is evidenced by a higher valuation placed upon it in the public marketplace. Furthermore, industry studies have shown that the average client relationship lasts ten years. This stability compared to the volatile character of year-to-year brokerage commissions, underwriting fees, and proprietary stock and bond trading make the investment management piece perhaps the most desired part of the financial services arsenal.

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Once public stockholders are introduced into the mix, there is reason to view the undivided loyalty to the client as suspect. Not necessarily nor willfully, the result can be a shift in primary focus from investment results to sales results. Stockholders demand growth in sales and earnings. In effect, boards of directors, as they represent public ownership, reinforce the ascendancy of the marketing function. A cynic could conclude that asset management firms have become asset-gathering firms with allegiances divided between stockholders, the actual investors who are not necessarily the majority owners, and the client. Senior management must balance this competition as it allocates its activities and resources across various lines of business. Such corporate actions can prove to be a distraction in time and effort to those who are doing the client's actual investing.

We would suggest that this model is a flawed architecture for investment management and one that is susceptible to the erosion of fiduciary responsibility. In our judgment, the client should have no competing entities, nor should his investor be subject to any corporate influences not of his own making. An investor when placing his money, should closely examine the structure of the firm he is choosing, particularly the ownership, because in the long-run, that will probably be the biggest determinant of success.

## ***Glossary of Investment Management Terms***

**Annualized** – The average annual rate of return a portfolio has achieved over the specified time period. Annualized returns only appear on reports for portfolios managed by Manchester Capital Management for more than one year.

**Capital Appreciation** – The amount a security has increased (or decreased) in value during a specified time period.

**Change in Accrued** – The difference in the amount of interest earned, but not yet received, on a fixed income security at the end of a specific period compared to the beginning of that period.

**Income** – Cash received in your portfolio from interest or dividends during a specified period.

**Investment Gain** – Total value of all capital appreciation plus income minus all fees and expenses during a specified time period.

**Realized Gains/(Losses)** – For tax purposes, the amount of capital gain or loss resulting from the sale of a security. Capital gains taxes might be due when profits are realized. Realized losses can be used to offset realized gains.

**Time-Weighted Return (net)** – This represents your total rate of return for a specified time period. Time-weighted simply means that it discounts the impacts of cash flows (deposits to and withdrawals from) your portfolio.