



MANCHESTER CAPITAL MANAGEMENT LLC

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Market Outlook

Driven by evidence of renewed economic growth, the stock market has made steady gains through the year, taking bad news in stride and advancing on good news. We continue to be positive on the market, given the data on GDP, personal income, durable goods, inventory levels, and even the improving employment numbers.

We take special note of the employment data because we are experiencing what the Federal Reserve has labeled a “job loss” recovery. Employment is normally a lagging indicator of a recovery as businesses wait for profits to recover before they are willing to rehire (employees are the costliest of all expenses). Yet even with this consideration, employment levels are notably below their normal trends for economic recoveries.

In our judgment, corporations are unlikely to rehire workers as aggressively as in the past. Corporations are now enjoying unprecedented increases in productivity created by technological advances and new business practices that will allow them to reduce staffing. Additionally, the globalization of world economies is prompting a shift of some jobs overseas where US employers find reduced labor costs in both the manufacturing and service sectors.

The stock market is a discounting mechanism, in that it strives to price securities today based on their future prospect. In the spring, the markets correctly calculated that the economy was improving and it advanced in accordance with this insight. The market is anticipating further recovery in 2004.

However, the valuation issue is becoming foremost in investor’s minds. On the traditional measures of price to earnings (P/E), price to book (P/B), and price to sales (P/S), the stock market is currently richly priced with each indicator above its historic trend line. We watch these numbers carefully and recognize they create constraints on long-term rates of return, but we expect stocks to hold on to their gains into next year as politicians stoke the economic fires in an election year.

Much of the strong third quarter returns came from the high beta securities, those stocks that are most volatile and in many ways the most speculative. The more stable securities, such as the larger blue chips,

*Current stock
market valuations
“discount” a
continued recovery.*

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trailed the averages, and now enjoy better prospects going forward because of their lower comparative valuations. Longer-term, the opportunities are still greatest in the small and mid capitalization area, and internationally in the emerging markets.

Trying to time these market trends by raising cash has been shown to be difficult and unproductive because market returns are so “lumpy”, that is, most advances and declines happen suddenly within a very limited number of days. The best defense is, first, to be conscious about the price paid for any security or funds, and second, to diversify with uncorrelated asset classes, favoring those with the best valuations and reducing those with the worst.

The markets are volatile. The events of 9/11 remind us that panic can affect everything. Fortunately, such events are a short-lived phenomenon despite the way they test every investor’s conviction. Such one-off events are generally opportunities to buy rather than signals to sell.

Another Scandal

Consider this hypothetical: After the market’s close, Intel announces that they’ll beat revenue expectations and the stock rises ten percent higher in *after market* trading. It appears likely that the news will have a positive effect on other technology stocks in tomorrow’s market. You also know what mutual funds held large positions of Intel and technology in general because some mutual fund companies allowed you to view account holdings. And best yet, they will allow you to purchase their mutual funds after the close of trading but at that day’s 4PM EDT price.

This is a practice called “late trading” and it’s not allowed for obvious reasons. Any fund order placed after the market’s close will be executed at the following day’s closing price. It’s pretty close to a risk-free trade. It’s also somewhat under the radar screen – you’re only stealing a little from a lot of investors. On the hypothetical trade, the day trader probably netted about 4/10th of one percent. The average fund investor wouldn’t even notice the loss as it’s spread out over 99% of the other fund investors.

The practice is the equivalent of allowing someone into the lottery pool after the winning ticket number has been picked. New York State Attorney General Elliot Spitzer has shown that the practice represents a clear breach of securities law. The majority of investment firms and individuals refuse to break investment laws, but not all. Amazingly, this practice was permitted by Bank of America’s Nations Funds unit. Other names being formally investigated so far are: Bank One Corp., Janus Capital Corp., Invesco, and Strong Capital Management, Inc.

What does it mean to us and to our clients? The following points should be noted:



Aggressive and thorough investigations are necessary.

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- 1) Disclosure will be the investment community's method of cleansing itself. We are still in the early stages of uncovering possible abuses. Mutual funds and hedge funds are still receiving subpoenas. Brace yourself for further tawdry revelations. This should be viewed as a strength of the system.
- 2) Truly great firms will exit with their reputations intact or heightened. The great majority have nothing to hide or fear. The Vanguard Group, when asked to supply information, publicly announced "these practices are not and have never been allowed at Vanguard." We'll hear many similar statements. Intuitively, our feeling is that the overwhelming majority of firms, when presented this "opportunity" to cater to large hedge fund investors, understood it for the illegal, debilitating scam that it was and discreetly said "no thanks."
- 3) At this time, it appears that the illegal aspect of this scandal only reaches back about two years at most. This should be viewed positively. There will always be someone trying to "game the system" and the market timing scandal is a distant cousin to the insider-trading gambit. Hopefully, the investigation will prove that industry and government officials have been timely about uprooting and punishing illegal behavior.
- 4) Lastly, an aggressive and thorough investigation is necessary and helpful. Our hunch is that the next few months will be an important psychological indicator. If investors feel the government is dealing forthrightly with these crimes, then investor confidence will increase and this will show up in stock prices.

Against this backdrop, we naturally find much to be disgusted about, but also somewhat of a silver lining. We try to keep both sides in perspective.

Recognizing Change



One of our most important responsibilities is to step back from the day-to-day frenzy of the markets and constant flow of media opinion to look at the bigger picture. Where are we in the moving tides of economic forces? What are the larger events that will impact investment opportunities? What has changed and what hasn't?

The bond market has enjoyed a 25 year bull market, and interest rates are now at record lows reflecting very low inflation. Given the growing federal deficit, accelerating economic activity, and increasing current account deficits, interest rates are headed higher. Bonds valuations will suffer.