

Report Card '03

"Let's say someone told you last year that stocks would make a roaring comeback in the first half of 2003 and that we would find ourselves in a bull market, with returns zooming 20% or more. Most likely, you would have thought: 'Yeah, and the tooth fairy is real – and Elvis lives.'"

BusinessWeek, June 30, 2003

market had ended *five months earlier*, in October of 2002.

Don't look for the editors of *BusinessWeek* (or any other financial publication) to acknowledge how wrong they were about the markets. Report cards from the media are rare, and for good reason; if readers knew how poorly served they were by the economic forecasts and investment advice dished out by the mainstream media, they might think twice before renewing their subscriptions.

"2003 will be a happy New Year indeed for those brave enough to buy stocks now."

fcNOTES, December 31, 2002

By early March, following three consecutive losing months for stocks, the major averages appeared to be on the precipice of another bear market downleg. As the S&P 500 slumped below 800, a mere 20 points away from the October 2002 lows, the March 10 issue of *BusinessWeek* magazine hit the stands, the cover featuring a frightened investor biting her fingernail, a corkscrew roller coaster with blurry stock prices on the side of the cars, and the headline "WHIPSAWED BY WALL STREET."

Just two days later, on March 12, stocks reversed course and began a rally that has lifted the S&P 500 stock index 32% off its March lows, a year-to-date return of 20%.

As is always the case, the media would be the last to recognize the turning point in the market. Five days after the March bottom, the editorial page of *BusinessWeek* proclaimed the bear market alive and well: "As we enter the fourth year of a bear market, the end is still not in sight." And one week later, even as stocks continued to gallop higher, the March 24 issue of *BusinessWeek* featured an article titled, "Don't Bank on a Bounce-Back," which listed more than a dozen reasons why investors should avoid stocks.

Our readers knew better than to follow advice like this. In the March issue of *fcNOTES*, we wrote that, "The market always moves well in advance of major changes in the underlying economic fundamentals... By the time the media jumps on the bandwagon, the perceived danger is either already on the way out – or it never existed at all."¹ The fact that publications like *BusinessWeek* were warning readers earlier this year that the end of the bear market was still not in sight was proof enough that the danger of falling stock prices was finally behind investors. Indeed, the bear

Our approach is different. Every November, we dedicate *fcNOTES* to examining our own analysis and recommendations from the previous twelve months, reserving the final issue of the year for our annual market outlook. If nothing else, we hope that the following recap will demonstrate once again that the greatest dangers – and opportunities – are found in what the press *isn't* reporting. Just as the 2000-2002 bear market began at a time when investors were worried about missing out on the opportunities of the "New Economy," today's bull market gathered steam in the face of countless economic risks, when missing out on rising stock prices was the *last* thing investors feared – and hence the outcome that we most expected.

A Happy New Year Indeed

Perhaps our greatest contribution to *fcNOTES* readers in 2003 was forecasting that stocks would have a terrific year and urging our investors to stay the course during the first quarter, a time when most Wall Street professionals and media pundits were warning about dark storm clouds on the horizon.

Last December, we predicted that 2003 would be "a very big year for stocks,"² and by almost any measure, we were correct – over the past eleven months, the tech-heavy Nasdaq Composite has surged 47%, the small-cap Russell 2000 index has risen 43%, and the large-cap S&P 500 index has returned 20%.

Such gains were unimaginable to most market observers in the early months of 2003. Stock prices were falling, "geopolitical risk" was rising, investor sentiment was plummeting, and even bullish analysts

¹ "Where Demand Meets Supply," *fcNOTES*, March 31, 2003

² "Gap Analysis," *fcNOTES*, December 31, 2002

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confessed that stocks were unlikely to enjoy strong returns any time soon. "Given the economic and military uncertainties the U.S. faces, only a fool would be optimistic at this moment," declared the editorial page of *BusinessWeek* on March 17.

The problems facing the markets in the winter of 2003 may have seemed insurmountable, but for those with an understanding of market history and investor psychology, optimism was hardly foolish. "The relationship between supply and demand in the stock market today is nearly the opposite of what it was in early 2000, a year that will go down in history as one of the most dangerous times to be in the market," we observed in March. "Seen in this context, will it really be all that surprising if 2003 is remembered as one of the best years to buy stocks? We don't think so."³

The Sun Also Rises

In February, we highlighted some of our favorite investment themes, including our largest foreign equity position – Japan – and our largest style allocation – small-cap growth stocks. Although we rarely disclose specific portfolio holdings in *fcNOTES* (those are reserved for our clients), we always strive to bring to our readers' attention significant trends that are being overlooked by most market participants.

Japan certainly qualified as "overlooked." In spite of the fact that Japanese stocks had outperformed just about every other large regional equity market in 2002, the silence on Japan in early 2003 was deafening – it was almost as though the experts had written off Japan completely, finding it unnecessary to even mention the many structural problems in that country after thirteen long years of declining stock prices. This was bullish in our view, because basic finance theory tells us that the price of any security is nothing more than a function of supply and demand, and once most investors have given up on a particular category, demand has nowhere to go but up. "The bar of expectations has been set so low for Japan that the odds favor these stocks outperforming in the next few years," we wrote in February. "This presents a compelling opportunity for investors who can ignore the silence of those who have tried and failed so many times in the past to predict a recovery in this beleaguered market. And for this reason, we are currently recommending that investors overweight Japan in the equity component of their portfolios."⁴

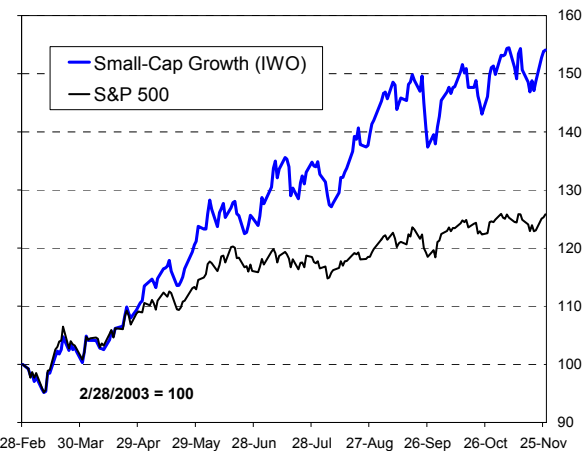
Like many global markets, Japanese stocks continued to decline for several weeks after the U.S. markets bottomed in March, but we didn't have to wait long to see the performance we expected. From February 28 through the end of November, EWJ (the exchange traded fund for Japan that we use in our portfolios) gained 31%, compared to an increase of 26% for the

S&P 500 and 24% for the Dow over the same period. Going forward, we expect that Japanese stocks will continue to outperform their U.S. counterparts, and we will address our outlook for global markets in more detail next month.

Small Is Beautiful

In addition to Japanese equities, we urged our readers to overweight small-cap growth stocks. "Small-caps have outperformed big-cap stocks in the early stages of every bull market since 1932, and the harder stocks have fallen in the prior decline, the better small-caps have done on the rebound,"⁵ we wrote in the February issue of *fcNOTES*.

But in spite of the perfect record of small-cap stocks besting their large-cap rivals during the early months of market recoveries, we were bothered by the fact that small-cap *value* funds were one of the three most popular equity mutual fund categories in 2002 based on cash flows as a percentage of net assets. Since 1987, the mutual fund rating service Morningstar has ranked the nation's three least and most popular fund categories each year and has found that over the next three years after each new ranking, the least popular funds have outperformed the average stock fund 75% of the time and have beaten the three most popular fund categories more than 90% of the time.



We resolved the apparent conflict between the historical performance data and the Morningstar study by comparing the past returns of small-cap *growth* stocks and small-cap *value* stocks, and we discovered that small-cap value stocks held up very well during bear markets, losing only 4.8% on average. (No wonder then that this mutual fund category was so popular last year – in the two years ending December 31, 2002, the Russell small-cap value index slipped only 3.6%, compared with a loss of 37.9% for small-cap growth stocks during the same period and a decline of 33.36% experienced by the big-cap S&P

³ "Where Demand Meets Supply," *fcNOTES*, March 31, 2003

⁴ "It's What They Don't See..." *fcNOTES*, February 28, 2003

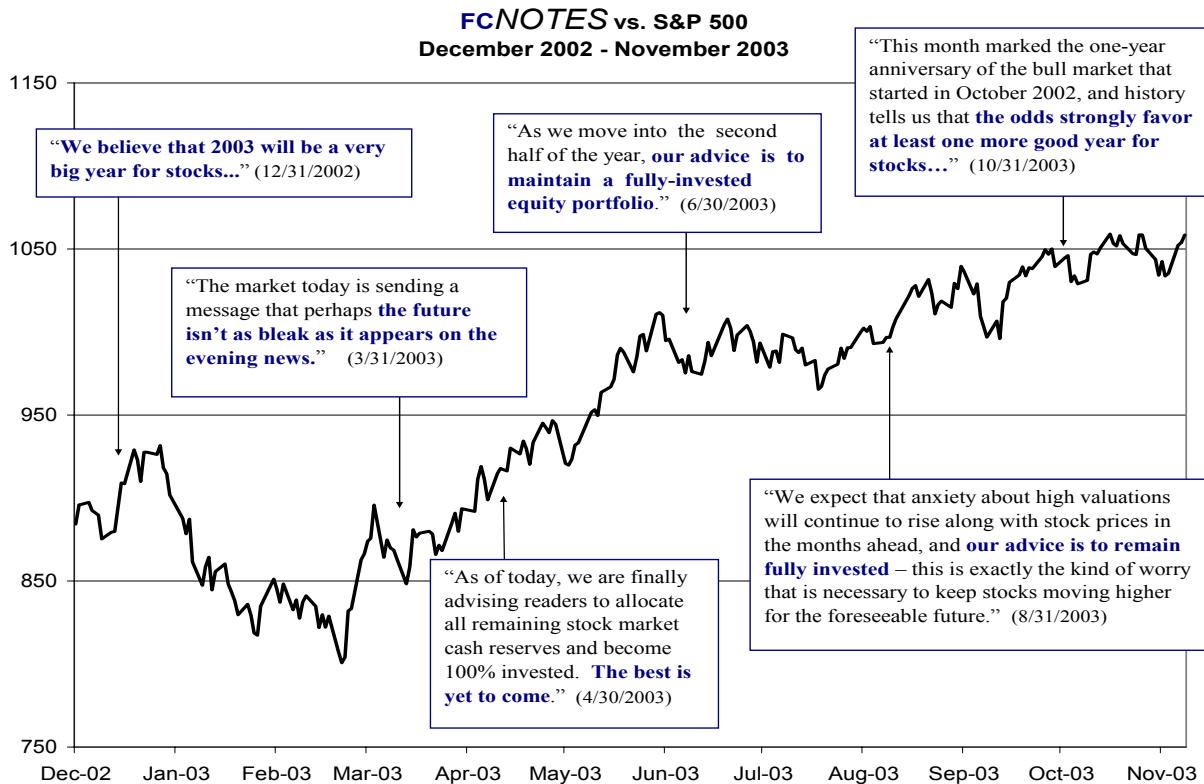
⁵ "It's What They Don't See..." *fcNOTES*, February 28, 2003

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500 index.) But in the early stages of bull markets, we found that the small-cap performance advantage switched to growth stocks, and given our view that the bear market was over and a new bull market was underway, we concluded that investors would be best served by overweighting small-cap growth. In our portfolios, we used IWO, the exchange traded fund that tracks the Russell 2000 growth index, and the decision paid off nicely. Since recommending small-cap growth on February 28, IWO has surged 55.5%, nearly *three times* the return of the S&P 500 and better than the increase of 48.4% for IWN, the Russell small-cap value ETF.

equity markets quickly recovered from the initial scare.

More important than SARS in our view was an event in April that received far less attention from investors: For the first time since the fall of 2000, all the major stock market indexes were trading above their respective 200-day moving averages, an area of important long-term support in bull markets.⁷ In October of 2002, we had increased our recommended equity allocation to 60%, and we advised our readers that, "If the Dow, S&P 500, and Nasdaq can all break out above their respective 200-day moving averages and find support there, we will deem this to be



Climbing The Wall of Worry

By April, investors had added the SARS outbreak in Asia to a long list of worries that included the war in Iraq, the continued threat of terrorism, rising unemployment, a steep drop in consumer confidence, and the ballooning federal deficit. But we reminded our readers that, "The intensity and duration of media attention devoted to any major news story is *inversely* related to the probability of that story having a material, long-term impact on your portfolio, and SARS is unlikely to prove an exception to this rule in the months ahead."⁶ As we expected, U.S. stocks hardly reacted to the SARS hysteria, and even Asian

technical confirmation of our bullish outlook and finally recommend a fully-invested position."⁸

⁶ "The Media Epidemic," FCNOTES, April 30, 2003

⁷ As we reported in the October 31, 2002 issue of *fcNOTES*, the historical relationship between the direction of stock prices and the 200-day moving average has been documented by Jeremy Siegel, professor of finance at the Wharton School of the University of Pennsylvania. Siegel tested an investing strategy based on the 200-day moving average using the daily price closing price of the Dow Jones Industrial Average from 1886 to 1997, and the results suggest that an investor who had used this strategy would have significantly reduced downside volatility without a corresponding adverse impact on long-term investment performance. Although we do not use technical analysis to form our big-picture outlook, we believe that methodologies such as the 200-day moving average strategy can be useful for confirming – or challenging – the conclusions we reach based on our primary contrarian approach to the markets.

⁸ "No New News," FCNOTES, November 30, 2002

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Since advising our readers to allocate all remaining portfolio cash reserves to stocks in April, the S&P 500 has risen 15.4%, and our two largest holdings, EWJ (Japan) and IWO (small-cap growth) have performed far better, with gains of 39.8% and 39.0% respectively.

Such strong returns in the face of so many obvious problems for the economy and the markets came as no surprise to *fcNOTES* readers; as we wrote in August, "Bull markets always climb a wall of worry, and it really doesn't matter what is making investors anxious, so long as the anxiety is plentiful. An infectious disease like SARS, a 'quagmire' like Iraq, a financial problem like the expanding federal deficit – any of these supposed threats to the economy and the markets will do just fine."⁹

"The world's economy is in bad shape... Europe's economy is stagnating. The U.S. is growing far below its potential, pushing unemployment higher. The dollar is sliding, perhaps too fast, and the euro is rising, probably too much. China is seized up thanks to severe acute respiratory syndrome (SARS). The world is adrift, without economic leadership..."

BusinessWeek, May 19, 2003

"The market remains risky on a number of levels... Right now may not be the best time to back up the truck and start loading."

Fortune, May 12, 2003

"Stocks are simply the safer choice right now."

FCNOTES, May 31, 2003

Sell Bonds!

SARS wasn't the only global contagion worrying investors in the spring of 2003. By early May, there was a consensus among Wall Street economists and analysts that *deflation* posed a significant risk to the world economy. Rising worry about the dangers of falling prices had been reported on for some time in the media, but when the Federal Reserve said that it was concerned about an "unwelcome substantial fall in inflation" and would act aggressively to protect against even the possibility of deflation in a statement following its May 6 meeting, deflation became headline news. Traders interpreted the Fed's statement to mean that the central bank would go so far as to buy Treasuries if necessary to keep interest rates down, and bond fund managers who had been worried about the possibility higher interest rates and lower bond prices only a few months earlier breathed a sigh of relief. After all, in a deflationary environment,

bond holders get a bonus beyond interest payments – their return of principal is worth more than when the investment was made.

During the first several months of 2003, our bias towards bonds had been slightly negative. We were apprehensive about the huge amounts being shoveled into bond funds by investors who were attracted to the huge gains Treasuries had posted during the three-year bear market in stocks and were convinced that in a time of economic uncertainty and geopolitical risks, bonds were a "safe" investment. We warned our readers in March not to be fooled by the apparent security of bonds: "Whenever prices rise in a relatively free market, so too does the incentive to figure out some way to produce more. And at some point, supply outstrips demand and prices turn lower... With an expensive war being waged in Iraq and a tax cut in the works, not to mention state and local governments suffering from huge budget deficits, the incentive for government agencies to create more bonds and take advantage of the record-high prices (the corollary of record-low rates) seems obvious to us, though apparently not to the countless investors who are dumping equity fund investments and pouring record amounts into bond funds."¹⁰

As fears of deflation mounted, bond prices continued to rise – and so did our concerns. On May 31, we urged our readers to take action: "We are now adopting a negative bias towards Treasuries, especially for longer-term maturities, and we are advising readers to reduce Treasury bond holdings at this time."¹¹

Less than one month after we advised investors to lighten up on bonds, the bottom fell out. On June 25, the Federal Reserve cut its key interest-rate target by 25 basis points, less than the half-point that many traders had hoped for. Treasuries, which had already begun to weaken ahead of the decision, suffered the biggest drop after any monetary-policy easing since 1985, and by the end of July, the decline in the value of 10-year notes and 30-year bonds exceeded that of any since 1927.

The Biggest Surprise of All

We are pleased to have kept our readers on the right side of the markets in 2003, but this report card would be incomplete were we to overlook our prediction that the S&P 500 would gain 45% this year. Although December is historically one of the best months for stocks, hitting our price target would require an unprecedented one-month gain of 25% (the biggest monthly increase in the S&P 500 since its inception in

⁹ "Bubble Trouble?" *FCNOTES*, August 31, 2003

¹⁰ "Where Demand Meets Supply," *FCNOTES*, March 31, 2003

¹¹ "What About Bonds?" *FCNOTES*, May 31, 2003

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1957 was a gain of 16.3% in October of 1974).

Our forecast for the S&P 500 was based on a methodology that we call Gap Analysis. We start with the supposition that the market is highly efficient, meaning that stock prices reflect virtually all available information. The reason for this could not be more simple: Investors want to make money. If there is any news that might affect stocks for better or for worse, investors move quickly to act on it, causing share prices to rise or fall accordingly. This process ensures that consensus expectations of the best-informed and most widely-followed market observers – the Wall Street economists and analysts – are discounted by the market in the *present*, which means that the most likely outcomes for the *future* direction of stock prices are those that are not generally accepted – the gaps in the consensus.

In January, we reminded our readers that there were only two “gaps” in the forecasts of Wall Street professionals: “We see only two possibilities: the S&P 500 either will surge more than 45% or will suffer another double-digit decline. *Let us be very clear on this point: another down year is more likely than the gain of 10 to 20 percent that the majority of forecasters predict.* But it is not the most probable outcome. The market usually moves in ways that surprise the greatest number of people, and right now a sudden and massive move higher will come as a much bigger surprise to just about everyone than will another lousy year.”¹²

Barring a catastrophic stock market crash or an unprecedented move higher in December, the S&P 500 might very well close the year right where most of the analysts thought it would, somewhere between 1000 and 1100.

Given the events of the past three years, we should have anticipated the possibility of this extraordinary

outcome. The miserable failure of Wall Street’s best and brightest to understand and anticipate the devastating bear market that stretched from March of 2000 to October of 2002 taught investors to be skeptical of the prognostications and predictions of the professionals, and this cynicism turned into unreserved hostility as revelations surfaced about the conflicts of interest and outright fraud perpetuated by the very same analysts who had been lauded as heroes during the stock market boom a few years earlier. By the start of 2003, investors had every reason to doubt the consensus expectations of the experts, *meaning that the information on which these expectations were based might not get priced into the market.*

Surprises move markets, not what everyone expects, and the analysts actually getting it right was just about the last thing anyone expected in a year in which the *failure* of the Wall Street establishment was one of the most widely-reported stories in the media. Indeed, the analysts themselves are probably astonished by this outcome, having slashed their own estimates during the first few months of the year in the face of rising uncertainty about Iraq and the economy.

Next month we will address the implications of the surprising success of the experts when we deliver our 2004 market outlook, and we will also discuss some important trends that are being overlooked by most investors and the media and thus hold the potential for opportunity – and danger. We will outline in more detail our reasons for continuing to recommend small-cap growth and Japan, along with overweight positions in U.S. technology sectors and the index ETFs of Germany, France, and Brazil.

We would like to extend a special thank you to our investors for their continued confidence and support, and we wish all of our readers a happy, healthy, and, of course, *prosperous* holiday season.

Ian Fraley *MANAGING PRINCIPAL*

Stephen Brennan *PRINCIPAL*

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¹² “Brother, Can You Spare a Dime?” *FCNOTES*, January 31, 2003