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Investment Management

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Q4 2003 Market Review 1/15/04

It was the year stock-market investors had been waiting for. After three straight down years that wiped away trillions of dollars in market capitalization, share prices rebounded around the world in 2003, overcoming war in Iraq, renewed terrorist fears, U.S. deficits and a tumbling dollar. With interest rates low and many stocks looking cheap (or at least not quite so expensive), investors bet that a U.S.-led global economic recovery would boost corporate profits. In typical "buy the rumor" fashion, investors dove into stocks in mid-March on the belief that a recovering economy would yield strong profit growth. In this case, it did, but the "sell the news" aspect of this never really came into play because the earnings growth was so good that multiples never really expanded. The Dow Jones Industrial Average ended up 25.3% for the year after a nearly 13% rise in the fourth quarter -- its best quarterly gain in two years. The blue-chip index climbed back above the 10000 mark in December after 18 months below it. The Nasdaq Composite Index did even better, soaring 50% for the year -- its third-biggest annual gain since its inception in 1971 -- after a 12% rise in the fourth quarter.

Still, the 2003 returns generally weren't enough to erase all the bear-market pain that investors have suffered since those glory days. According to the Wall Street Journal, an individual who put $10,000 into the average U.S.-stock fund five years ago, at the beginning of 1999 would have an investment worth more than $14,000 in value in August 2000 before tumbling to a month-end low of $8,441 as of September 2002. The $11,910 value at year-end is up 19% from the initial investment of five years ago, but still almost 17% below the peak. Centurion accounts generally fared much better over this period as our disciplined investment philosophy of avoiding large losses to maximize long term returns provided a more stable performance for our investors.

Meanwhile, many individual investors actually fared far worse than that hypothetical example; mostly because people tend to buy high and sell low, and they react late. For instance, investors were pulling money out of stock funds as the market hovered near a bottom in the second half of 2002, although flows into stock funds have since rebounded strongly. In the year just ended, funds holding overseas stocks performed even better than those investing in the U.S., in part because the weakening of the U.S. dollar increased the value of securities denominated in foreign currencies. Centurion investors benefited tremendously from our investment in foreign currency denominated securities this year.

One of the oddest things about the recent rally has been the feeling of déjà vu. By far the biggest gainers have been the stocks that were the most discredited during the bear market -- technology stocks, notably those related to the Internet.

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With the economy on the mend and stocks up for the first time this century, most investors missed what may be the biggest long-term shift in the market in 2003: Companies are focusing on dividends again. Since President Bush signed the bill in May that slashed dividend-tax rates by more than 50% for many people, companies have hopped on the payout bandwagon. A total of 229 companies boosted their dividends by an average of 26% and 21 companies, including the likes of Microsoft Corp. and Best Buy Co., started paying dividends for the first time, the biggest number of new payers in at least 24 years. How did investors react to this sea change? By snapping up stocks that don't pay dividends. Companies in the S&P 500 that pay dividends have returned a healthy 31% in 2003, but shares of non-dividend-payers have soared nearly 57%.

These results aren't surprising, given the big economic and stock-market rebounds. Investors seeking to profit from the bounce-back flocked to the riskier names that tend to do best when the market is up strongly. Few of those companies, which tend to be smaller and more volatile, pay dividends. That may change when investors see the impacts of dividends on after-tax income. That will happen in the spring, and the change will be dramatic. Say an investor in the 35% tax bracket earned $10,000 in dividend income this year and last. A year ago, the tax bill would have been $3,500, but this year the bill will be slashed to $1,500 under the new 15% tax rate that applies to most dividend income, putting an extra $2,000 in investors' pockets. Furthermore, there is plenty of room for growth in dividends by historic standards. Only 370 companies in the S&P 500 pay dividends, down from 435 just 10 years ago and the dividend yield is just 1.67%, well below the 3.87% level it was at as recently as 1990.

Where do the markets go from here? Bullish market technicians cite two reasons for their enthusiasm. From a calendar-based perspective, stocks tend to do well in election years as incumbents try to keep investors happy by keeping interest rates low and by perpetuating economic growth. As a group, fundamentals-based market players also see a bright future for equities. After catapulting to a 7.2% increase in the third quarter, the U.S. gross domestic product is poised for further gains at least into the second quarter of 2004. Fourth quarter earnings are already expected to be stellar, interest rates are still low, and even the labor market is showing signs of improvement.

The concern is that stocks tend to rise most strongly at the start of an economic recovery, not when the recovery is already well under way. The worry-word in the front of many people's minds today is "sustainability." We've gone nine months now without suffering even a 5 percent correction. The question is whether the robust recovery, which saw the economy rebound 8.2% at an annual rate in the third quarter, can be sustained. The fear is that, as economic growth and profit gains inevitably slow, investors will be disappointed and begin pulling back from stocks, capping the rally. Adding to these worries, the broad S&P's

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500-stock index is trading at 27 times its companies' earnings for the past 12 months, well above the historic average of 16. Analysts like to say that stocks are "priced for perfection," meaning that such high price-earnings ratios can be justified only if the economy, corporate performance and world stability all remain strong. If chinks start to appear, stocks could suffer.

It's a double-edged sword really. If the economy continues to be robust, then interest rates should move higher, diluting the stock market's main fuel. On the other hand, if the economy falters, earnings could suffer, also hurting stocks. And if the economy pursues a middle course, growing modestly, then economists could start worrying again about deflation, or falling prices. As investors digest the cheery performance news for 2003, many are reminded that, as was the case last year, stocks have a way of surprising people -- both on the way up and on the way down.