The Centurion
COUNSELOR
Vol. 12, No. 1, January 2005

UNDERVALUED SECTORS (CONSIDER!)
- LARGE CAP VALUE
- DIVIDEND STOCKS
- CONSUMER DEFENSE

OVERVALUED SECTORS (AVOID!)
- HOME BUILDERS
- CALIFORNIA MUNICIPAL BONDS
- AIRLINES

2005 Forecast

The celebration of the New Year brings with it much that is familiar: the Rose Parade, resolutions to lose weight, and predictions of what is to come in the next annum.

We believe the theme of 2005 will be change or at least attempted change. It is important to note that, historically, the markets do not like change. This was most recently demonstrated last year as the markets did almost nothing until after the election. It was the fear of change that kept the markets stalled. This year, we don't have to worry about the election but change will be in the headlines with constant talk about Social Security and tax reform, along with changes to the Supreme Court and maybe even the Fed.

This means that the year should provide investors with a multitude of opportunities as well as challenges. It now appears that the Fed will increase rates at least 2 more times early in the year. In spite of a 1.25% increase in short term rates, the benchmark ten-year Treasury bond was basically unchanged last year. Inflation, or the lack thereof, is the key to 2005 since rising interest rates often serve as a headwind for equities. Forecasters are widely divided on inflation expectations this year. The pessimists believe it could reach 6% while the bulls believe it will stay in the 2.0% to 2.5% range. Our view is somewhat in the middle of the two camps; We think inflation will pick-up a modest amount but the effect on the consumer will be minimal because of falling oil prices.

It is our expectation that, until investors know what the tax and social security packages look like, the markets will mark time. This may make for tough sledding in the first six to nine months of 2005. We still have confidence that the markets will end the year higher, however, but the year will most likely not be quite as good as 2004.

Bond yields will go higher on both the long and short end but the 10-year treasury yield will still be under 5%. Meanwhile, we feel the Dollar will be stronger against the Euro but will continue to fall against the Yen and other Pacific Rim countries.

Centurion Counsel, Inc., Registered Investment Advisor, 365 S. Rancho Santa Fe Road, 3rd Floor, San Marcos, CA 92069
(760) 471-8536, (800) 878-8536, e-mail: info@centurioncounsel.com, FAX: (760) 471-0399

Dividends Are Key

The start of the fourth quarter and indeed most of 2004 focused on the election. The markets were uncertain until Election Day but surged after the result was known. In 2005, we believe that the focus will be on fundamentals due to current tax policy on dividends. Data published by Ibbotson Associates show that in the period 1927 to 2002, more than 40% of the compound annual growth of large cap stocks can be attributed to dividend payouts. This contribution has ranged from a high in the 1970s of 70% to a low in the 1990s of 15%. The table below shows how over long periods of time the market rotates leadership between growth and value (dividends).

Dividend Contribution to Equity Total Returns

Decade	Cap. Appr less Appreciation (1)	Total Dividends (1)	Dividends as a % of Dividends	Return	Capital Total Return
1940s	2.99%	5.87%	-2.88%	9.17%	63.97%
1950s	13.58%	5.31%	8.27%	19.35%	27.43%
1960s	4.39%	3.28%	1.10%	7.81%	42.06%
1970s	1.61%	4.14%	-2.53%	5.86%	70.74%
1980s	12.60%	4.62%	7.98%	17.55%	26.30%
1990s	15.31%	2.64%	12.67%	18.20%	14.52%

(1) Compound annual growth rate
Source: Ibbotson Associates; Bear, Stearns & Co.

In periods of low inflation and stable interest rates, capital appreciation has been the leader, while dividends have carried the day in periods of higher inflation and rising interest rates. These periods of higher rates are typically times when price/earning ratios contract.

The 1950s environment of low interest rates and high P/E multiples lasted until the early 1960s, which also is the case in the 1990's and early 2000s. Interest rates in the future may trend up from their current historical lows and inflation may start to reappear. If this occurs, the balance of this decade may look like the 1960s and 1970s versus the 1990's.

We believe the long term case for dividends is strong given their favorable tax treatment and their relative out-performance in periods of increasing inflation. Last year (2004) appears to be the start of this trend with S&P 500 stocks that pay dividends outperforming their non-paying bretheren.

Helping Our Clients Isn't Only About Stock Picking…

The message is reiterated constantly. "Diversification is the key to a well-managed portfolio." "Make sure to have international exposure in your investments"; "You have to invest outside the U.S." etc. Centurion Counsel has been echoing these statements for years to our clients, many times when these beliefs were much less popular than they are today. Now that the message is the new gospel in the investment community, it's important to distinguish the right and wrong ways to benefit from the mantra's above…and to show why these theories are like preaching to the choir for Centurion investors.

With the dollar at multi-year lows, a belief that its slide versus other currencies is going to continue is leading many investors to pump money into mutual funds that hold foreign stocks or bonds. But picking an appropriate fund requires asking about a topic many investors never consider – do these funds hedge against currency risk?

When the dollar is weakening, as it has since early 2002, investors potentially earn higher returns in funds that don't hedge their foreign-currency exposure. However, currency practices vary significantly among funds and the funds themselves don't tell investors the degree to which hedging affects performance.

When U.S. funds invest in securities denominated in foreign currencies, there are two distinct component's to investors' returns: the changing value of the portfolio securities in their local currencies and the impact of fluctuating exchange rates. What people overlook is that the latter is the most significant component of all.

When a fund fully hedges its currency exposure, U.S. investors earn returns that are in line with the securities local currency returns, minus the costs of hedging. There's the catch-22. Most international stock funds that hedge their currencies to the dollar have, in fact, closely mirrored the performance of U.S. equities. In such cases, investors who may have invested in international funds seeking diversity are, in fact, not receiving much diversification at all.

The key in utilizing international investments from a diversification standpoint is to make sure you HAVE exposure to currency fluctuations, particularly when you believe the dollar will weaken. Centurion Counsel utilizes un-hedged funds that have resulted in our investors enjoying currency gains greater than the returns of the underlying securities as well as providing an asset class that is distinctly NON-correlated to U.S. equities, further providing diversification and portfolio protection. We typically use un-hedged no load bond funds which provide the currency exposure while providing income streams backed by G7 countries.

How has that fared for our clients? Since the end of 2001, the dollar has tumbled 31% against the euro and 21% against the yen. It is also at a 9 year low versus a weighted basket of major foreign currencies. These returns have helped provide a boost to our investors' total returns over the past three years, especially given the U.S. market downturn over this period, and helped protect our client's portfolios overall.

While We're At It…

Here's another example of how we've taken portfolio management beyond simple stock picking. A recent study shows it makes more sense to put bonds in a tax-deferred account and stocks in a taxable one. The latest Federal Reserve Survey of Consumer Finances shows that Americans invest their taxable accounts and their tax-deferred accounts—their 401(k)s and Individual Retirement Accounts—almost identically, devoting just over two-thirds of each to stocks. Those who do this are missing the point. They should put bonds into the sheltered accounts and stocks into the taxable accounts. Investors are bombarded with information about proper asset allocation: how they ought to split their money among stocks, bonds and other assets. Meanwhile asset location between taxable and tax-deferred portfolios gets short shrift. Yet according to Carnegie Mellon finance professor Robert Dammon, putting securities into the wrong type of account can easily slice 20% off your ending nest egg. It's especially costly to young and middle-age investors, because their mistakes have longer to compound.

Your basic goal is simple: to put your most highly taxed assets in tax-deferred accounts, while stashing more lightly taxed assets in your taxable account. With a little research, you'll find that you do best if you put your bonds and real estate investment trusts, whose payouts are mostly taxed at ordinary (federal) income rates of up to 35%, into your tax-deferred accounts. Put your stocks, which pay long-term capital gains and dividends taxed at a top 15% rate, into your taxable account. That holds true, the study shows, even if you trade stocks a lot, generating highly taxed short-term gains, or hold a mutual fund that does the same. Those who put stock into a tax-deferred account will get whacked at 35% when it's withdrawn, compared with the light 15% tax on dividends and long-term capital gains in a taxable account.

Holding lots of stock in a taxable account has other advantages. If you aren't Warren Buffett, you're going to have losers along with winners. Give away the winners to low-bracket children or to charities, or just let them ride. Sell the losers for the tax losses. Another reason to favor stocks in your taxable account is that they can dampen the volatility of your portfolio. Your return is dampened on the upside because the government taxes some of it away. But it's also dampened on the downside because you can use your losses to offset other gains and income. That's true for both stocks and bonds, of course, but since stock returns are much more volatile, you'll get a greater reduction in volatility if you devote your taxable account to stocks.

Centurion has been putting bonds in tax-deferred accounts and stocks in taxable accounts where possible for all of our clients since inception. Focusing on providing the best performance for all of our clients goes beyond simply picking the right stocks for your portfolio. It extends to positioning your assets as favorably as possible to provide you the best return possible to achieve your investment objectives. While we may be accused of patting ourselves on the back here, it's important for our clients to know that you have an investment manager that is working as diligently as we are to ensure your investment success. For what it's worth, we're pretty good at stock picking too…

Centurion Counsel Wishes You Continued Prosperity in 2005!