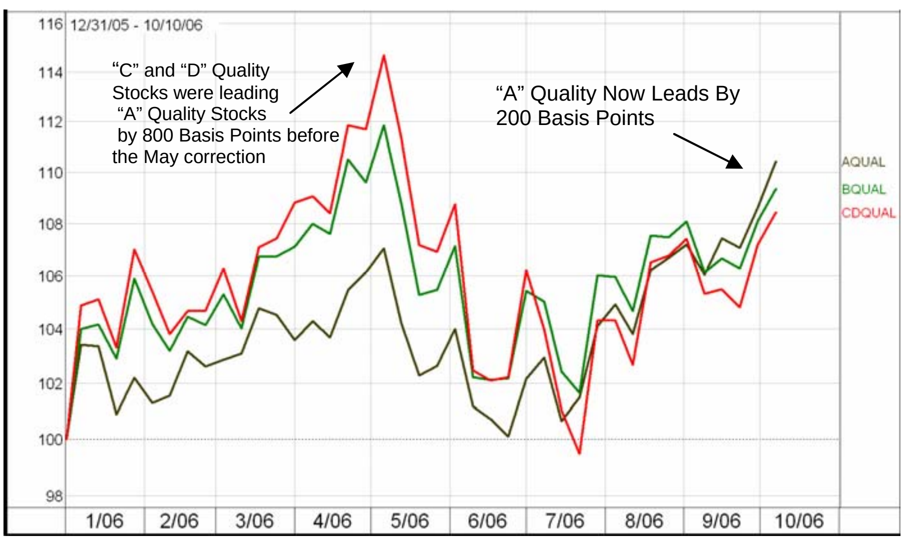
Market Commentary

High quality, large cap stocks staged an impressive rally in the third quarter. As we had been predicting, it was only a matter of time before the market began to rotate back towards these names. Energy was the worst performing sector for the quarter with a return of -1.7%. Former laggards Technology, Healthcare and Telecom rebounded and were the best performing sectors, up 8.5%, 10.2% and 10.6%, respectively. Large cap stocks continued to dominate small cap with the S&P 500 returning 5.7% in the quarter, bringing the year to date gain to 8.5%. The Russell 2000 returned only 0.4%, although the index's strong first quarter performance has kept the year to date return at 8.7%. It is interesting to note that while the Dow recently surpassed its 2000 peak of 11,750, the S&P 500 is still showing a cumulative loss of 2.6% from its peak in March 2000. The primary reason was its larger weight in high-multiple technology stocks at the time. Small cap stocks have had a great run since the bottom of the bear market in October 2002. The Russell 2000 returned 132% on a cumulative basis compared to 85% for the S&P 500. Small cap stocks traded at record discounts to large cap at the peak of the market in 2000. They now trade at relative premiums. The current P/E of the Russell 2000 is 24, compared to 16.6 for the S&P 500. One factor in the dominance of small and mid cap stocks over the past few years has been the proliferation of hedge funds. Long / short equity funds tend to invest more in the smaller stocks as the view is that intensive research can pay off better in these areas. More cynically, it may be simply because it is hard to justify paying typical hedge fund fees of 2% and 20% for buying GE and Microsoft.



With interest rate volatility receding, fixed income returns are tracking close to their income yields. Long term bond yields have dropped slightly as the market is concerned that the economy is slowing and convinced that the Federal Reserve has finished raising short-term rates. Indeed many have argued that an impending economic slowdown translates into a potentially substantial decrease in long-term rates and corresponding large gains in long duration bonds.

Late last month I attended the Grant's Interest Rate Observer Fall Investment Conference, which was a refreshingly serious discussion of investing in today's financial markets. The general consensus was that investors have become too complacent about risk and it is therefore extremely difficult to find undervalued assets in this environment. Referring to the rapid proliferation of hedge funds, James Grant questioned whether the only good investment opportunities today were those that could not justify a 2% and 20% management fee. Large cap stocks and treasury bonds were given as examples.

In a notable session, Seth Alexander the Chief Investment Officer of MIT and protégé of Yale Endowment Chief David Swenson, indicated that return expectations would need to be reduced for large institutions as every conceivable asset has been bid up in price. He went on to say that a large number of institutions currently rushing into alternative assets on the back of Yale's success are following the wrong model. The Yale Endowment, he said, went into alternatives because it saw the opportunity to acquire undervalued assets, not because they followed an asset allocation model built around past returns. Yale analyzed investment fundamentals and made decisions based upon a favorable trade-off of risk and reward. He stated that it is better to be "undiversified in undervalued assets than diversified in overvalued ones".

We do believe that the potential risks in the hedge fund industry may outweigh the return potential. Hedge funds are the latest in a long history of "new paradigms" in the investment world that have in the past always turned out badly for investors. Wall Street has an uncanny ability to ruin a good idea by putting too much money, hype and fees into it. We believe there is a serious risk that this may be happening with hedge funds. As large institutions have discovered the "asset class" and are charging in with their eyes firmly affixed on the rear view mirror of performance the game has been changing. When we recommended our first hedge fund of fund in 1997 there was less than $300 billion invested worldwide in hedge funds. That number has grown to about $1.6 *trillion* today. This amount of money has turned many formerly small entrepreneurial partnerships into institutional asset gathering businesses with billions of dollars under management and charging record fees, typically 2% of assets under management plus 20% of the performance. Our view is that the laws of large numbers and diminishing returns have not been rescinded. Returns, given no increase in risk levels, have to be lower going forward than they were over the past eight years. If we are wrong and hedge fund of funds continue to perform at say, 7.0% annually net to the investor then even this return is not competitive, on an after tax basis with a municipal bond portfolio. Hedge fund returns tend to be predominantly ordinary income, therefore a 7% at the 28% AMT bracket is reduced to 5.0% after tax, only about 100 basis points above a typical municipal bond portfolio. Throw in state income taxes, if applicable, and the fact that the layers of internal management fees cannot usually be deducted against income and the return picture gets worse. Never mind that to achieve a 7% pretax net return to the investor a fund of funds needs to gross upwards of 12%. We do see value in certain niche strategies, particularly those that have not been the beneficiary of the record capital flows of the past few years.

"We do see value in certain niche strategies"

Steve Browne,CFA
CIO
Paul Comstock Partners

We continue to be wary of trailing the movements of large institutional pools of capital (but more than happy to have them flow toward existing client investments). The best investment values today are not only in those areas that typically do not justify hedge fund or private equity fee schedules, but also those where inherent capacity constraints limit institutional participation. This would include smaller real estate and private equity investments, as well as niche areas like closed end funds. In particular, we believe that high-quality stocks will continue to be attractive investments. The broad enthusiasm for alternative investments will likely wane, particularly if there are more Amaranth-type implosions. If this does happen the sector will get more interesting. In the meantime, we will continue to focus on identifying those areas where clients have the potential to enjoy significant risk-adjusted returns.

Questions? Please call Nancy Savoie at (713) 554 0169.