2007 INVESTMENT COMMENTARIES: 2nd Quarter, 2007 in Review

After an uninspired first quarter, stocks around the world surged in the second quarter. Domestically, bigger was better, with larger companies delivering the highest returns, followed by mid-caps and then small-caps. It was also a good quarter for growth stocks. Remember how badly TCW Select Equities did last year? Now it is sprinting past the S&P 500 (as of 7/16/07). Fueled by the second quarter's returns, growth indexes have now out-returned value indexes for the year to date in all market-cap segments. International stocks had another strong quarter and out-returned the U.S. market again.

Non-equity asset classes were mixed. Emerging-market short-term bonds (PIMCO Developing Local Markets) performed very well and added a lot of value relative to the U.S. bond market, which was slightly negative for the quarter and only slightly positive for the year. Commodity futures (PIMCO Commodity Real Return) were negative for the quarter though still positive for the year.

In every economic cycle there are points where the indicators are particularly confusing. During these times investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times as investors vacillated between fears of economic weakness (driven by the housing market) and strength (driven by the buyout boom and a strong global economy).

I've never believed that I could add value using an investment strategy that relied on accurate forecasts of the economy over the near term. Instead I focus on identifying tactical opportunities in which asset classes are fundamentally mis-valued. When they are found, in most cases it means a superior return opportunity. At the same time it means I believe we have a significant margin of safety to protect us from the many risks that are always present. Even when there are no bargains, my research company can generally assess valuations in the various asset classes so I can form an opinion about the degree to which there is (or isn't) a margin of safety. At an absolute level, there are no asset classes priced at levels that make me confident that we are likely to capture big returns over a several-year time horizon. On a relative level there are two areas I continue to be excited about: large cap domestic stocks, and short-term emerging market bonds, but I will elaborate on only one of them.

From November 1999 through February of this year, large-caps (S&P 500) had a total cumulative return of only 9.6% (1.5% annualized) compared to 72.7% (9% annualized) for small-cap stocks (Russell 2000 Index). This sizable performance discrepancy leaves large-cap stocks bargain-priced compared to stocks of smaller companies. Moreover, stocks of larger companies tend to do better when the dollar is weak (their foreign earnings are worth more converted back to dollars and U.S. exports become more competitive), which is partly why mega-cap stocks are now experiencing stronger earnings growth than smaller companies. They also tend to perform much better than small-caps late in the economic cycle.

A reasonable question to ask is whether large-cap stocks are cheap on an absolute basis, or only a less-pricey segment of an overall market that is expensive. The short answer is that I believe domestic large-caps are reasonably valued and therefore attractive, but not Charlize Theron attractive – just Susan Sarandon attractive. (They have a new movie coming out in the fall. I play golf with Charlize's mother and she says the acting is superb.)

Which will do better in the future – stocks or bonds? The research I read suggests that over five years, current stock valuations seem to suggest that it is reasonably likely that stocks will do better than bonds, even in a fairly bearish earnings environment. (That doesn't mean stocks will always be in positive territory.) I mostly use bonds as risk protection, so just because I expect stocks to outperform bonds, that does not mean I intend to reduce bonds. And just because I expect stocks to outperform bonds in the next five years, doesn't mean there won't be a time when I reduce stocks and maybe increase the money market.

Perhps the biggest risk to longer-term stock returns is inflation and interest rates. The rapid growth in the developing world has caused demand for basic commodities to spike in a big way and is one source of potential inflation. At some point supply is likely to catch up with demand but that point may still be a ways off. However, there is a growing consensus among some of the sharpest fixed-income managers that inflation from a variety of sources is working its way back into the system and that it is likely to move higher in the next cycle (though no one we know of is predicting double-digit 1970s-style inflation).

Getting back to the question of large-cap stocks, what is the bottom line? Based on the analysis I read, large-cap stocks are a compelling opportunity relative to stocks of smaller companies. Thus, your portfolios are significantly underweight small-caps and overweight large-caps.

Over the shorter-term, as investors continue to try to read the economic tea leaves in an environment with various cross currents and stresses, I wouldn't be surprised to see some news—economic, financial, geopolitical, a hedge fund or derivative-related blow-up—over the next year that spooks investors and triggers a quick stock market correction. A 10% decline would not be surprising given the performance run since February of 2003 (the S&P 500 has almost doubled). This isn't a prediction but I wouldn't be surprised. If it does happen, I think the downturn is likely to be a short-lived correction rather than the start of a bear market, unless we are heading to a recession, which is possible but seems unlikely given current global economic strength.

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