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Evaluating the market's tide

Low-quality stocks have been dominating the last two years. Stocks ranked B+ or better by Standard and Poor's returned 25 percent, while those B or worse returned 38 percent in 2003 and 2004.

Typically coming out of a bear market, lower-quality issues lead the way, partly because their stock prices suffered the most during the market decline. They also have the most to gain in coming out of a recession, as fiscal and monetary stimulus is helpful to these typically heavily indebted and cyclical companies.

We have had two years of excellent corporate earnings growth, as earnings for the S&P 500 rose over 14 percent in '03 and almost 24 percent in '04.

Expectations by securities analysts are that 2005 earnings growth will be under 10 percent, and most economists believe the economy's beginning to slow from its pace in '03 and '04. A slowing rate of corporate earnings growth favors high-quality stocks.

As the Fed raises interest rates, low-quality companies are negatively affected as debt service increases. Higher-quality companies are much less dependent on the economy. So we believe managers who focus on high-quality companies will begin to perform better in the next couple years.

Portfolio rebalancing is in order. The Russell 2000 small cap index has outpaced the S&P 500 by almost 65 percent in the last six years. The small-cap indexes are loaded with low-quality companies. Rebalancing

portfolios is a must, as many portfolios are over-weighted in small stocks.

Large-cap value managers have beaten large-cap growth managers for five consecutive years. For the period ending December 2004, the Russell 1000 value has outperformed the Russell 1000 growth by 14 percent per year.

The Russell 1000 growth is priced at 21.5 times earnings today versus a PE ratio of over 55 on Dec. 31, 1999. We are also seeing many "value" managers beginning to take positions in traditional growth areas.

This is a good sign for growth. On top of that, almost half of the value index is comprised of interest-sensitive stocks that look vulnerable in a higher-interest-rate environment. Portfolio rebalancing is recommended here, too, as we believe the odds favor growth.

Many investors have become impatient with large-cap growth managers who focus on higher-quality names and are beginning to throw in the towel. We have emphasized repeatedly that comparing performance to benchmarks isn't much of a judge of future performance. Investors need to understand why performance happened and look forward.

There are many studies about the dismal success of many investors. In most cases, their poor experience can be attributed in rearview mirror investing. The SEC requires that published investment track records carry the statement "past performance is not an indication of future performance" for good reason. It simply doesn't work.

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