



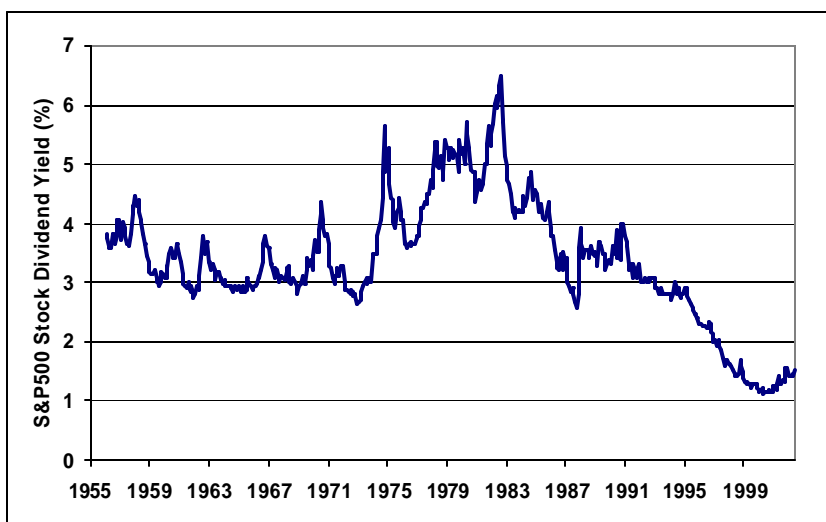
Where Do You Look For Return Now?

Georgia State University
Economic Forecasting Conference
Wednesday, May 22, 2002

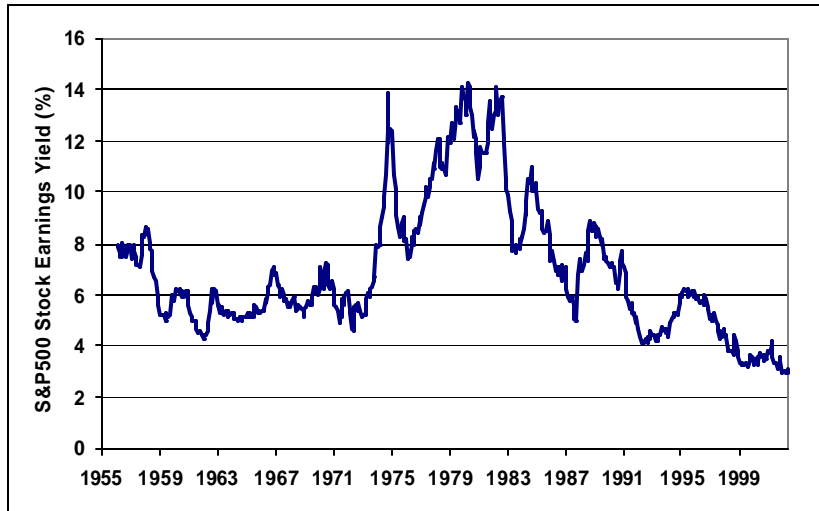
Max Darnell
Partner



Does This Tell Us Anything? *Dividend Yield*



What Does This Tell Us? Earnings Yield



Attributing Return Ibbotson Data

	76 Years, Starting Dec. 1925	Prospects from May. 2002
Starting Dividend Yield	5.1%	1.4%
Growth in Real Dividends	1.3%	2.0%?
Change in Valuation Levels*	1.1%	** ? **
Cumulative Real Return	7.5%	3.4%±
Less Starting Bond Real Yield	3.7% (a)	3.3% (b)
Less Bond Valuation Change**	-0.8%	** ? **
Cumulative Risk Premium	4.6%	0.1% ±

(a) A 3.7% yield, less an assumed 1926 inflation expectation of zero.

(b) The yield on US government inflation-indexed bonds.

* Yields went from 5.4% to 1.4%, representing a 2% annual increase in the Price/Dividend Valuation Level.

** Bond yields went from 3.7% to 5.8%, representing a 0.4% annualized drop in long bond prices; real yields on reinvestment were also poor during much of this span.

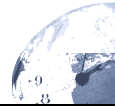
Based on Ibbotson data

Where To From Here?

- **Equity Risk Premium**
 - Will Be Lower Than What Investors Expect

- **Valuation**
 - Still High by Historical Standards

- **Earnings Quality**
 - Lower Than What Investors Have Believed?



Equity Investing

- **Core Equity Management**
 - **Past:** Marginal underperformance somewhat more tolerable when equities were returning 15-20% and more
 - **Future:** Alpha is much more important, especially when equity returns are negative

- **Market Neutral Equity Management**
 - **Past:** Best if alpha was ported back to equities, so removing the market exposure was less important
 - **Future:** The role of equities in generating alpha without market exposure is far more attractive in this environment.





The Conventional, Unconventional Source of Return

■ Absolute Return/Hedge Fund Strategies

- Past: Great Alpha, Uncompetitive Returns
- Future: Alpha adds to spendable returns. Look for negative correlations with major asset classes

*"Nobody goes there anymore;
it's too crowded."
– Yogi Berra*



“Uncrowded” Sources of Return

■ Macro-oriented Hedge Funds

- **Past:** Focused on unique (i.e., unrepeating) sources of value added (e.g., Soros, Robinson)
- **Future?:** Focused on exploitation of recurring market inefficiencies as is often done in stock selection

■ Active Currency Management

- **Past:** Simply hedging foreign equities would have worked well for US investors
- **Future:** Removing the hedge makes sense from a US dollar perspective, but with an expensive pound sterling, this will only work if selective hedging is in place.





“Uncrowded” Sources of Return

- **Tactical Asset Allocation**
 - **Past:** Episodic returns, large alpha
Couldn't match roaring bull market
 - **Future:** In see-saw markets, no asset class dominates
In turbulent markets, TAA is at its best

- **Rebalancing**
 - **Past:** Boosts risk-adjusted returns, but costs money
 - **Future:** Boosts returns



Summary

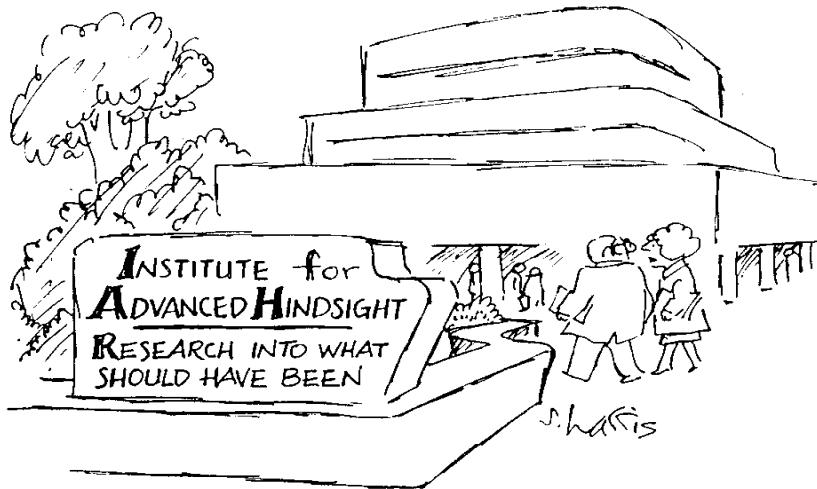
- **Equity Risk Premium Will Be Lower**

- **Marginal Value Added Matters More**

- **Look For Value Added Where Others Don't**



We (Now) Knew It All Along!



But Do We Learn?

“There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.”

John Kenneth Galbraith
A Short History of Financial Euphoria

