

FOCUS

Volume 18, Number 4 / October 7, 2005

***Is the S&P 500
obsolete?***

The Standard & Poors 500 stock index has been the gold standard for performance benchmarking of domestic stock portfolios for years. Several of the largest mutual funds build their portfolios around this index, and virtually every active money manager tries to beat it. Research by Robert Arnott, the editor of the *Financial Analysts Journal* and chairman of Research Affiliates LLC, may be about to revolutionize the way in which all investors think about indexes in general and portfolio structure in particular.

The S&P 500 is a simple mathematical construct: the price of each company in the index is multiplied by the outstanding number of shares of that company, those products are then summed, and the sum is divided by a factor that normalizes the result. Thus, companies in the index are weighted by shares and price and not by sales, or profitability, or intrinsic value, or any other measure of economic performance or size. Price alone dictates most of the movement in the index and thus the contribution of each company to the performance of the index, since price changes much more frequently and significantly than does the number of shares outstanding.

Arnott's work shows that this approach is flawed in two respects: companies, even relatively small ones, that trade at high price-earnings ratios, will be overweighted in the index, and companies, even large ones, that trade at very low price-earnings ratios, will be underweighted. He also shows that companies that sport the highest valuations in a given period rarely maintain that value, and in fact lag the market for extended periods following their day in the sun (remember Cisco?).

To remedy this flaw, Arnott constructed what he terms the “fundamental” index. First, he starts with a larger universe of companies than just those in the S&P index. He then calculates a weighting for each one based on revenues, cash flow, dividends, and book value. Companies with no dividends are weighted using only the other three factors.

Over a period of 43 years (1962-2004), the fundamental index outperformed the S&P by just under 2% annually. The S&P returned 10.53%, while the fundamental index returned 12.47%. This may not seem like much until you consider the terminal values. A dollar invested in the S&P over that period grew to \$73.98; the fundamental index would have produced \$156.54.

What is even more remarkable is that these results also apply to smaller company indices such as the Russell 2000 as well as to foreign markets. Perhaps the best news of all is that the volatility of these fundamental indices is no greater than that of their capitalization-weighted cousins, meaning that the return:risk ratio is significantly higher.

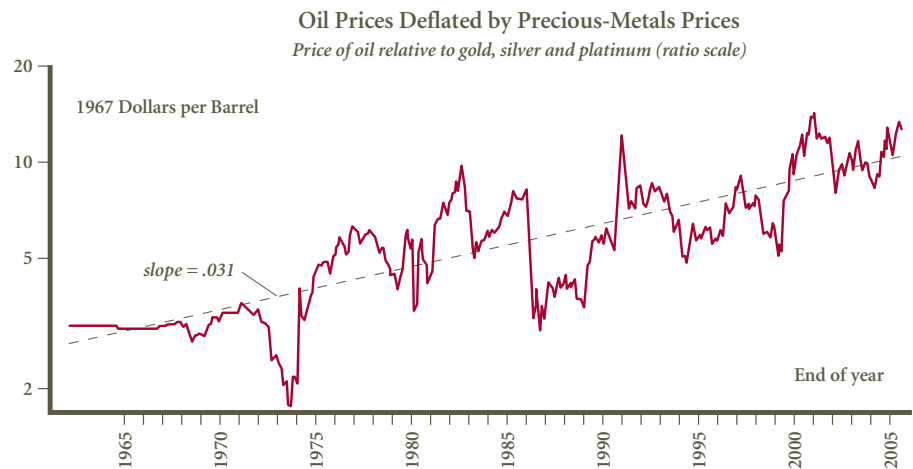
This research has not gone unnoticed by the fund industry, and a number of products designed to track the new and improved indices are either in registration or on the drawing board. What remains to be seen is whether the industry at large will abandon its attachment to cap-weighting and embrace fundamental weighting or, instead, remain tied to what seems to have been proven to be an inferior way in which to invest.

***An energy
bubble?***

David Ransom, editor of *Wainwright Economics*, has been an astute observer of important economic and market trends for well over 30 years. Recently, he published an analysis that suggests that the recent surge in energy prices may be short-lived.

To make his point, he first adjusts the oil price index for inflation using a weighted average of gold, silver and

platinum as a real-world proxy for inflation (instead of the Consumer Price Index or other calculated measure, which can be manipulated) and then plots the ratio of oil vs. this index over time as shown below.



Two observations emerge. First, on average, real oil prices (net of inflation) have risen on average about 3.1% per year over the last 45 years. The second observation is that while prices have varied above and below this trend line, they do tend to revert to it. Moreover, on average, it takes about two years for prices to do so, whether from an over- or under-priced state.


The current trend line value is about \$41/barrel. Assuming the 3.1% slope remains intact, we should expect to see prices back in a range between \$41 and \$43.60 sometime between now and 2007. While prices for refined products may not decline due to the lack of refining capacity, this expected decline could have a negative impact on the share prices of a number of the currently high-flying oil companies. ☒

***The China
slowdown—
Be careful what
you wish for***

Art Cashin, investment strategist with UBS, recently made some potentially worrisome observations about China that have significant implications for the world's economy. They were prompted by the announcement that China's trade surplus for June was \$9.7 billion and that its exports jumped 30% over the same period in 2004.

He refers to a Bloomberg report that Wal-Mart, Gap and other manufacturers are looking to India as an alternative source of manufacturing if China is forced to revalue the Yuan significantly, which would raise their costs. Cashin continues: "...China has experienced the greatest mass migration in history. In a few short years the equivalent of the current population of the United States moved from the rural area to the cities in the south and east. You can't allow that many itinerants to mill about idly—lest they turn from sullen to mutinous. So, if they can't find jobs, you need to grow jobs by growing the economy quickly. To paraphrase the Queen's comment to Alice in Through the Looking Glass, you have to run as fast as you can just to stay in place. That's where China is.

"The potential of all of this is enormous. Imagine India beginning to build production capacity to compete with China. And China needs to keep running flat out as the second wave of migration begins. The result could be global overcapacity [of manufacturing—*ed.*] that could cap prices [of manufactured goods] for decades and maybe bring actual threats of deflation."

We believe current overcapacity is a strong contributor to the 'conundrum,' i.e., the paradox that long-term rates are holding fast in the face of rising short-term rates and rising inflation, which Fed Chairman Greenspan labeled a conundrum. 

Have a nice day

Want to really worry about something? How's this for a forecast:

“Economy falls into a recession after the Fed raises the federal funds rate to 5% because inflation increases at a faster pace. The ensuing economic downturn averts higher inflation as fears of deflation resurface. The housing bubble bursts exacerbating the economic downturn. Geopolitical turmoil is widespread. US imposes 27.5% tariff on all imports from China. China invades Taiwan. Commodity prices plunge. Terrorists destabilize Saudi Arabia. The US bombs Iran's nuclear sites. Iraq is torn by a civil war. Oil prices soar. The bird flu kills millions around the world.”

Fortunately, the author, Ed Yardeni of Oak Associates, only puts a 10% probability on this scenario. Just as fortunate, he puts a 70% probability on the following outlook:

“Real GDP increases 2.5% during 2006. Consumer spending continues to grow as employment expands and real pay per worker increases along with productivity. Capital spending gets a boost from ample corporate cash flow. Core inflation remains low [at] around 2% as the price of oil stabilizes around \$60/bbl. The Fed raises the federal funds rate to 4.5% by early 2006 and stops tightening over the rest of the year. [Corporate] earnings increase as profit margins remain near cyclical highs while business sales grow at a solid pace. Sales are boosted by exports.”

President Truman was right—we need a one-handed economist!

From our tech team

Identity theft and the security of personal information continue to be a front-burner topic for anyone who uses a personal computer. Recently, we attended a seminar on information security presented by a security expert from our parent company. One of the topics he discussed at length was the construction of passwords.

For a password to be “strong,” it needs to have four characteristics:

- Has at least 8 characters
- Contains both upper and lower case letters
- Includes numbers
- Contains special characters (@, #, \$, %, etc.)

Furthermore, a strong password will not contain any information that relates to your name, your social security number, your address, your telephone number, or any other identifying information. It should also not use a word or words that can be found in the dictionary. Finally, and just as important, you must be able to remember it. Therefore, it can't be too complicated.

Here are some examples of “bad” passwords:


ILOVESHOPPING
#1BearFan
wamwam123

On the other hand, here are some good examples:

DAWG#howz8 (meets all four criteria)
\$VBt0ppm (ditto)
8834\$muG (ditto, but...)

Note that it is common for some people to substitute ! for 1 or i, \$ for S, and @ for a. Therefore, the last one may be marginally safe. As a final example, while the following password is certainly strong, could you remember it?

T2wi^KleL\$

In summary, structure your passwords wisely, change them regularly, and don't store them in a file on your computer (or, as some people do, on Post-Its under your keyboard) or carry them in your wallet. Your security starts with you. 

***Aging gracefully,
or maybe not so
gracefully***

It was fun being a baby boomer... until now. Some of the artists of the 60's are revising their hits with new lyrics to accommodate us aging baby boomers. They include:

Herman's Hermits—Mrs. Brown, You've Got a Lovely Walker

The Bee Gees—How Can You Mend a Broken Hip

Bobby Darin—Splish, Splash, I Was Havin' a Flash

Ringo Starr—I Get By With a Little Help From Depends

Roberta Flack—The First Time Ever I Forgot Your Face

Johnny Nash—I Can't See Clearly Now

Paul Simon—Fifty Ways to Lose Your Liver

Commodores—Once, Twice, Three Times to the Bathroom

Marvin Gaye—Heard it Through the Grape Nuts

Procol Harem—A Whiter Shade of Hair

Leo Sayer—You Make Me Feel Like Napping

The Temptations—Papa's Got a Kidney Stone

Abba—Denture Queen

*Tony Orlando—Knock 3 Times On The Ceiling,
If You Hear Me Fall*


Helen Reddy—I am Woman, Hear Me Snore

Inside Woodside

We are pleased to welcome to the Woodside family Emily Alice Sedgwick, daughter of our head trader Tom Sedgwick and his wife Kathryn Spain, born at 4:14PM on September 25th and weighing in at 8lbs. 2oz. Congratulations to all three!

And, with a very red face, your Editor hereby announces (belatedly) the marriage of our Client Service Manager, Kathie Silici, to Joseph Silici on New Years Eve. Congratulations and best wishes to both. 🍷

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