Woodside Asset Management

Focus

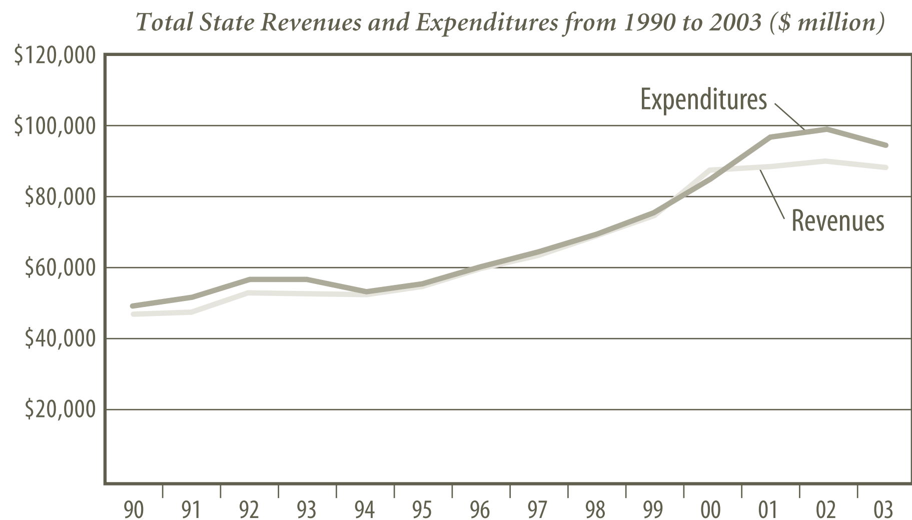
Volume 16, Number 2 / April 1, 2003

The Crisis in California

California's budget deficit has mushroomed from the $7 billion estimate last summer to somewhere between $26 billion (according to the independent Legislative Analyst's Office) and $39 billion (the most recent estimate by the Governor's office). Our deficit now equals one-third of our total expenditures. How could California be in such a mess? A recent *Policy Brief* by Michael Dardia and Thomas MaCurdy of the Stanford Institute for Economic Policy Research (SIEPR) offers a simple but clear insight into the sources of the budget crisis and suggests a set of solutions that would have a good chance of returning the state to fiscal sanity.

The chart below, which compares state tax revenues and expenditures since 1990, tells the story.

Total State Revenues and Expenditures from 1990 to 2003 ($ million)



As early as the beginning of 1999, forecasters had warned that the increase in revenue came from "uncertain sources that could not be counted upon in the future." Moreover, the tax base has become very narrow since 1996: the top 1% of

taxpayers now account for over 40% of personal income taxes. In the past, sales taxes and the Vehicle License Fee were the main sources of revenue. Nevertheless, when revenues flattened in 2000, the government continued to increase spending.

Governor Davis' proposed budget for 2003-2004 would decrease spending by 17%, which is still 5% higher than levels in 1994. Given the announcements of pink slips for our K-12 teachers, it is hard to believe that the proposed education spending is above 1998 levels. Health and social services will be cut by 10%.

Dardia and MaCurdy suggest that the state needs to widen the tax base, give cities and counties more control over revenues and spending, and (shocking!) save excess revenues for debt repayment and future capital spending. Debt repayment is a long way off—we expect the supply of municipal bonds to increase dramatically over the near term to help pay for the deficit. As for the delegation of power and resources from the state, that sounds remarkably familiar: state governors have been asking for the same thing from the US government for years. This part of the proposed solution will probably not occur during this budget debate, if ever. The suggested widening of the tax base does make sense, because the tax on capital gains and the exercise of stock options should not be the basis of permanently higher state spending. For example, in 2001, these sources represented 25% of General Fund revenues; in 2002, it is estimated that they accounted for less than 8%!

From our perspective, given the penchant of both the Governor and the Legislature to avoid making hard choices, it is likely that whatever solution is adopted will not come close to MaCurdy's and Dardia's proposals. Therefore, the situation could even get worse before it gets better.

[You can download a copy of this and many other interesting papers on economic policy from the SIEPR website:

http://siepr.stanford.edu. Morgan White, a Managing Director of Woodside Asset Management, serves on SIEPR's Advisory Board.]

Does real estate still make sense as an investment?

Real estate is one of the six asset classes that we use to diversify our investment portfolios. Except for a few, older partnerships, our holdings in this asset class consist of equity REITs (Real Estate Investment Trusts). An equity REIT is a company that owns, manages, leases and sometimes develops commercial, investment-grade real estate projects such as office buildings, apartment complexes, industrial parks, shopping malls and retail strip centers. Many of these companies trade on the major exchanges and have reached sufficient size to be included in major market indexes such as the S&P 500. The performance of equity REITs during the current three-plus year bear market may surprise you.

One of the key factors in choosing an asset class to include in a diversified portfolio is, of course, its long-term return. Another, less obvious ingredient is the correlation of its returns to those of the other asset classes that have been chosen, i.e., how closely its up and down movements track those of the other asset classes. A correlation of 1 between two asset classes means that they track perfectly; a correlation of –1 means that their returns are the exact mirror of each other.

The table on the following page contains a sample of correlation coefficients of various asset classes to one another. For example, you can see that equity REITs (the NAREIT Equity index in the first column) have a correlation coefficient of only 0.60 to the broad market (Wilshire 5000) and 0.55 to the S&P500. This means that equity REITs tend to move up and down at different times than do the bulk of the stocks that comprise the market.

FOCUS / *Vol. 16, No. 2 / April 1, 2003*

CORRELATION OF TOTAL RETURNS

Upper right: January 1993-February 2003

	NAREIT	WILSHIRE 5000	NASDAQ	S&P 500	GOV'T BOND
NAREIT	1.00	0.30	0.14	0.27	0.07
WILSHIRE 5000	0.60	1.00	0.87	0.97	0.01
NASDAQ	0.50	0.89	1.00	0.79	-0.06
S&P 500	0.55	0.98	0.84	1.00	0.02
GOV'T BOND	0.19	0.23	0.14	0.24	1.00

Lower left: January 1973-February 2003

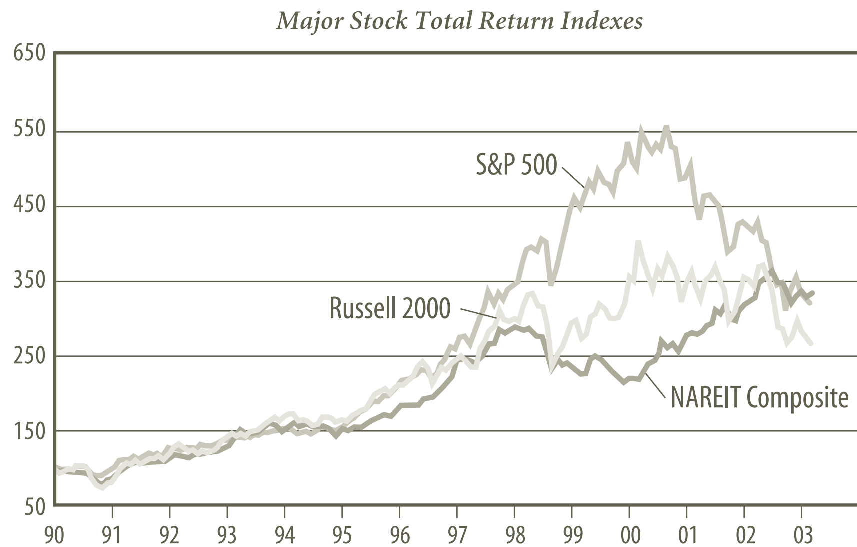
Now you ask, so what? Well, this happens to be very important. If you had a portfolio of six asset classes, each of which produced a 10% per year return every single year (which would mean they were perfectly correlated to one another with a coefficient of 1.00), your portfolio would produce a total annualized return of 10% over the long run. Seems obvious. However, if you had a portfolio of six asset classes, each of which produced a long-term annualized return of 10% (but in some years exceeded 10% and in some years fell short of 10%) and each of which was not highly correlated to the timing of the movements of the others, your portfolio would produce a long-term return higher than 10%, even though none of the asset classes exceeded 10% over the long run. This is a mathematical fact that is not intuitively obvious.

This brings us to our REITs and a look at what they have done for our portfolios during this horrendous bear market. For simplicity, let's look at the period from January 1, 2000 through February 28, 2003, even though the bear market began in March of 2000. Over this period, the S&P 500 was down 38%, and the NASDAQ was down 71%. Foreign equity markets (as measured by the EAFE Index (Europe, Australia & Far East) were down 46%. You would think that with the decline in the U.S. market, equity REITs surely must have

been down, but maybe not by as much.

Well, here is a real life example of a lack of correlation. Equity REITs were actually up for this period. And they weren't up just a little, but rather were up a whopping 48%. Over a longer period, January 1, 1990 through February 28, 2003, equity REITs produced an annualized return of 10.0% versus 9.2% for the S&P 500 (see graph below). You can also see from this graph that their returns were less volatile than those of the broader market, as evidenced by a smoother line. Over an even longer period, the 31-year stretch from 1972 through 2002, equity REITs out-performed the S&P 500 with a return of 12.2% versus 10.9%, again with less volatility.

Major Stock Total Return Indexes



The performance of equity REITs over the past three-plus years may lead one to conclude that they are over-valued today. Surprisingly, as a group they are trading at valuations equal to their net asset value, meaning that they are neither over- nor under-valued. Further, their yields are right in line with those of long-term corporate bonds, also an historic norm. But within this group average, certain REITs are clearly over-valued while others are under-valued. Since real estate fundamentals tend to lag the economy, one should move with great caution buying any REIT today.

FOCUS / *Vol. 16, No. 2* / *April 1, 2003*

Computer haiku

The Web site you seek cannot be located,
but countless more exist.

Chaos reigns within. Reflect, repent, and reboot.
Order shall return.

Program aborting: Close all that you have worked on.
You ask far too much.

Windows XP crashed. I am the Blue Screen of Death.
No one hears your screams.

Yesterday it worked. Today it is not working.
Windows is like that.

Your file was so big. It might be very useful.
But now it is gone.

Stay the patient course. Of little worth is your ire.
The network is down.

A crash reduces your expensive computer to a simple stone.

Three things are certain: Death, taxes and lost data.
Guess which has occurred.

Having been erased, the document you're seeking
must now be retyped.

Serious error. All shortcuts have disappeared.
Screen. Mind. Both are blank.

Inside Woodside

We are very pleased to report that in a recent nationwide survey of 210 independent wealth and asset advisory firms conducted by Moss Adams LLP for Charles Schwab & Co., Woodside was selected as one of the 21 best-managed firms of the 221 firms surveyed. Selection criteria included growth, employment practices, client selection and retention, levels of service, corporate structure and profitability. Both we and the

management of Silicon Valley Bank are committed to the continued use of these "best practices" in our new role as a subsidiary of the Bank.

On a sadder note, we recently bid farewell to Wendy Malesic, who had served in virtually every staff position at one time or another during her 14-year tenure at Woodside. Wendy has moved to Southern California to become the office manager for another investment advisor. We all wish Wendy a fond farewell and sincere best wishes for success in her new position.

As a reminder, our offices will be closed Monday, May 26, for the Memorial Day holiday.

FOCUS / *Vol. 16, No. 2* / *April 1, 2003*

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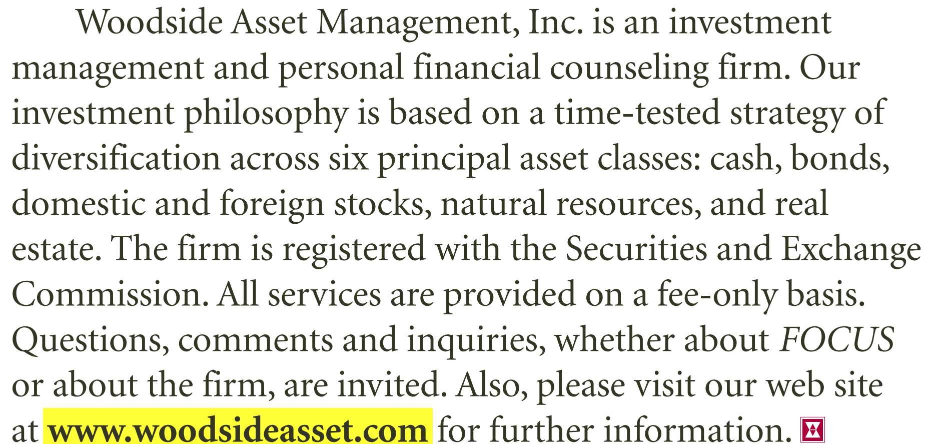

Woodside Asset Management, Inc. is an investment management and personal financial counseling firm. Our investment philosophy is based on a time-tested strategy of diversification across six principal asset classes: cash, bonds, domestic and foreign stocks, natural resources, and real estate. The firm is registered with the Securities and Exchange Commission. All services are provided on a fee-only basis. Questions, comments and inquiries, whether about *FOCUS* or about the firm, are invited. Also, please visit our web site at **www.woodsideasset.com** for further information.

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The Bank has 11 offices throughout California and operates regional offices in Phoenix, Arizona; Boulder, Colorado; West Palm Beach, Florida; Atlanta, Georgia; Chicago, Illinois; Boston, Massachusetts; Minneapolis, Minnesota; New York, New York; Durham, North Carolina; Portland, Oregon; Philadelphia, Pennsylvania; Austin, Texas; Dallas, Texas; Northern Virginia; and Seattle, Washington. More information on the Bank can be found at www.svb.com

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