INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

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2006: Buying or Breaking the range

Last month in "Overview 2005," I wrote about stocks' and bonds' range-bound low volatility last year. To wit, the S&P 500 varied by just 5.8% off the midpoint of its trading range, and the 10-year Treasury by 8.2%, or ±0.35% in terms of yield. I finished by cautioning that such placid appearances should not be construed as forecasting a riskless future. Since overviews tend to be longer on description than interpretation, I may have left some of you wondering: what's implied by what I described?

My first response is simple to point of being dismissive: for true long-term investors (and no one with a short investment time horizon should buy equities or longer maturity bonds), a year's volatility or stasis should be irrelevant. Interim cash flows (dividends and interest) and end-period values are what matter, and time is the lever by which well-diversified, risk-enduring strategies outperform. Though this may be a logically satisfactory thing to say, it is nonetheless *unsatisfying*, particularly for anyone not already sitting on a portfolio they think robust for the long haul… for instance, anyone deliberating how to allocate cash.

My other responses address two different scenarios. In one scenario, the markets remain range-bound, with stocks breaking out neither to the upside nor the downside, and bonds continuing in their drift to uniformity across the term structure of interest rates (a flat-lining of the erstwhile yield "curve").

What's it imply if we remain "Home, Home <In> the Range"? If stocks' price appreciation is stifled, dividends will play an especially important role in total return. Conclusion: we should **favor** stocks with **well-supported dividends** that look apt to increase. If the Fed restrains itself to just another 0.25-0.50% of rate hikes – and if foreigners maintain their appetite for dollar-denominated debt – bond market returns should be largely undifferentiated across maturities. Conclusion: we should **favor shorter-term maturities**, since we receive no evident premium for treading further out in years.

Moreover, there are a couple of secondary implications for a tightly range-bound environment. First, overweight cash balances look unlikely to be penalized as much as they have been historically. Conclusion: **We should not abhor cash**. Second, since range-bound markets by definition mean static performance for market index portfolios, one way to pursue absolute returns is to trade more actively. Conclusion: Whereas our ideal is to buy and hold for years, we should be more willing to consider taking profits when prices seem to get ahead of values; we should **be more opportunistic in realizing gains** than would typically suit strict tax-sensitivity.

The other scenario is that the range breaks apart, either upward or downward. While we think a near-term leap in stock prices the least likely outcome, we expect to participate in such a surprise by **maintaining your target strategic allocations to equities**. We are not *short* the U.S. market, my dourness about unsustainable corporate profit margins and deficit spending by consumers and government notwithstanding. For truly long time horizons, we still think it important to hold stocks, though it will at times prove very uncomfortable to keep doing so.

We expect to protect against downside breakouts by populating your equity portfolios with **high quality companies** (stable earnings, reasonable debt levels, rising dividends). That said, bear markets can take a bite out of these stocks, too (relative outperformance can still mean absolute losses), so we don't regard quality as a refuge from loss, and neither should you – rather, quality can be a brake on losses. Likewise, **low duration fixed income** portfolios can provide a brake on losses and preserve flexibility to rebalance should prices of stocks or longer bonds tumble to attractive levels. Normally, such opportunistic flexibility comes at a cost – higher yields foregone – but that's not the case with a flat yield curve.

Whichever scenario prevails – range bound or range breaking – we are working to position your portfolios in ways that suit either.

William A. Harris, CFA
Portfolio Manager

Firm News

Tara Hendison, Allen Trust Company's Vice President and Trust Officer, has joined the Estate Planning Council of Portland, a select group of attorneys, CPAs and financial industry professionals specializing at the forefront of trust and estate practices in Oregon.