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Overview 2005: A year of range-bound Resilience

Despite numerous potential volatility triggers – force 5 hurricanes, soaring energy prices, stirrings of inflation, GM and Ford credit rating downgrades to junk status, unrelenting Federal Reserve rate hikes, terrorism in downtown London, and spectres such as avian flu and jittery demagogues with nuclear ambitions – the US bond and equity markets bumped along unremarkably

Total Return 2005	
Allen Trust Equities	7.91%
Allen Trust Bonds	1.59%
Dow Jones Industrial	
Avg	1.72%
S&P 500	4.90%
Russell 2000	4.56%
Lehman Agg Bond	2.43%

for the year. In other words, they were range-bound, with the S&P 500 nodding about between 1,136 and 1,276, and the 10-year

Treasury yield wandering between 3.9% and 4.6% only to end the year a mere 0.15% higher.

Perhaps what *didn't* happen was more important than what did. Namely, US consumers didn't collapse from exhaustion (though they closed the year on pace to spend more than they earned for the first time since the Great Depression), the housing market didn't implode (which abetted the aforementioned personal deficit-spending), long bond rates didn't climb with short-term rates (so borrowers didn't suffer terribly), the US dollar didn't tumble down a rat hole (despite record trade and fiscal deficits; indeed, foreigners have been net US investors to the tune of roughly \$100B per month), and fear never took hold in the stock market (to the contrary, NYSE margin debt – a proxy for speculative sentiment – has reached its highest level since 2000, the peak year of the previous bull market).

To sum up, our economy, our currency, and our markets proved resilient if unexciting.

Contributing to market stability have been excess global liquidity, and a concomitant slimness of risk premia. When there's more money than opportunity for return, investors' notions of what constitutes risk can change – they can be willing to take on more risk for the prospect of smaller incremental returns than has historically been the case. This seems to be the situation now, hence the anecdotes noted above: foreigners investing to the US despite challenges facing the dollar, and margin investors trying to juice their stock market returns via leverage. What's more, range-bound trading

can further encourage risk-taking insofar as a placid market *looks* risk-free.

When people stop worrying so much about risk, prospective returns too can become seemingly range-bound. Consider the homogeneity of year-end yields noted in the table below. What would conventionally be considered the least risky asset here (the two-year Treasury) now yields just 1.0% less than the top of this yield range, represented by the conventionally riskier 10-year corporate bond and the trailing earnings yield (EY = net income/market price) on the S&P 500. It's a gross oversimplification for me to say so, but on the whole, investors aren't differentiating much between investments that are fundamentally dissimilar.

A Homogeneity of Yields	
2yr Treasury	4.41%
5yr Treasury	4.32%
10yr Treasury	4.36%
2yr Corporate	4.84%
5yr Corporate	5.19%
10yr Corporate	5.40%
SP500 GAAP EY	5.34%
SP500 Core EY	5.08%

This matters. Placid surfaces can conceal complex forces, and the relationships necessary to maintain so tight a trading range as we've enjoyed can vary far more in their extremity than appearances might suggest. For instance, to the extent that hedge funds make oppositional bets and leverage to capture small differentials and inefficiencies, they can – in a normal market – wring volatility from the market and make it behave nicely. But what happens in non-normal times, when events stray into what statisticians call the "tails" of the probability distribution, when the unlikely happens despite its unlikelihood? When complex systems break, they can break badly.

By no means am I predicting that things are going to "break badly." I'm just pointing out that they can. *We do not believe that 2005 trumpeted the end of risk.* Engineering volatility out of the market for a time is not the same thing as engineering out risk.

William A. Harris, CFA
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Firm News

Our very own Sharon Heth, Vice President of Charitable Services, has joined the OHSU Foundation Planned Giving Council as an advisor. Sharon's expertise will help the Foundation better support Oregon's only health research university in its mission: to improve the health and well-being of the state and its citizens. Kudos, Sharon!