

Fund Interviews

By Capital Link

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Fund Performance (2nd Quarter 2004) and Outlook



Interview with
Michael Porter
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Michael Porter is a Senior Analyst at Lipper Inc., a subsidiary of Reuters. He shared with us Lipper's Fund Performance for the second quarter of 2004 and the outlook for the Mutual Fund Industry.

Capital Link: *What was the performance of Closed-End Equity Funds in the first half of 2004?*

Michael Porter: Domestic Stock Funds extended their winning streak to five quarters in the second quarter. However, they did so just barely, as the trend of rising interest rates, inflation and uncertainty in Iraq set a sober tone on Wall Street. The Equity funds were barely positive for the quarter with the average US Diversified Equity Fund up 0.84%. On the negative side, World Funds underperformed with an average decline of 2.4%. However, for the first half, all Funds did manage to hold on to gains on a year-to-day basis through 6/30.

Capital Link: *Do you see any particular trends?*

Michael Porter: Looking at the Highlights and Lowlights of the Equity Fund arena, we can spot certain trends. The World Funds on average were poor performers, with emerging markets down 10%, China Funds down 9%, Asian Funds ex Japan down 10%. Generally this reflected fears of an overheating Chinese economy as well as of the threat of higher US interest

rates which caused risk aversion on the part of investors in emerging markets and caused those markets to decline on fears that the Chinese authorities would clamp down on an overheating growth in that economy.

Gold suffered a very bad decline as well; Gold funds went down 18% in the quarter and are now down 20% on a six month basis.

On the positive side we saw natural resource stocks do quite well. This is because of the rise in oil prices and concerns about what was going on in Iraq. They rose on average about 5% in the quarter.

We also saw that small cap value equity funds were up to 2%. In general however, large cap outperformed small cap and value outperformed growth and that suggests to us along with these other trends that there was an increase in risk aversion on the part of US equity investors during the quarter as they looked at the threat of rising US interest rates and a possible slow down in both the Chinese economy and the Global economy and the US economy.

To summarize, we can say that despite those headwinds of rising interest rates, concerns about the transfer of

sovereignty back to Iraq, the political outlook etc., the Domestic Equity Funds were still fairly resilient in face of uncertainties. The World Funds were hit by nervousness and also by the poor outlook for the US dollar as our trade deficit expands at an alarming rate.

As I mentioned before, value beat growth in terms of style and Large Cap beat Mid Cap, which beat Small Cap, which reflected greater risk aversion on the part of investors. The Fed hike of 0.25% was very well anticipated and in our opinion had no real major impact on performance. I think the concern was how much the Fed would increase rates in the cycle. I think that was on investors' minds.



Capital Link: *What about looking ahead for Equity Funds?*

Michael Porter: Looking ahead, we would say that if interest rates rise at only a moderate level, that scenario would not necessarily be negative for US equities.

In fact if you look at the four past tightening cycles of the Fed, you would see that on a six-month basis, following the initial hike of the Fed Funds rate, stocks have increased about 8% on average. In the twelve months following the start of Fed tightening, stocks have gained on average of about 5%. So, what we see is that the Earnings per Share growth rate tends to exceed the growth and the rise in interest

rates. Therefore, you still have something supporting stock prices even as the interest rates cycle starts to go up.

Capital Link: *What about valuations?*

Michael Porter: In terms of valuations, the correction in the stock market at the same time that earnings have increased to new record heights has improved equity valuations.

For example the S&P 500 is now priced at a perspective P/E multiple of about 17 times and that's near the lower end of its ten-year range and below its average of 21 times. Despite the increase in interest rates in yield US stocks still appear under priced relative to government bonds and here we look at dividend discount models to make that conclusion.

Capital Link: *What about investor concerns and investor behavior?*

Michael Porter: Valuations aside, at the same time the public is not in a speculative mood. As we see there was a tendency towards increased risk aversion. However it is very difficult to identify a catalyst that will lead and drive stock prices and therefore funds higher or lower reflecting geopolitical concerns such as the Middle East and also the rise in the price of energy, which if it persists, it will derail our economic recovery. We also have terrorism concerns that still prevail both in the Middle East and also on our shores.

Also, concern gathers about the convention etc. The domestic political scene is another

concern. The market is expecting a very close election between Bush and Kerry. Bush's approval ratings are at historical lows for an incumbent at this point in time in the presidential race. Of course there is a lot of confusion, a lot of noise about interest rates, which keep investors sidelined somewhat.

We think that memories of the blowing up of the bubble in 2000 are also driving caution on the part of the mutual fund investors in terms of what we are hearing them say: why rush in now?

We would say that investors still love yield, so they are waiting for a good time to look at Bond Funds as opposed to Equity Funds and we think they are adjusting their long-term expectations earthward, not expecting double digit gains or 20% plus type of gains going forward.

As a result of this, and the political season, we are looking for this kind of deadlock between the markets going up and down. It is in a kind of stalemate right now.

Capital Link: *Any other factors to take into consideration?*

Michael Porter: Looking forward, it is important to take note at the weakening dollar as our trade deficit expands. This will be negative in terms of attracting foreign investment into our market and may act as a negative in terms of the equity market. We are expecting only a moderate expansion in the increase in the interest rates affecting the modest expansion in GDP. We think that the Fed will take note of the fact that

the US consumer has built up a lot of debt and there is also a lot of debt in our financial system. We think that that may constrain the Fed from raising interest rates too far and too fast and that is a scenario that is basically equity-friendly.

If on the other hand the Fed increased rates more aggressively, that would be obviously a negative. Of course the presidential election will be very important to which way the market moves.

Capital Link: *How can investors position in this environment?*

Michael Porter: In this environment, we would suggest caution. Defensive portfolio positioning in consumer staples and health care as well as in the energy and utility sectors and selective consumer discretionary names that can maintain pricing power.

We would generally under weigh interest sensitive sectors such as banking and high beta sectors such as technology. While we do expect a difficult environment for stocks in the next few months we think the rally later in the year is quite plausible after the fall elections.

We would stress value, large cap. We think that world equity or foreign stocks might be a good bet here and we will stick with natural resource funds, which while they have done well, they still have further upside in our view.

Some contrarian calls might be Japan which went down in the quarter although is up to year-to-date. We think the economy there is recovering nicely, structural reform continues and

growth in exports is being driven by continued growth in China. Even if China's growth slows down, they will still be bullish. We think that Japanese exporters like Cannon and some of the bigger names there have very good multiples.

Real Estate would also be a nice contrarian call with interest rates growing at just a moderate pace here and obviously utilities. While they are perceived to be interest rate sensitive, in fact they are not really that sensitive.

Everyone is very edgy, we do expect some more volatility in the market which will keep people somewhat on the sidelines. As I will indicate further on, buyers are pulling back into a shell and we think it's important to keep your eye on the Big Picture which is that growth is still positive, that interest rates outlook is for moderate increases and Earnings per Share Growth is very strong and valuations are very reasonable.



Capital Link: *How about investor purchases of funds?*

Michael Porter: In the last few months purchases as a percent of Total Net Assets (TNA) of the Mutual Fund Industry have been on a downward slope, which reflects the greater caution that we were talking about.

Redemptions by and large if you look at the second quarter of April, May and June they have been on a rising trend. As a result, the Net Purchases as a percent of TNA have declined quite sharply.

Capital Link: *What about the performance of Fixed Income Funds?*

Michael Porter: Turning to the Fixed Income Performance in the second quarter, we have to look at recent returns. We should also examine in a nutshell the CPI numbers, take a look at the implications of the Fed Funds futures and review some of the results of the fixed income Funds in the US.

What we can see here is that there was a lot of damage done in May and in fact there was also a lot of damage done in April and the bond funds were unable to recover from those levels. In June, most of the Bond Funds had positive performances. However, overall for the quarter the Bond Funds had negative results and this is the first quarter in almost three years that the average fixed income classification was in the red.

As I mentioned, April brought the Bond Funds down before they could even get started and they were unable to recoup the losses that they incurred in April, through the remainder of the quarter. The one bright spot were Loan Participation Funds for the taxable bond fund investor. World Income Funds like the World Equity Funds did not fair well in this current environment.

Let's take a look at the CPI for the past years and look at it with all items, ex Food & Energy and CPI for services. The main point to make here is to ask oneself whether the economic news was any different during the month of June versus the month of May. The answer to that is "No" and did the Fed say really anything different in June

versus May? The answer is "No". Were the PPI and CPI numbers significantly different in June versus May? The answer to that also is "No".

So, we have to ask what happened that it was such a poor quarter overall for the Bond Funds. We would say that the bond market went a little haywire with the releases of CPI data in April and May, which they kind of edged up there in May. The market took these values as indicative of what's to come rather than as a spike in the rates and the Fed had been saying that this was a spike and that some of the inflationary factors had been transitory.

The last two CPI releases for June and July tend to back up the Fed on this. Therefore there was an overreaction on the part of the market about the need to raise interest rates and the expected path of future inflation, which now the market is conceding, may in fact start to moderate.

At the end of the quarter the implied inflation rate in the 2012

tips was 2.6% versus nearly 2.9% in late May early June. The Fed Funds expected rate is now expected to be nearer to 2% by the end of the year versus 2.5% that the bond market was expecting in mid June. So there is hawkishness on the part of bond investors right now and that is obviously bullish for the fixed income market and the Bond Funds, which had a very good month of July, so far.

Capital Link: What about the performance of the various fixed income fund categories?

Michael Porter: Taking a look at the quarterly results for the various fund categories in the fixed income category, for the quarter ending 6/30/2004 there are negative results for virtually every category except Loan Participation Funds, which were up very modestly.

Short term Investment Grade Debt Funds which basically broke even, but otherwise all the categories were in the red.

As we mentioned, most of these losses were incurred in April and despite the recovery in June, the funds could not get to the break even point, although they have done well subsequent to the quarter end.

Question: What about looking ahead?

Michael Porter: Looking ahead, we think that inflation may come in a little lower than what people expect. The implied inflation rate for the next 8 years looking at tips. Bonds is 2.66 of what was expected a year ago (1.7 or 2%). But even at 2.66 at the end of the quarter probably is still too high an estimate for the CPI for the remainder of this year. So, we expect that investors in shorter duration of funds should do fairly well and we would expect longer duration once they do well. Once we have another Fed Funds increase or two and would therefore be safe about the outlook for Fixed Income Funds.

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