



How Bad Was It? January 6, 2003

No serious-minded observer of financial markets can claim that 2002 was anything but a pretty terrible year. The litany is familiar enough – economic weakness, fear of war and terrorism (neither of which emerged in a big way during the year, despite disturbing undercurrents at home and too many incidents abroad), joblessness creeping past 6%, more high-profile corporate collapses, more indications of malfeasance both in the corporate sector and on Wall Street. It all added up to a nervous year.

In the end, the equity market was simply bad. The S&P 500 index finished the year with a total return of –22.1% for 2002, following on years of –11.9% in 2001 and –9.1% in 2000¹. The three-year loss comes to –37.6%, just over three-eighths of the value of the portfolio at the millennium. US investors didn't fare much better overseas. For 2002 the Morgan Stanley Capital International EAFE (Europe, Australasia, and the Far East) Net Dividend index returned –15.94% in dollars. It would have been worse if not for the weakening of the dollar during the year. In local currencies, the same index returned –26.07%. Germany was the worst major market; the MSCI Germany index returned –43.31% in Euros². As the dollar weakened over the course of the year from, for example, 131 yen to 119³, US investors found their foreign holdings declining less in dollar terms than in local currency terms. When the dollar weakens, foreign assets do better in dollar terms for the same reason that European vacations become more expensive.

Were there any bright spots in the investment world during 2002? Cash was safe, as usual, but produced low returns. Money market fund yields vary, but Treasury bills give an idea of the rates available on cash investments. Investors buying the 13-week Treasury bill at last auction of 2002 are earning an average yield of 1.17% (average discount, source Bureau of the Public Debt). The comparable figure for the last auction of 2001 was 1.69%, so investors

¹ *Wall Street Journal*, January 2, 2003

² Source for international equity returns: MSCI at www.msci.com

³ Yahoo! Finance

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holding cash for the year only earned modest returns. Adjusted for inflation, cash looked even more anemic. The Consumer Price Index rose by 2.2% for the year.⁴

Some investors point to precious metals as a bright spot for the year. The returns were surely good – gold returned +24.5% for the year (*Wall Street Journal*, 01/02/03). But while it may occasionally be reasonable to bet on gold in a highly active strategy, gold is a poor core holding, since it is a store, but not a producer, of value. In a way, it is like cash, only riskier.

The real winners among core investments in 2002 were bonds. The Salomon Smith Barney Broad Investment Grade Bond Index returned +10.09% for the year.⁵ US Treasuries were especially strong. The benchmark 10-year Treasury note started the year at a yield of 5.06%. At the end of the year, that yield stood at 3.82% (Yahoo! Finance). It's important to remember that bond prices rise when yields fall. The net result (*Wall Street Journal* 01/02/03) is that the 10-year Treasury returned +14.6% for the year: around 5% in income, and about 9-1/2% in price appreciation. The performance of Treasuries has two leading explanations. First, economic weakness has led to both low inflation and low demand for capital. Inflation is an important component of interest rates, and interest rates represent the price of a type of capital. The Federal Reserve has also been pursuing a policy that tends toward lower rates. The Fed kept their target for the Fed Funds rate, a key short-term rate, at 1.75% for most of the year, lowering it to 1.25% in November. Second, bonds may have had the benefit of upward price pressure simply because investors were seeking the safety of Treasuries in the face of the same uncertainties that undermined the equity markets. The 10-year Treasury yield stands near its lowest levels in recent history.

In general, other types of bonds did reasonably well, but not so well as Treasuries. Most corporate bonds participated in the general drop in yields along with Treasuries, but those with weaker credit ratings generally lost ground relative to Treasuries because the market perceived declining credit quality. Bonds backed by consumer mortgages, although considered strong credits, did not participate fully in the price appreciation of Treasuries because when interest rates fell, many homeowners refinanced their mortgages. For holders of those mortgages and bonds backed by them, this meant that they received their principal back early, and the yields available to them on reinvestment fell with the interest consumers paid. Municipal bonds vary greatly, but the fiscal condition of many state and local governments (notably in California) deteriorated during the year, so credit concerns have also begun to affect the pricing of munis.

⁴ 12 months to 11/30/02. Source: Bureau of Labor Statistics web site

⁵ Source: Salomon Smith Barney

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In the end, most bonds did well during 2002 due to the persistence of low inflation, Fed policy that kept short-term interest rates low, and subdued economic activity. That Treasuries did especially well seems directly related to the difficulties in the equity market. When investors perceive high levels of uncertainty and are suffering losses in risky assets, they often look for safety. The perceived safety of US Treasury instruments makes them an attractive destination for those “flight to quality” cash flows. Some will argue that precious metals offer the same sort of haven in difficult times, but gold and other metals only store value, they do not produce it. Investors making permanent allocations with a view toward portfolio growth should emphasize assets that truly represent capital investments in economic growth. That really means stocks and bonds.

We have written in the past in these notes about the importance of asset allocation. An investor wishing to position a portfolio for growth, and yet keep risk at a manageable level, should think carefully about the proper mix of stocks, bonds, and other investments. Investors with heavy allocations to equities generally did poorly in 2002. Those with more balanced mixes of stocks and bonds generally did better – and of those, the ones that implemented their bond allocations largely in Treasuries also enjoyed the benefits of a general market flight to quality, which gave those securities an extra boost relative to many other bonds. But investors should always remember that past performance does not indicate future results. It would be extraordinary if in 2003 Treasuries repeated their performance of 2002. Just the same, they remain an important choice for many investors, particularly because they often show the greatest strength just when riskier assets are at their weakest.

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Sources for data indicated in footnotes and text
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