



# All Star Quarterly

Second Quarter 2005

Volume 9 Issue 2

## 2<sup>nd</sup> Quarter Review & Preview

### Is Another Year-End Rally In Sight?

#### Overview

Is 2005 turning into a repeat scenario of 2004? Time will tell, but at this moment, the hope is that the stock market will enjoy a second half rally, much as it did after a relatively flat start in the first half of 2004.

The second quarter proved to be a mixed bag for investors. The broad stock market began the quarter with some weakness, driven in large part by the continued upswing in oil prices. The market managed to overcome fears about the oil market and some disappointments in corporate earnings, and enjoy a modest gain that held by quarter's end.

Through all of this, the economy maintained a reasonable level of strength. While inflation did not become a big concern (despite the trend of higher oil prices), the Federal Reserve continued to raise short-term interest rates. Surprisingly, this did not take a toll on the bond market, where interest rates on longer-term debt securities moved lower during the quarter.

So will the second half provide investors with the kind of news that will spur an upswing in the stock market, much as happened in 2004? Among the factors we'll be closely watching are:

- Will oil prices continue to move higher, creating a strain on the economy?

- After slowing in the first half of the year, will corporate profits recover?
- Will the red-hot housing market cool off, and if so, will that take a toll on the overall direction of the economy?

We expect generally positive answers to these questions in the months ahead, which could lead to another happy ending for investors in 2005.

#### Economy

##### *\*The 2<sup>nd</sup> Quarter\**

Considering that the price of a barrel of oil today is about 50% higher than a year ago, it is amazing that the U.S. economy is growing as fast as it is. In fact, the government's final report of first-quarter growth was actually revised upward, from 3.5% to 3.8%. That was a clear indication that the negative trend of rising oil prices is not creating major economic problems.

Another important piece of evidence that the economy is on the right track is that job growth seems to have gained a firm footing. More than 500,000 jobs were created in the 2<sup>nd</sup> quarter, and the unemployment rate drifted very close to the 5% level (ending at 5.1% in June).

This news seemed to be all the encouragement that Alan Greenspan and the Federal Reserve needed to continue their strategy of raising short-term interest rates to help keep any inflation threat in check. The Fed bumped rates twice during the quarter. In total, the Fed has hiked rates nine times in the current money-tightening cycle. Typically, such Fed action should lead to higher interest rates on longer-term bonds, but that hasn't happened.

Mortgage rates remain quite low by historical standards, and that has helped the housing market's run to continue. Businesses spending also has risen (by 6.6%) and consumer spending has stabilized, but is still growing at better than a 3% rate.

#### Bob's Corner

##### THANK YOU, PAT!

With a sad heart, and a sincere wish for the best, I would like to say "thank you" to Pat Gibbs for her loyal service and the very important role she has played on the All Star team. Pat and her husband, Charles, are moving to Arizona to escape the Minnesota winters. Plans are to be down there sometime between September and November, so in case she departs early, we wanted you to know that we are already looking for 3 people to replace her (seriously, though, if you know of anyone who would do well as our Office Manager, let us know), and we will miss her tremendously. Thank you, Pat, for making all of our days more enjoyable! To your continued success in Arizona – CHEERS! (I hope your new house is big enough for all of us suffering from the winter blues ☺)

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THANK YOU FOR YOUR BUSINESS!

**\*Looking Ahead\***

We anticipate that the economy will continue its modest but steady rate of growth through the end of the year. A survey of economists by *The Wall Street Journal* calls for growth in the 3.25% to 3.5% range into next year. Given that level of growth, inflation does not appear to present any significant risks, and forecasts call for inflation to stay around the 3.0% range. The unemployment rate could show subtle improvement, but will probably settle in at around the 5.0% range, close to where it is today.

What's less clear is what will happen to oil prices - the 800-pound gorilla in our economic house. Global demand has been on the rise, and some believe this is an irreversible trend, particularly given the growth of economies in nations like China and India. Some forecasters anticipate that oil prices could reach the \$100/barrel level in the near future - a price that is likely to have a significant impact on our economy. But others are not convinced. They believe that oil prices can't be sustained at current levels, and could actually drop below the \$50/barrel level over the coming months. Certainly this is a variable that could have a major impact on the economy as we prepare for the months ahead.

Healthcare and biotechnology stocks benefited from the increasing demands of an aging population, and enjoyed a surge late in the quarter as well. A number of companies in these sectors reported solid profits and exceeded expectations of the investment community.

Growth stocks, which have been lagging value stocks for most of the current decade, showed signs of life again for the 2<sup>nd</sup> quarter in a row. The Russell 3000 Growth Index gained 2.55%, compared to a 1.96% jump for the Russell 3000 Value Index. However, this trend did not carry across the board. Value stocks outperformed growth in the small- and mid-cap sectors, while growth stocks dominated the large-cap market.

Small-cap and mid-cap stocks (up 4.32% and 4.18% respectively, based on the Russell Indexes) outpaced large-cap stocks (up 2.05%) for the three-month period. This small-mid cap out-performance could be short-lived - valuations and manager outlooks favor large caps going forward.

**\*Looking Ahead\***

Over the past three 12-month periods, corporate earnings have enjoyed an annualized average of double-digit gains. It seems unlikely that such a record can be sustained given the modest level of growth in the U.S. economy. Most likely, these gains have been driven by the combination of pent-up demand for products and services following the sustained correction in the markets that marked the early years of the decade, and unprecedented fiscal and monetary stimulus.

Still, we remain optimistic that returns in the 8.0% range or higher can be achieved in the years ahead. Standard & Poor's estimates that final corporate earnings growth will reach 11% in 2005 - a respectable level that should lead to a positive return for the stock market by year's end. Corporate earnings will be closely watched in the months ahead, but one reason for optimism is that tax incentives led many companies to accelerate capital spending into 2004 rather than saving it for 2005. That could leave more profits in place this year, helping to keep earnings moving in the right direction.

**Performance Update**

**U.S. Stock Markets**

**\*The 2<sup>nd</sup> Quarter\***

U.S. stocks (as measured by the Russell 3000 Index) returned 2.24% in the 2<sup>nd</sup> quarter. One driver of positive performance was Real Estate Investment Trusts (REITs), which benefited from the continued bull market in real estate. Utility and energy stocks also enjoyed strong gains - beneficiaries of the continued upsurge in oil prices. Utility stocks continued to draw interest as their high dividend yields looked more attractive than the alternative of low bond yields for income investors. Energy stocks were given a late lift due to a surprise bidding war for Unocal by Chevron and a Chinese oil company.

| Market Index        | 2 <sup>nd</sup> Qtr | 1-Year      | 2-Year       | 3-Year      |
|---------------------|---------------------|-------------|--------------|-------------|
| DJ Ind. Average     | -1.85               | 0.86        | 9.43         | 5.99        |
| S&P 500             | 1.37                | 6.24        | 12.48        | 8.28        |
| Russell 2000        | 4.00                | 8.14        | 19.41        | 11.39       |
| S&P Mid-Cap 400     | 4.26                | 14.03       | 20.77        | 13.15       |
| <b>Russell 3000</b> | <b>2.24</b>         | <b>8.05</b> | <b>14.07</b> | <b>9.45</b> |
| MSCI EAFE           | -1.46               | 10.75       | 19.49        | 10.67       |
| NASDAQ Comp.        | 2.89                | 0.45        | 12.57        | 12.01       |
| Lehman High-Yield   | 2.76                | 10.86       | 10.58        | 14.49       |
| Lehman Agg. Bond    | 3.01                | 6.80        | 3.51         | 5.75        |
| Lehman Credit Idx.  | 3.58                | 8.15        | 4.03         | 7.74        |
| Lehman Gov. Bond    | 3.36                | 6.65        | 2.56         | 5.40        |

Within the equity markets, many analysts anticipate that growth stocks are poised to enjoy the upper hand in the coming months. This would be a shift from the trend that has existed for most of the 2000s. In the current market, growth stocks generally appear to be more attractively priced than their value counterparts.

Some sectors of the stock market could be in for a cooling off. Dividends of utility stocks are not as attractive as they were in recent years and valuations are above historical averages. REITS have also enjoyed an extended period of positive performance, but that could be in jeopardy if the fizzle goes out of the real estate market.

## **Bond Markets**

### ***\*The 2<sup>nd</sup> Quarter\****

Economists and market-watchers continue to anticipate that long-term interest rates will settle in at higher levels. With the Federal Reserve determined to keep raising short-term rates, long-term rates were expected to follow suit in the 2<sup>nd</sup> quarter. But once again, the experts were confounded as rates on 10-year bonds dropped more than 50 basis points (from 4.49% to 3.92%) over the three-month period.

Long-term bonds generated some of the best returns of the period (+5.2%). The top performers in the fixed-income market were emerging market bonds (+7.4%). This occurred even with the dollar enjoying a solid rebound against major currencies. Many global bond funds lost ground, having to swim uphill against a stronger dollar. Intermediate and ultra-short bonds were also strong categories during the quarter.

The biggest news in the corporate bond market centered on the credit downgrade of two corporate bond giants, Ford and General Motors. Both saw their debt rating reduced to "junk" status. This played havoc with the high-yield bond market, though the junk bond mutual fund sector still managed to stay in positive territory

(+1.8%), while the Merrill Lynch High Yield Master Index lost ground (-2.1%).

### ***\*Looking Ahead\****

It seems the best way to predict the bond market in recent years is to look at the "expert" forecasts and then invest in the *opposite* direction. The current consensus view is that interest rates will continue to rise, pushing the 10-year yield to 4.5% at year-end. Will the experts be wrong again? Time will tell, but time is probably on the side of those who expect rates to rise.

There is good reason to expect that the Federal Reserve will give short-term interest rates at least one or two more bumps in the months ahead. If the U.S. economy continues to grow at a reasonable level, yields on longer-term bonds can be expected to move higher and probably stay there for at least the near term.

We still prefer ultra-short bonds for their high quality, rising yield, and limited price risk. High quality corporate bonds and emerging market bonds look attractive as well. High yield bonds may offer less potential, as credit spreads are at historically low levels (that's the difference in yield between high-grade and low-grade bonds). Lower inflation may also limit the appeal of inflation-protected (TIPS) bonds.

## **International Markets**

### ***\*The 2<sup>nd</sup> Quarter\****

International stocks were a mixed bag during the 2<sup>nd</sup> quarter. The average global stock fund gained 1.7%, but the place to be was emerging markets,

which were up 5.07%. Latin American stocks led the way, rising 11.4%.

European (-0.31%) and Japanese (-1.37%) stocks suffered small declines for the period. Small and mid-cap stocks once again showed positive returns (+2.5%) in all geographic regions. Large cap foreign stock funds lost 1.0% on average. The dollar's surprising recovery against the euro and yen had a negative impact on the return of global funds.

### ***\*Looking Ahead\****

Several major political events have raised questions about the direction of foreign markets. Voters in France and the Netherlands rejected the European Constitution, raising doubts about the future of a unified European economic bloc. Also, China announced its intention to de-link its currency from the dollar, which may help head off talk of more protectionist policies by the U.S. It also could cause currencies in the Asian bloc to appreciate.

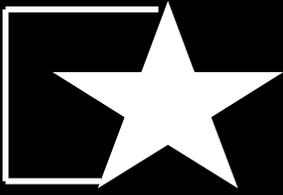
Latin America's days as the top performer among emerging markets could be numbered. We anticipate that improved liquidity and higher corporate governance standards could give India's market an edge in the coming months.

Growth in Europe and Japan is likely to be slow for the rest of 2005, but good values can still be found among selected blue chip stocks in these regions.

## **Summary**

While the direction of the economy is not clear, due primarily to concerns about the future of oil prices, most general trends are positive. Many mutual fund managers seem confident that the months ahead will be favorable for investors, and growth fund managers seem particularly optimistic. If oil prices fade as an issue, stocks could be in for a solid year-end rally, while bonds may face a more challenging environment.

If corporate profits continue to perform better than expected, investors could be pleasantly surprised!



## Hedge Funds 101

### What are hedge funds?

Hedge funds are pooled investment vehicles, similar to mutual funds, but with several important differences. First, they are unregulated and do not offer investors the same protections offered in registered investment vehicles. Hedge funds are able to avoid regulation by limiting the number of investors and selling only to accredited investors. Second, they are aggressively managed in order to achieve a high rate of absolute return. These aggressive tactics may include short-selling, leverage, derivatives, and investing in highly illiquid investments. Finally, they typically aim to achieve a high level of absolute return, as opposed to most fund managers who seek to outperform the market as a whole. The quest for positive absolute returns, regardless of market conditions, is what makes hedge funds more popular in bear markets.

### Who invests in hedge funds?

Hedge funds traditionally have been used by the super-rich, endowments, foundations, and other institutional investors. They have increased in popularity as more mainstream investors and institutions have used them in an attempt to boost returns or reduce risk. Still, most funds require a minimum \$1 million in net worth and an annual income of at least \$200,000. Most investors end up buying a fund of hedge funds, which adds another layer of fees to the investment.

### Who regulates hedge funds?

No one, although the Securities and Exchange Commission (SEC) is currently pushing for a new rule that would require hedge funds to register with the SEC beginning next year. Ironically, it seems that regulators are tightening regulations after investment inflows to hedge funds have already peaked (2002).

### How have they performed?

Like any investment, their performance is linked to their underlying investments and the skill of the manager. In addition, most hedge funds charge a 20% performance fee on top of typical management fees of 2-4%. For all of these fees, the average hedge fund investor earned a mere +0.30% this year through May 31, 2005, according to the CSFB/Tremont Hedge Fund Index.

CSFB/Tremont also found that a passive S&P 500 Index outperformed every major hedge fund strategy by a whopping 6% annually during the 1994-2000 periods. An earlier study by Yale/Stern NYU economists found that the average return of offshore funds was 13.6% during 1989-1995, while the S&P 500 Index return was 16.5%. Clearly, investors are not getting a lot of bang for the buck.

### Do I need a hedge fund?

Probably not. The London Business School thinks “no”. “Hedge funds are not a retail product. The costs and risks to the average investor are higher than the probable returns.” A NASD Investor Alert urges investors to carefully consider the risks in hedge funds:

- 1) **Unregulated Investments** - normal investor protections are lacking
- 2) **Risky Investment Strategies** - the high potential for gain carries a high risk of capital loss
- 3) **Lacks of Liquidity** - most hedge funds have lock up periods and withdrawal windows which limit the ability of the investor to withdraw funds.
- 4) **Adverse Tax Consequences** - many are run as partnerships and the tax consequences can be complex. Delays in receiving tax information are common.