Market Review and Outlook—January 10, 2005

After going nowhere for nine months, **stocks managed a fine final act.** US stocks rose 10% and non-US stocks rose 14% during the fourth quarter. Bonds were steady, rising 1%.

The year-end surge appeared to be due to the **release of the pressure from uncertainty**, uncertainty that diminished in the closing months. While conditions in Iraq did not improve, the US presidential election was resolved, and oil prices stopped their climb (and actually receded). Economists strengthened their call for a further recovery in 2005. These 'positives' fed on each other, and the markets rose very strongly from late October on.

After losing ground in the first nine months, **growth and tech stock funds were red hot**, rising more than 15%. While growth funds outperformed value in the last quarter, for the whole year value led growth.

For the year, both natural resource and real estate funds rose more than 30%, while gold fell 8%.

International stock funds extended their rebound which had begun a few months earlier, and ended the year outperforming most US stocks.

Bonds had a mixed year, falling badly in April, and falling a bit in May and in November. They rose during the other nine months, and ended up 4 to 5%. As the US economy's recover began to take hold, high yield bonds rose sharply, 10%. As the dollar weakened, investors warmed to global bonds, a sector that rose almost 10%.

The recovery from the lows of late 2002 resumed, as stocks posted their second consecutive winning year. Bonds managed to make money for the fifth straight year, however this streak is in jeopardy.

Best Approach
It is a common refrain, however I want to again point out the value of setting targets, and regularly rebalancing. In 2004 some stock funds rose 20% or more. Real estate not only rose strongly, but has a very long record of above market results. Paring back winners, especially when you have more of them than your targets, makes great sense to me at this time.

Category	4th Q '04	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Money Market—Taxable	+0.29%	+0.75%	+0.87%	+2.37%	+3.70%
Intermediate Term Bond	+0.98%	+3.83%	+5.52%	+6.90%	+6.89%
Intermediate Muni Bond	+0.59%	+2.36%	+4.81%	+5.54%	5.44%
Large-Cap Core Stock	+8.86%	+7.79%	+1.28%	-3.45%	+9.98%
Mid-Cap Core	+11.93%	+15.52%	+8.97%	+6.28%	+13.18%
Small-Cap Core	+13.02%	+18.38%	+11.85%	+10.33%	+12.96%
Int'l Stock (Large-Cap)	+14.17%	+18.05%	+10.24%	-2.01%	+6.44%
Real Estate	+15.81%	+32.03%	+23.60%	+21.41%	+14.87%
Natural Resources	+6.78%	+30.16%	+16.97%	+14.26%	+13.77%
Science/Technology	+15.90%	+5.60%	-2.57%	-16.31%	+9.64%
Multi-Cap Growth	+12.06%	+10.71%	+1.90%	-7.51%	+10.42%
Multi-Cap Value	+9.97%	+14.39%	+6.87%	+5.36%	+11.86%
Balanced	+6.44%	+7.93%	+4.32%	+2.01%	+9.09%

How Did We Do—How Will We Do?

I wanted to take the opportunity to see how accurate our expectations turned out in 2004, and then to share our expectations for 2005 (expanding on the recent newsletter article). On January 12, 2003, the MARKET REVIEW suggested that 1) real estate should slow down and lag other markets, 2) large-cap stocks should beat smaller-cap stocks, 3) value and growth investing should stay close, 4) foreign stocks should offer compelling returns, 5) we are likely to take a few more steps forward than backward in 2004, 6) bonds will do not much more than earn their yields, and 7) high-yield and non-US bonds should excel.

Sector	2004 Prediction	2004 Actual	2005 Prediction
Large-Cap US Stocks	Catch up to small-caps	Up 7.8%	Up 4 to 6%
Smaller US Stocks	See above	Up 16.5%	Up 6 to 8%
Non-US Stocks	Compelling Returns	Up 18.05%	Up 6 to 8%
Growth vs Value	Horserace	Value up 14%, Growth 11%	Horserace
Real Estate	Expect them to lag	Up 32.0%	Flat at best
General bonds	Expect yields only	Up 3.8%	Up 0 to 4%
High yield bonds	Better than general	Up 9.9%	Up 4 to 6%
Non-US bonds	Better than general	Up 9.8%	Up 4 to 6%

I was wrong on the first and second points, fair on the third guess, but fairly accurate on the last four. Real estate had another strong year, returning over 15%, more than the average multi-cap core stock fund (up 11%). Large-caps (up 7.8% did not outperform small-caps). However, growth and value jockeyed each quarter, ending the year with growth up 11% and value up 14%. Foreign stocks beat US stocks, 18% to 11%. Overall, both stocks and bonds made money in 2004. Standard bonds rose 4%, about their interest yield. However, both high-yield and non-US ('world income') bond funds both rose 10%.

In 2005 I expect large-cap stocks to come closer (than in 2004) to matching the returns from smaller stocks. The falling dollar should help larger companies, which export more than smaller companies, sell more goods and services. Further, large company stock prices have not risen as sharply as smaller firms; this means that large companies have more potential for price rises due to 'PE expansion' than do small companies. This, of course, is balanced by the likelihood of investors directing more dollars into small cap and mid-cap stock funds, those that rose sharply in 2004. There is a real risk of real estate falling in 2005, due to their tremendous recent results, and due to rising bond yields.

I expect foreign stocks to outperform US stocks. While they had a strong 2003 and 2004, foreign stocks are still under water for the past five years, and I am not too concerned about them being grossly overvalued. Their strong 2003 and 2004 will likely attract new money from investors.

I expect general bonds to return less than 4%. I expect intermediate– and long-term interest rates to rise 1% this year, bringing bond prices down. If bond investors are lucky, the price declines will be matched by interest income. If foreign governments fail to continue their relentless purchase of US Treasuries, and/or should the US government continue its relentless deficit spending, US Treasuries in particular could be hit in 2005. As I expect the US economy to grow in 2005, I expect that high-yield bonds will do fine. I expect the US dollar to weaken, and for global economies to grow; together these expectations lead me to believe that global bonds will have a good year.