
Investor's HOTLINE

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Exclusive sound-wealth wisdom from the world's leading financial experts

IH0503

March 2005



Forenotes from JOE BRADLEY

March Guests

1. **Sol Waksman**, president of The Barclay Group, the premiere resource on the performance of hedge fund and managed futures managers, explains how he selects managers for his own portfolio.
2. **Harry Dent**, the author-demographer who has accurately traced the impact of the baby-boom generation, gives his outlook for the economy and the markets for the rest of the decade and beyond.
3. Release date is Friday, 2/18/05.

IH Guest Selection

1. In considering money managers, Joe Bradley gets referrals from members and other guests but also checks out potential guests' track records and ability to control risk by referencing reliable databases.
2. Two of Joe's primary database sources are Morningstar for traditional managers—primarily those who manage mutual funds—and Barclay for alternative managers such as hedge funds and managed futures.
3. Joe purposely includes both traditional and alternative investment managers on IH because he keeps portfolio diversification—for himself as well as members—in mind when choosing guests.
4. Joe personally and his family have money invested with many of the managers interviewed; any of them might also be suitable for balancing out

portfolios of members who are looking for diversification.

5. Beyond money managers, IH guests may be technical analysts, economists and other financial authorities; the basis for their inclusion is that they have something meaningful to say that will challenge the thinking of members and enhance their investment intelligence—both guests this month fit the “investment intelligence” category.
6. IH has periodically featured representatives from key resources, including Morningstar and another alternative asset database, *Managed Account Reports*; this month, Joe rightfully adds The Barclay Group to the distinguished IH roster.
7. The Barclay databases, covering 734 managed futures managers and 3,495 hedge funds, contain detailed stats useful for evaluation; members who are investment professionals or with large personal portfolios may want to consider using the databases directly.

Investing in Consumer Debt—An Update

1. About a year ago, IH featured a full interview with Peter Bennett [IH0402] on an opportunity in this unusual investment sector and followed with a special briefing in August [IH0408].
2. Bennett conservatively estimated that investors would earn 19% in his Charged-Off Debt Fund, but in fact, performance has been better than 25%.
3. Bennett has announced a new offering with a deadline of March 15, 2005; the minimum investment is \$250,000.
4. Interested members may contact Peter Bennett at Applied Income Sciences, LLC by phone at 415-561-1507 or by email at info@incomesciences.com.

For membership information visit: www.investorshotline.com

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Screening Criteria for Hedge Funds and Managed Futures

1. Both categories are good investment vehicles; futures advisors trade more liquid markets with greater transparency; their performance tends to be more volatile than hedge funds.
2. For Waksman, the most important factor in considering a manager is how much the manager has lost in his worst period—even if it is a long way back; if the answer is a level beyond an investor's tolerance, the investor is vulnerable to redeeming at the worst time.
3. Investors are most likely to look at returns as an evaluation criterion, but returns are the worst predictor of future performance; the two predictors that hold up over time are volatility and cross-correlations with other managers.
4. The best benchmarks for determining the degree of correlation with traditional assets are the standard indexes for the various asset classes—e.g.,

the S&P 500 index for US stocks; the Barclay statistics also allow comparisons within hedge fund/managed futures areas.

5. Waksman personally prefers to look at a manager's performance history for three years or longer; however, he concedes that some research shows that greater returns come from investing with newer managers—but doing that also involves greater risk.
6. Unless you are willing to do the additional due diligence involved in putting money with a newer manager, go with established managers.

Cautions about Manager Success

1. That the interest level and success of managers tends to wane after five years or upon their reaching \$5 billion is a debatable opinion, but Waksman advises that investors maintain a relationship with their managers and be attuned to warning signals.
2. Investors may feel pressure to invest before a manager raises minimums or closes a fund—which does happen as managers achieve success; however, investors should never make an investment decision under pressure.
3. The amounts of money at stake are large, and investors should take their time to evaluate; with a universe of over 4,000 managed futures and hedge fund programs, there will always be another opportunity.

Personal Contact

1. Investors should visit or at least talk to a prospective manager personally;

people who rely solely on numbers are making a mistake because what the manager is doing should be understood at a deeper level.

2. Find out and get comfortable with how the manager manages the risk of his positions; find out about the internal controls such as the contingency for emergency replacement of the manager; explore why the manager has been able to make money.

Risk Factors

1. Beyond knowing the maximum drawdown, an investor needs to understand a manager's strategy as well as the instruments the manager is trading.

2. For example, buying micro-cap stocks from the long side is much easier to do than selling them; the possibility of not being able to exit quickly is a risk, but it wouldn't show up in performance history during an uptrend.

3. For investors who do not have enough money to invest in both hedge funds and futures, the best option is to invest in a fund-of-funds that includes both; each class plays an important part in a portfolio.

4. Barclay's research shows that when managers are ranked by downside deviation, upside deviation and Sharpe ratio, all three rankings generate the same rank order—the manager with the lowest downside deviation will also have the best Sharpe ratio; in your own evaluations, use whichever volatility measure you are most comfortable with.

5. Each investor has to determine personally how much risk is tolerable in relation to potential returns; some managers with good track records and very high upside may have a drawdown of 20% in contrast to less volatile managers with much lower performance.

6. Investors should translate percentage drawdowns to real numbers based on their investment amount and ask themselves if they can tolerate such a dollar loss without redeeming; if not, the manager, is a poor choice.

7. Diversification among managers is prudent; investors who use only one or two managed futures or hedge funds should consider multi-advisor funds.

Realistic Objectives

1. Waksman thinks that a return in high single-digits from a portfolio of hedge funds and managed futures is a realistic target over the next 2–3 years.

2. Objectives change with time; conservatively expect 2–3 times the rate of risk-free return; today's risk-free rate of return is 2%.

3. Despite modest upside targets, higher fees and a potentially higher tax burden than traditional investments, hedge funds and managed futures by comparison are an intelligent diversification; the stock market still has not recovered to its previous highs four years ago.

4. Be cautious about investments that are high-performing (e.g., 15%–20%); consider them, but understand the risks that are being taken to achieve an outsized rate of return.

5. The performance of hedge funds in general has moderated in the last few years, and higher returns will be harder to achieve going forward because so many people have awakened to the protective value of these asset classes.

Non-Traditional Strategies

1. Most hedge funds employ arbitrage strategies—profiting from the discrepancy in price between similar securities; as more money comes into these types of strategies, the differences are arbitrated away, resulting in lower rates of returns.

2. However, other strategies are directional and do not depend on inefficiencies; over the long term, they can provide higher rates of return, although with corresponding higher volatility.

3. Global macro, managed futures and emerging markets are all promising strategies.

4. Emerging markets can be quite volatile, but P/E ratios and other traditional measures indicate that the stock markets of emerging economies are cheap relative to developed markets.

Practical Investment Points

1. In the short-term, coming in during a drawdown may take some volatility away, but the time of entry does not matter with a long-term approach.

2. Based on efficient-frontier studies, 10%–20% is a reasonable allocation for hedge funds and managed futures; personal knowledge and comfort are important—Waksman commits 100%, but does not recommend that.

3. Hedge funds require more due diligence than managed futures because they are less transparent, their instruments are not as liquid, and the strategies are more complex.

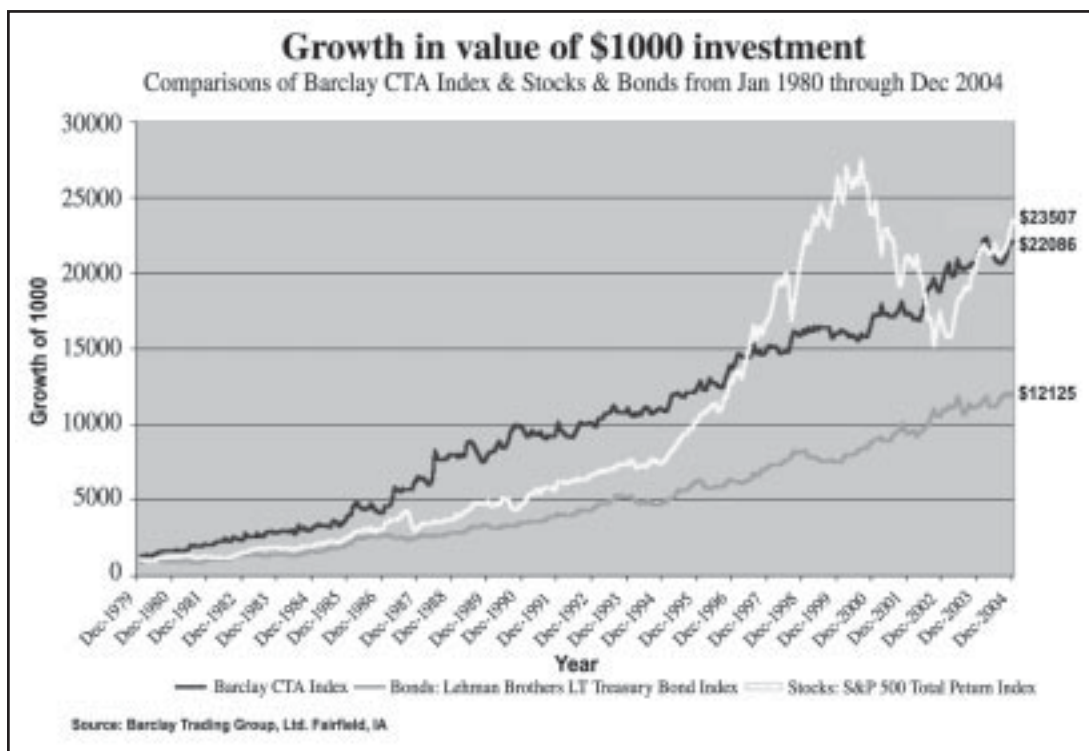
4. Managed futures advisors are for the most part trend-followers trading exchange-traded instruments that are marked to market daily.

5. Waksman prefers a manager to have tenure of at least three years.

Mutual Fund Risk

1. Waksman does not see a compelling argument for long-only being a better strategy than long-and-short; there have been decades-long periods when stocks lost money.

2. Markets have not changed their nature; Nasdaq investors who lost in technology mutual funds are nowhere near close to where they were in 1999.



Off-Shore Funds

1. Off-shore funds have less regulatory oversight and offer investors less security if something goes wrong; not being constrained to a limited number of investors, they tend to be more open to waiving stated minimums.
2. US investors must use money not subject to taxation for investing in off-shore funds.

Reliability of Statistics

1. Make sure a fund you are considering has been audited and ask to see those results; failure of a fund to be audited is a red flag.
2. Protect yourself against crises by diversifying; if you invest in enough funds, sooner or later, you will hit a land mine, but if it represents a very small portion of your portfolio, you will not get hurt.

Bad Press

1. Waksman notes that *Forbes*, source of scathing articles on the hedge fund industry, equates to *The Inquirer* of financial reporting; Waksman has not

found the magazine credible on hedge-fund topics.

2. Bad news sells newspapers, so reporters jump on a story with negative potential; fraud has occurred with some hedge funds, but it occurs in every aspect of business.

Exit Points

1. Decide where you will exit before you make an investment so that you can think through your parameters objectively—once you are in, you are no longer objective.
2. If you have set 20% as the maximum drawdown you can tolerate and a manager reaches that level, then pull out.

Summary Advice

1. If it looks too good to be true, it probably is; diversify your portfolio; do not make investment decisions under pressure.
2. Allow a couple of months for the manager-selection process; meet with the manager at least once; a second meeting (or a phone call) to clarify information or to ask things forgotten the first time is advisable.

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The Next Great Bubble Boom

1. This book is an extension of Dent's examination of the demographic boom driven by the aging of the baby boomers; their spending boom that started in the early 1980s will continue until about the end of the current decade.
2. The book also considers how technology cycles bring productivity and new growth industries; the pattern is an initial growth boom followed by a strong shakeout and a second strong boom before the tech cycle peaks out.
3. The second strong tech boom is about to occur; expect it to be accompanied by another stock market bubble led by tech stocks.

The Tech Cycle Push

1. New technologies move in an S-curve; once they go through the difficult trial period to reach 10% of the population, they move rapidly to 90%—that burst started in 1994 for the Internet and cellular phones.
2. When the correction began, the technologies had reached about 50% of households, predictably where the shakeout begins; now the second-stage move to 90% is beginning during which Internet, broadband and wireless connections will expand to more households.
3. The combination of another tech leg up and continuing baby-boom spending is likely to make the next five years the best in stock market history—at least rivaling 1925–29 and 1995–99.

4. Government stats are showing a delay in boomers cashing in—between ages 46–50 instead of 45–49, plus the tech S-curve projections on key technologies have also been lengthened about a year; therefore, Dent's current expectation for a top in the market is between late 2009 and early 2010, instead of 2008.

Leadership in the Tech Area

1. The move in technology stocks should be broad, but new leadership has been emerging after the last shakeout.
2. Surviving Internet companies such as eBay and Google are doing very well and leading again; networking technologies will build on their success, and broadband is coming into its own.
3. Broadband is moving twice as fast on its S-curve as the Internet—it will go from 10% to 90% of the population from about 2001 to 2009; biotech is starting to come into more commercial practicality; semiconductors will be strong, though presently lagging.

Protective Advice

1. Avoid going strictly by emotion; get an historical perspective because the tech cycle is counterintuitive; pay attention to the fundamentals.
2. Dent suggests that investors familiarize themselves with history (first two chapters of his book)—a strong growth bubble leads to businesses overshooting and a shakeout followed by a second bubble.
3. Going on instinct, investors are likely to be overly cautious about investing in the next bubble; by waiting too long to get in, they increase risk of getting hit at the top—the next bubble will be steeper and break even faster.

Dent's Market Forecasts

1. Expecting the strong surge in 2003, Dent gave his strongest buy signal in 15 years in October 2002; he also correctly anticipated a sideways market in 2004; now he thinks the market will take off in 2005.

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2. In the second half of 2005, new highs will convince people of a new bull market, but they will have missed a big surge up—early 2005 is the last chance to enter the markets at reasonable valuations.

3. His rough targets remain high—35,000–40,000 for the Dow and 13,000 for the Nasdaq; returns after this correction will be extraordinary.

4. The bubble boom is creating higher average returns than ever before (15% per year since the early 1980s), but the swings up and down have become stronger—corrections are now 40%+ compared to an historical 20%.

The Decennial Cycle

1. The decennial cycle should be more powerful than demographics in 2005; in most decades (eight out of ten in the last century), the markets tend to be weak in the first 2–3 years; the 2000s began with this same weak pattern.

2. A prudent investment model is to be defensive in the first 2 1/2 years of a decade (e.g., being in bonds) and get back into the stock market mid to late in the second year, after which most of the returns for the decade are made.

3. The second half of a decade is almost always stronger than the first half; the fifth year has been the strongest year on average and has never been down over the last hundred years.

Demographic Shifts at the End of the Decade

1. A major reason for the economy being strong through the 1980s, 1990s and 2000s is the boomers' move up the strong spending and productivity cycle; people earn and spend more money up to age 46–50 and then spend less the rest of their lives.

2. After 2009–2010, with the boomers moving down the spending cycle, demand will decline, and the economy will slow; slow GDP and earnings will negatively impact a stock market that will be overvalued by that time.

3. Retirement among boomers will increase as they near ages 63–64; that change will slow workforce growth, which correlates with inflation rates, so inflation during the boom should be more modest than generally predicted.

4. The downturn in the economy and wider retirement will trigger a deflationary trend—bad for everything from housing to most equity investments.

Impact of the US\$

1. The US\$ being low now is a stimulus to US growth, but currencies actually correlate very little with the economy and the US stock market—the US\$ has had both high and low extremes during the boom.

2. The US\$ went down in response to Fed stimulation and lowered interest rates and is staying down because the US is growing faster than Europe and other US trading partners.

3. When tech industries come back strong by mid-2005, the low US\$ will boost their exports, but the US\$ will correct as the economy strengthens.

4. A low US\$ was a condition preceding the unprecedented stock run, strong economy and high productivity of the late 1990s; contrary opinion calls for a strong rally in the dollar and stocks; if it has not already bottomed, the US\$ should bottom within six months.

Inflation vs. Deflation

1. The chance that accelerating interest rates and an unresponsive economy like the mid-1970s will reemerge is low; that period was inflationary due to high numbers of unproductive baby boomers being absorbed into the work force; since 1980 the environment has been disinflationary.

2. Low inflation (2%–3%) will continue through this decade and then flip into a deflationary cycle from 2010 to about 2022; deflation is the most deadly cycle, worse than inflation.

Sector Outlook

1. Technology (Internet, networking and biotech) in general and semicon-

ductors as a particular area should lead; health care has probably bottomed under pressure from drug issues and should turn around.

2. Financial services also looks promising, though that sector may be up-and-down a bit with erratic interest rates; Asia (Korea and Taiwan) continues to be attractive despite some of its problems.

3. Dent utilizes mutual funds and index funds to implement a sector-focused strategy; rather than buying individual stocks, he prefers ETFs because they can target specific sectors.

4. Expect the Nasdaq to perform the best (35%–40% annual average returns with highest volatility), followed by the S&P 500 and the Dow (20%–24%).

A Growth Allocation Model

1. An aggressive growth investor might have 35%–40% in technology, 20% in financial services, 15% in health care, 10% in biotech, 10%–15% in Asia (ex Japan).

2. To bring down risk, a conservative investor could add bonds and sectors such as multi-national and Dow stocks; small cap value is also a good diversifier.

3. Dent thinks both small-cap and large-cap growth companies will do well, but the large-caps are easier to identify and tend to be less volatile.

A Turn in Real Estate

1. Most people buy their biggest house in their late 30s–early 40s; the boomers have recently peaked in trade-up home buying; interest rates (mortgage rates) have flattened and are not likely to go much higher or lower, so they are no longer a continuing impetus.

2. Real estate will slow and maybe flatten or even decline somewhat in the next few years (especially urban and suburban areas)—but not crash; after 2010, housing is likely to take a major decline with the high-end markets in overvalued areas being most vulnerable.

3. Vacation, resort and ex-urban areas (the outskirts of the suburbs) remain attractive; the migration areas of the Southeast (best valuations) and Southwest look like the strongest geographical regions.

4. Whereas real estate got leveraged by the recent decline in stocks and the long-term decline in interest rates, home prices are going to under-perform stock prices substantially for the rest of the decade.

5. The demographics for home-buying will shift for the next two decades from starter and trade-up family homes in urban-suburban areas towards ex-urban areas and vacation-retirement homes; retirees, however, move in much smaller numbers than people in their 20s.

6. Empty-nest homebuyers often prefer to move into town homes or condominiums for low maintenance—often in outlying, peaceful, lower-cost areas, but sometimes in cities for convenience.

7. Dent's book *The Roaring 2000s* (1998) covers real estate, especially exurbia, in depth; Chapter 4 of *The Next Great Bubble Boom* has a good, basic analysis of real estate markets other than exurbia.

Guidelines for Relocating

1. Use web sites that cover census data and other demographic information; local and regional sites provide help with home valuation, ratios of house prices to rents or house prices to income, momentum in prices, etc.; you can find out how over- or overvalued real estate is in particular cities.

2. If you want to buy a home for appreciation, look at areas where the average population is young (so that trade-up demand will remain strong) and where home values are reasonable (so that there is room on the upside).

Closing Advice

You need to question yourself if you are thinking like everyone else; doing what everyone else is doing is the worst way to invest.