

Investment Perspective

Second Quarter 2005

“Learn from yesterday, live for today, hope for tomorrow” -- [Albert Einstein](#)

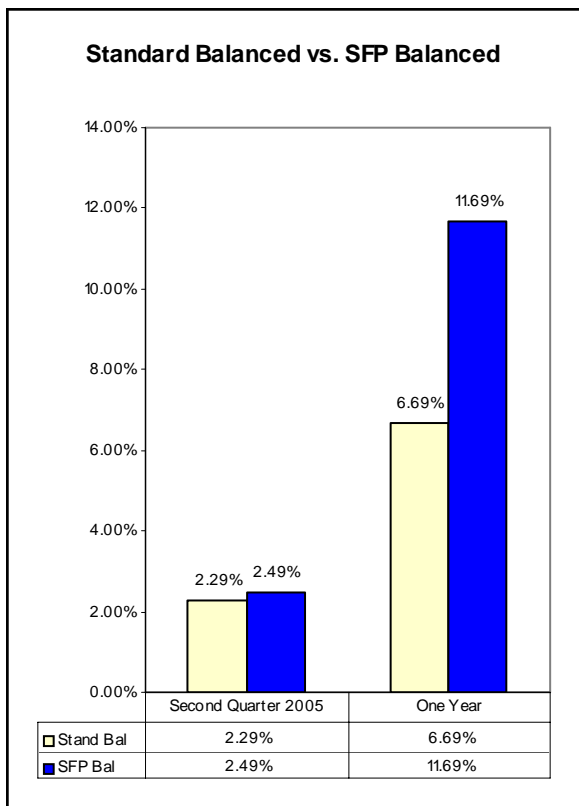
SFP Core Strategies*	Quarter 2	
	2005	One Year
US S&P 500 (Enhanced)	1.51%	5.81%
US Large Value	2.74%	15.05%
US Micro Cap	3.93%	8.00%
US Small Value	3.01%	12.64%
US Equity Real Estate	14.71%	33.21%
International Large Value	-1.39%	16.47%
International Small Cap	-1.63%	19.13%
International Small Value	-1.14%	24.89%
Emerging Markets	3.46%	34.51%
Emerg Mkts Small Cap	0.68%	32.66%
Emerging Mkts Value	1.05%	42.45%
Ultra Short Fixed Income	0.88%	1.96%
Shrt/Int Global Fixed Inc	2.93%	5.56%
SFP Model Portfolios		
SFP Income Portfolio	2.37%	9.10%
SFP Balanced Portfolio	2.49%	11.69%
Non SFP Std Balanced	2.29%	6.69%
SFP Aggressive Growth	2.40%	13.71%

As the summer of 2005 began, I found myself increasingly frustrated. The S&P 500 index was seesawing along and going nowhere during June. The sun was failing to make its regular appearance Seattleites like me had come to enjoy over the past few years. And worse yet, Ichiro's averages seemed to be much better than that of the weather forecasters.

But after thinking about this, I realized my expectations were unrealistic. The weather in Seattle results from interactions around the world among countless molecules in the air, the land, and the sea. In many ways, it's remarkably similar to the stock market, and the reliability of predictions should be viewed in this context. Fortunately, many of the forecasts we have discussed in previous newsletters played out again this quarter.

Overall, the capital markets returns were small but respectable. The Skaggs Financial Planning, LLC (SFP) Balanced Portfolio returned 2.49 percent. From a relative standpoint, this slightly trumped the Standard Balanced return of 2.29 percent and continued our streak of out performance – 11.69 percent vs. 6.69 percent respectively for the one-year period. (Please see the comparison chart and the table of returns.)

The most surprising returns came from the bond market which returned 2.93 percent, as measured by our Short/Intermediate Global Fixed Income Strategy. This resulted from declining longer-term interest rates that bucked the trend of the Federal Reserve's continuing increases in the short-term Fed Funds rate. It also left The Maestro himself, Dr. Alan Greenspan, contemplating this conundrum. Additionally, real estate securities turned in a blistering 14.71 percent return for the quarter, while international stocks took a breather after handily outpacing their US rivals over the last couple of years.



In the domestic markets, small and value stocks have continued to perform well. While the S&P 500 index, which is comprised of both large-growth and value stocks, returned 1.51 percent, our value and micro cap stocks returned 2.74 percent and 3.93 percent respectively (all as measured by our associated strategies). This was a key factor in our model portfolios' above-average performance again this quarter.

Small and value stocks, which receive significant weights in the Skaggs Financial Planning, LLC portfolios, will not always do better than their large and growth stock counterparts. This, of course, raises the question: how reliable are these factors in delivering superior returns and how often should we expect our portfolios to outperform?

To help answer these questions, let's slice the market into four sections according to company size. We will take the largest 20 percent of companies represented by column one (CRSP 1-2) in the chart below, followed by the next largest 30 percent of companies (CRSP 3 - 5) in the second column and so on until we reach the smallest 20 percent of companies in the far right column (CRSP 9 -10). In this case, let's compare five-year returns during the last fifty years between these different market segments. For simplicity, I have highlighted the best-performing segments in blue and the worst-performing segments in yellow for each associated five-year period.

TOTAL RETURNS - 5 Year Period Data: 1955 - 2004				
	CRSP 1-2 (largest)	CRSP 3-4-5 Index	CRSP 6-7-8 Index	CRSP 9-10 (smallest)
1955 - 1959	98.71%	101.41%	101.43%	116.20%
1960 - 1964	64.92%	57.66%	43.48%	38.06%
1965 - 1969	23.53%	71.77%	110.95%	161.76%
1970 - 1974	-12.41%	-28.88%	-45.22%	-59.13%
1975 - 1979	88.53%	240.86%	380.34%	463.31%
1980 - 1984	91.73%	113.05%	123.79%	114.24%
1985 - 1989	149.97%	134.73%	100.19%	50.37%
1990 - 1994	50.04%	66.81%	67.04%	62.04%
1995 - 1999	271.83%	169.39%	160.85%	139.66%
2000 - 2004	-17.33%	22.90%	43.58%	108.02%
Growth of \$1 1955- 2004	\$147.78	\$365.23	\$449.62	\$468.06

As can plainly be seen, the smallest stocks, represented by the fourth column, do not always have the best performance. In fact, these small companies had the best performance during only four of the ten periods. This is equal to the large cap stocks that also turned in the best results forty percent of the time. Assuming the future patterns are similar to the past, we should not expect increased reliability in returns by over weighting small stocks vs. large stocks, even during periods as long as five years. That is the simple truth.

The good news is that the chart clearly shows a relationship between company size and returns. Take a look at the return pattern for each five year period. You will notice that as you move from the larger companies on the left to the smaller during each five-year period, the returns will either increase or it will decrease. Aside from two of the ten periods, 1980 through 1984, and 1990 through 1994, the returns do not jump around and they are determined by size. More importantly you will notice that when small outperforms large, it is by a greater margin than when large outperforms small. Although they both take turns dominating their time periods, the result is that \$1 invested in the largest 20 percent of companies during the fifty year period would grow to \$148 while the same dollar invested in the smallest 20 percent of companies would grow to \$468 (see the last row).

Simply put, we should not expect our small company exposure to consistently provide greater returns, but when small does outperform, we expect nice things. This has led to outperformance for the last few years. While we look forward to reaping these rewards in the future, our expectations must be realistic.

Have a safe and fun filled summer!

Sincerely,

Brian J. Skaggs, CFP