The Quarterly Report

A QUARTERLY PUBLICATION OF IRON CAPITAL ADVISORS | Spring Issue | April 2007

INSIDE STORY *The Right Benchmark*

Find out what the actual time-weighted return of your total portfolio really is...

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My wife's favorite movie is *When Harry Met Sally*. We own it on VHS and DVD and I'm sure we will own it on whatever platform comes next. In one scene, Sally (Meg Ryan) is berating Harry (Billy Crystal) over lunch for a string of meaningless relationships and one-night stands. Harry tries to defend himself by suggesting that his dates have all "had a good time." Then Sally suggests that Harry's dates may have only been pretending to have a good time. Harry denies that anyone could fool him, and Sally reminds him that it is simple math: most women have at some point pretended to be having a good time, while no man believes that this has ever happened to him. Then Sally demonstrates faking a good time, which is followed by the most famous line in the movie, in which a customer at another table says, "I'll have what she's having."

The Right Benchmark

I was reminded of this scene twice in this quarter. The first time was when one of my loyal readers pointed out that two quarters in a row I had referenced the same study from DALBAR, which says the average equity investor has gotten only a 3.51% average annual return over the last 20 years. Thanks to this insightful observation I have now referenced it three quarters in a row in the hopes I can get a second reader to pay attention. I was also reminded of this when visiting one of my institutional clients. This client has more than 16,000 participants in their 401(k) plan and their record keeper helped us with a study that showed that 91% of those participants are underperforming the professionally managed portfolios available to them. There are a lot of Harry's out there who accept the fact that most people need help, but surely it couldn't happen to them. Well, as Sally said, it is simple math.

That is why it is so important that you take my advice from last quarter and find out what the actual time-weighted return of your total portfolio really is. If you don't really know what return you are getting it is easy to fool yourself into thinking that you are not part of the 91%. That the average return numbers don't apply to me, they only apply to those average people.

Once you do know what your return is then you have to compare it to something meaningful. You need a benchmark. Most people use some sort of market benchmark, such as the S&P 500. Standard & Poors (S&P) has a committee that selects 500 of the most prominent companies in the US that it believes best represent the entire economy. The index tracks the movement of the stock prices of those 500 companies weighted by their respective market capitalization. In other words, larger companies have a greater impact than smaller companies.

There is nothing wrong with using market indices to judge your portfolio's performance. We use them ourselves to make sure we are doing a good job for our clients. I would suggest that this is the best way to judge professional money managers. (The S&P 500 is not always the best index to use when judging a manager but that is another subject)

However, market indices are not the best measure for you to use for your personal purposes. We suggest that investors need to calculate their personal required return. What rate of return do you need to achieve in order to reach your investment goals? Your portfolio should then be managed in a fashion that gives you the greatest probability of achieving those goals.

This concept is exactly what we mean when we say that we are bringing institutional discipline to our individual clients. Institutional investors are pension funds, endowments and foundations. If you were a company and your portfolio was a pension fund, you would hire an actuary who would calculate what rate of return you must achieve over time in order to pay out all the retirement benefits that you have promised to your employees. You would, or at least should, then manage the assets in a way that best covered your liability.

A good example of this is American Airlines. They just won the Best Corporate Plan Sponsor of the year award from *PlanSponsor Magazine*. They have been able to maintain their pension plan while most other airlines have been using bankruptcy courts to get out of the promises that they once made to their employees. What was the difference at American Airlines? While other pension plans were trying to outperform the market in the late 1990's American was focused on achieving their required rate of return. This meant that while other pension plans were buying high-flying tech companies at valuations that no prudent investor could ever justify, William Quinn, who manages the American Airline pension fund was sticking to investment basics. He took a lot of heat then, but now we can see how it turned out. Adriana Posada, who works for Quinn, says, "One thing we have never done is jump on the bandwagon with everyone else. It has served the plan well." It can also serve you well.

Many investors we talk to understand the concept of required rate of return when they are saving for retirement. If I contribute X% of my salary to my 401(k) and get X% return on average than I will have enough to money to be able to retire comfortably. What they don't understand is that this concept goes on into retirement as well.

> "...the average return numbers don't apply to me, they only apply to those average people."

Just as with the pension fund, you need to manage your portfolio in retirement much the same way you did when you were working. In retirement the mistakes tend to be different. Younger investors try to jump on the bandwagon and get rich quick, which usually leads to disaster. Retirees usually don't do this. They are too wise to make those mistakes. They make all new ones.

The most common mistake we see in retirees is an obsession with producing income. They feel that because they are retired they must have a portfolio that produces income, as opposed to returns from capital gains. They confuse income with safety and capital gains with risk.

Earlier this year I was at a dinner with Richard Bernstein, the Chief Investment Strategist for Merrill Lynch. He told a story about how Merrill had underwritten Brazilian Highway Bonds. The bonds were sold in what they refer to as tranches or blocks, with each tranche representing a section of highway. The bondholders would be paid back through tolls collected on the highway. They were selling tranche seven which represented the »

REVIEW *of* ECONOMY

THREE AND A HALF MONTHS AGO most Americans thought sub-prime was a specialty sandwich at Subway. Today we are all painfully aware of the sub-prime mortgage market. This sub-prime market is made up of home owners with weak credit who are now defaulting on these risky loans at record levels. The mortgage delinquency rate has climbed to 2.87% in the 1st quarter and realtors predict home sales will be down 2.2% this year and that average prices will drop 0.7%.

With all this bad news why is the Federal Reserve (Fed) still concerned about inflation? Because the economy continues to roll along. GDP grew 2.5% in the fourth quarter of 2006, and is predicted to come in at 2.3% for the first quarter of 2007. The federal budget deficit is down 14.7% due to increased tax receipts. Unemployment is a very low 4.4%. Retail same store sales were up 4.1% in March according to Thompson Financial, and overall consumer spending is expected to be up 3.2% in the first quarter.

Internationally the story gets even better. The International Monetary Fund (IMF) predicts that the world economy will grow at a blistering 4.9% rate this year, which would be the fastest pace on record since the IMF started tracking such things 37 years ago.

At the end of February, core inflation was up 2.7% year over year. One problem facing the Fed is that rising rent cost is one of the major factors in the rise of core inflation. If the Fed tries to stop inflation by raising interest rates, that will likely make the bad housing market even worse, which will increase the demand for rentals, which in turn will cause core inflation to continue to rise. So far the gloom of the housing market has not had a major impact on the economy. Perhaps, this is because the 97.13% of home owners who are not delinquent on their mortgage are not really impacted by higher rent cost or the flat value of their homes. But that is just theory. +

MARKET *forecast*

Not much has changed in our forecast. We believe the S&P 500 will finish the year up 10%. However, it will continue to be a volatile ride. Stocks continue to look more attractive than bonds with interest rates still very low by historical standards and the threat of inflation on the horizon.

Large cap stocks remain far more attractive than small cap stocks. The largest US companies remain inexpensive. The strong global growth will force most central banks to continue tightening the money supply which will make it more difficult for small companies and emerging economies to raise capital needed to fuel growth. This gives higher quality, large companies in established economies a relative advantage.

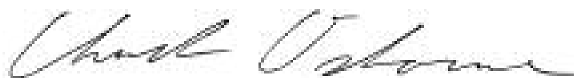
We continue to be bullish on the international markets but not as much as we were this time last year. We do think developed nations are more attractive now than emerging markets, and this did prove true in the first quarter as the MSCI EAFE index was up 4.15% vs. the MSCI Emerging Markets index which was up only 2.35%. We believe this trend will continue.

We continue to expect modest returns from bonds. The yield curve remains flat and interest rates show no sign of dropping soon. Even if the Fed does begin to ease before the end of the year, we don't see a drop in longer term rates. We expect no more than a 5% return on fixed income. +

» seventh section of the highway. There was no guarantee that the sixth or eighth section of highway would ever be built, nor was there a guarantee that there would not be a free road running parallel to this toll road. Yet, they sold out in a day. Retirees are obsessed with income-producing securities and in this low interest rate, low dividend environment they are unknowingly taking on entirely too much risk in order to get that income.

Retirees need to think in terms of building a portfolio that will maximize the probability of achieving the required return throughout their retirement. For example, if a retiree needs 6% of her portfolio as income and believes inflation will average 3%, then she needs to get a 9% return (6% income + 3% for inflation). She should build a portfolio that maximizes that probability with the least amount of risk. That is what we do for our clients.

It doesn't matter if you are saving for retirement or already there. The right benchmark for your portfolio is your personal required rate of return.



Chuck Osborne, CFA, *Managing Director*

REVIEW *of* MARKET

WELCOME BACK VOLATILITY. The S&P 500 went on a wild ride and finished the quarter up 0.64%. On Tuesday, February 27, the market had its worst day since right after 9-11. It started with China's market dropping 9.9% and then the Dow dropped as much as 4.3% in that one day.

Why all the volatility? We live in a world that is smaller than it has ever been before. It wasn't that long ago when it would have taken days to find out what happened in China, now, if you are up early enough, you can watch their market real time. We also live in a world that has more sophisticated market speculators than ever before, mainly in the form of hedge funds. When you combine those two things you get rapid overreaction to any news. Japan raised their interest rates from 0% six months ago, to 0.5% now, and all the hedge fund managers who had been borrowing money for free started to realize that this source for leverage was drying up. Then the Chinese government said they aren't going to allow their economy to run out of control and risk hyper-inflation. The end result was a rapid exit of the easy money out of China which triggered a sell off worldwide. Then the market fought back because the fundamentals remained positive.

Small cap stocks did surprisingly outperform large cap stocks with the Russell 2000 up 1.95%. Bonds did well up 1.50% as measured by the Lehman Brothers US Aggregate Bond Index. Finally, international was once again the best place to be with the MSCI EAFE index up 4.15%. +