

WEALTH MANAGEMENT ADVISORS, INC.
First Quarter Investment Commentary
April 2005

Quarter in Review

It was another tough quarter for the U.S. stock market. All of the major U.S. stock indices were in negative territory, with the NASDAQ leading the way with a decline in excess of 8%. General Motors (GM) reported below expected earnings, and due to its falling stock price, the market capitalization of GM is now below that of Harley Davidson.

When the Federal Reserve raised interest rates by .25% on March 22nd, it basically admitted that there may be more inflation than it had previously acknowledged, and that it stands ready to counter this threat. It makes you wonder if the members of this prestigious group ever go to the grocery store or put gas in their cars. Yes, inflation does exist.

Back-to-Back Good Years

After rushing to get out the 4th quarter 2004 statements and then starting to assemble information needed for clients' tax returns, we took a short breather before beginning the process of contacting clients regarding their portfolios. During this lull, we took time to review investment returns for clients over the last two years. Although you wouldn't know it from listening to the financial press, the period 2003-2004 was very good for a properly diversified portfolio.

Over that two-year period, it was not unusual to see the Large-Cap category average about 16% per year, the Mid-Cap category average over 21% per year, the Small-Cap category delivered up to 35% (!) per year in some cases, International averaged about 25% and the Specialty category did well, posting 22% average annual returns. Although these returns varied from client to client, what we have listed here was very representative of client portfolio performance during this period. The only thing that we were punished for owning during the period was cash, as short-term rates continued to be low until the last quarter of 2004, when the Federal Reserve began to hike interest rates.

So during a period in which we had corporate, mutual fund and insurance company scandals, the seemingly interminable war in Iraq, \$57 per barrel oil and a presidential election that was one of the most divisive in recent memory, clients' portfolios made money. Not only did they make money, *they made good money*, yet without much of the hoopla associated with the late 1990's. What this means is that if an investor is making reasonable withdrawals from a portfolio (in the realm of 4-5% annually), having two good years in a row like we have just enjoyed can provide a tremendous boost to long-term retirement success and a cushion for possible lean times in the future.

The Employee Benefit Research Institute published their Issue Brief No. 227 in January 2005. Although generically titled, "Changes in Wealth for Americans Reaching or Just Past Normal Retirement Age," it did contain some interesting statistics on how Americans born during 1931-1941 have fared financially in retirement, specifically during the period of 1992-2002. Here is an excerpt from the report:

“As wealth is tracked for those Americans born from 1931–1941 (those currently ages 64–74), the changes across years and over the entire period of the study were widely distributed both within and across various demographic groups. Despite some groups doing a better job than others, every group had at least some members on the right track in wealth management—and every group also had members who either had quickly lost all their wealth or were well on the way. And while the health status of individuals is important, it cannot be blamed as the sole factor for wealth loss, as many individuals without health concerns have found themselves on the wrong track in their wealth management in retirement.”

U.S. and China, a Co-Dependent Relationship

Trying to be an economic patriot these days and avoid buying goods manufactured in China is difficult. Whether it is a cheap toy, an article of clothing or an expensive piece of home electronics, the “Made in China” label appears ubiquitous. The American consumer is dependent upon the Chinese manufacturing complex, and Chinese manufacturers are dependent upon the American consumer. In a way, however, the Chinese government is also dependent upon the American consumer. Without our voracious appetite for Chinese goods, what work would be waiting for all of those Chinese peasants moving from the country to the city, looking for higher-paying jobs? If the average American goes on a consumption diet, the Chinese economy is in trouble. The *Los Angeles Times* reported that Liu Min, the chief of statistics in the Chinese city of Bengbu, recently jumped to his death. Speculation is that he faced intense pressure as the person in charge of generating economic growth data for the Bengbu region. If economic data is weak, foreign investors get nervous, and then China’s leaders look like they cannot sustain the economic miracle. Chinese unemployment is officially 4.3%, although private estimates place the rate of unemployment and underemployment at approximately 21%. This equates to 160 million people, more than the entire US work force. China must create a staggering 12 million new jobs in each of the next 10 years just to absorb entrants to its labor market. It cannot do this without the help of the American consumer. In return for America buying its goods, China buys billions of dollars of U.S. Treasury Bonds in an attempt to shore up the value of the dollar.

Wealth Management Advisors on the Road

In mid-March, one of our principals, Pat Warren, headed to Newport Beach, CA for a conference hosted by the PIMCo funds. He came back from this trip energized, confident in our strategy and happy he does not have to buy a house in Southern California. Here are his observations:

“PIMCo held a fixed income seminar on 3/21 and 3/22 at their headquarters in Newport Beach, CA. I attended the sessions along with about 50 other advisors from across the country. This was the second such event at PIMCo, with the purpose of helping advisors gain a deeper understanding of the bond market and to learn where Bill Gross and his investment staff see opportunities in today’s bond markets. PIMCo has been managing bond portfolios for 34 years and has generated the most impressive investment track record of any fixed income manager in the world. I came away impressed with the depth of their research and expertise across global markets which allow them to take advantage of market opportunities all over the world.

This was an opportunity to meet with the investment managers representing PIMCo’s funds while also meeting other advisors and engaging in ideas for structuring portfolios to generate investment returns and manage risk. There is a high level of confidence among advisors in PIMCo’s abilities to continue generating consistent returns above the relevant benchmarks and

to outperform competitors' fixed income offerings. Bill Gross and his management team have maintained a unique culture which encourages humility and a willingness to listen to new ideas. Gross and his staff believe that PIMCo possesses structural advantages which have been the keys to generating returns that have consistently beaten the indexes by at least one-half to one percent per year. These advantages include a longer term investment horizon, the ability to take advantage of short term market inefficiencies, and PIMCo's scale.

Listening to each portfolio manager speak, it became clear that they each agree on the long term (beyond the current business cycle) investment outlook, and this outlook influences their core portfolio decisions. PIMCo's characterization of the relationship between the global economy and financial markets is what they refer to as "stable disequilibrium". The US dollar's exchange rate with foreign currencies, the US trade deficit with the rest of the world, China's determination to continue creating millions of new jobs and move from a command economy to a capitalist economy, and Federal Reserve policy all are forces which are currently in motion and have led to U.S. interest rates that are too low. The U.S. is running a trade deficit with the rest of the world which measures \$650 billion. China and other emerging countries are saving more than they spend while the US spends more than it saves. These are unsustainable relationships that will ultimately unwind. The results will be higher US interest rates, rising inflation, a lower US dollar, and ultimately lower living standards in the US.

While PIMCo's managers agree on this outcome, they don't agree on when this will play out and how dramatic the effects will be. Will the imbalances be unwound in a year or two or will they go on for another ten years or longer? Will the effects be severe or will the corrections be made with manageable effects on the financial markets? One thing they agree on is that the longer these imbalances go on, the worse the impact will be when they finally do unwind. The managers each spoke at length of the need to construct their bond portfolios somewhat defensively, but at the same time they look for and find opportunities to add yield and return potential to portfolios to enhance returns because these relationships may take years to work themselves out. I am confident that PIMCo is well positioned to be the best at managing through these minefields and generating returns with the least amount of risk.

Many of these managers' long term investment themes for fixed income portfolios were consistent throughout the sessions. They include: 1) "stuff" (meaning tangible assets, i.e. commodities) will probably outperform financial assets. Paper portfolios should include commodities to enhance returns and reduce volatility; 2) own TIPS along with nominal bonds; 3) own a healthy dose of international fixed income exposure. If you can tolerate some volatility, own some emerging markets (these are the producers of the "stuff"). Emerging market countries aren't what they used to be. They are running current account surpluses, hold large currency reserves, and are growing their economies at a considerably faster rate than developing countries. Over half of emerging market debt is now rated by the credit agencies as investment grade (rated as safer, high quality debt) vs. around 10% historically. These countries will see rising living standards over the long term. "

Housing Bubble?

When Pat returned from Newport Beach, he brought the real estate section of the *Orange County Register* with him. It was almost like reading fiction to us in the Midwest. The average year-over-year increase in the price of new homes in Orange County, CA was 44.8%. While that sounds great, especially for long-time homeowners in that area, here are some other statistics to ponder with regard to real estate prices.

- In California, 70% of new home purchases are now financed with interest-only adjustable rate mortgages. Source: LoanPerformance
- The Japanese Ministry for Land, Infrastructure and Transport reported that residential real estate prices in central Tokyo rose .9% in 2004. This was the first increase in 17 years. Prices nationwide dropped 4.6%, the 14th consecutive year of decline. On average residential prices in Tokyo were at 41% of their peak in 1991, while commercial property prices were at 20% of their peak. Japan experienced a double-bubble of stock and real estate prices in the late 1980's.

What Lies Ahead

The crystal ball on Kevin's desk is a little murky these days. Even long-time investment professionals don't agree on the direction of the U.S. stock market.

"I have seen investors more bearish than they are now, but I have never seen more angst amidst such opportunity as there is today. I am quite optimistic about 2005." - Bill Miller, Legg Mason Value Trust fund.

"If someone can even walk out of it {the current economic cycle} with a plus in front on the stock side, I think they'll be doing well, but I think it will be a little better than that." - Dan Fuss, Loomis Sayles Bond fund

Closing Comments

As we have said many times, the financial markets can be difficult to navigate. However, we believe that sticking with a proven philosophy generates positive results, especially when the going gets tough. The quote below applies to every quality financial advisor.

"By exceeding the client's tolerance for short-term underperformance and getting fired, you commit a substantial disservice to yourself as a manager, but even more so to the client, who has not only underperformed with you, but then in addition often transfers into a stronger performing alternative, usually doomed to suffer the consequences of a mean-reverting world by falling badly just as the investment strategy they terminated recovers." - Jeremy Grantham, Chairman, GMO Funds

As a reminder, we do have a web site at www.wealthmgt.com. Commentary is updated weekly, and other articles and links are updated at least monthly.

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