



CLIFFORD ASSOCIATES

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SECOND QUARTER 2005

HAVE YOU GOT CHANGE FOR \$48 TRILLION?

by Randy Zaharia

Despite economic downturns and the tech stock market crash over the last 15 to 20 years, the US, as a whole, has gotten wealthier. From early 1990 to early 2005, household net worth – that is, the total value of stocks, bonds, cash, real estate, etc., less liabilities such as debt – increased from about \$20 trillion to over \$48 trillion. That is over 140% for the 15-year period, or an increase of roughly six percent annually, a rate well in excess of inflation which has been about 2.7% for the same time frame.

This was despite real estate declines in the early 1990s and a harsh stock market decline in the early 2000s.

The graph below underscores this strong upward trend of the last 15 years.

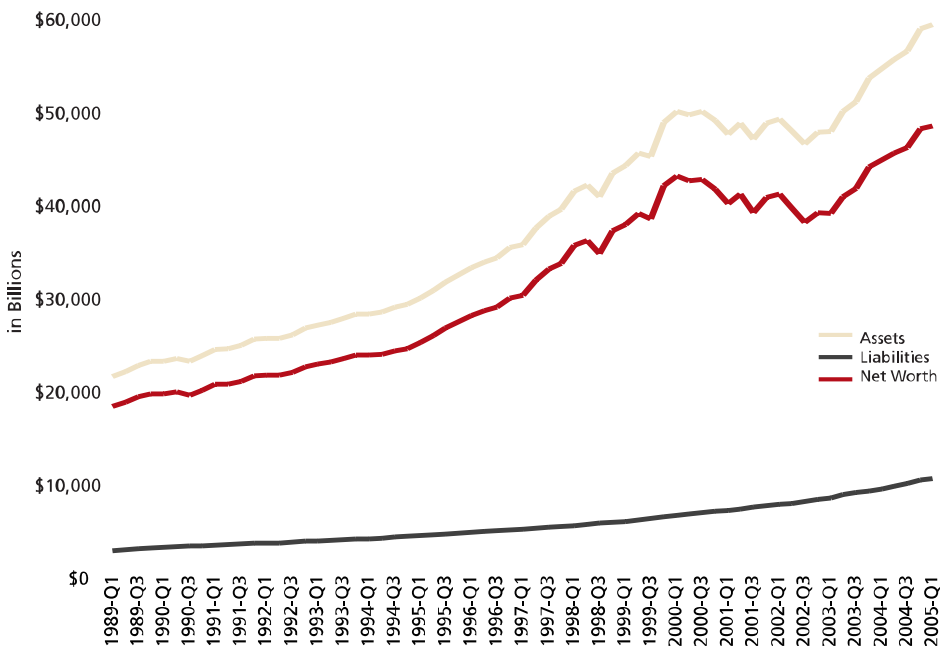
GROWTH OF NET WORTH

This increase in net wealth did not occur through an increase in a single individual asset class, but rather represented growth from a combination of asset classes, appreciating at different times. Interest rates and inflation declined from the double digit levels experienced in the early 1980s to the current low single digit levels (infla-

tion rates and ten-year US Treasury yields at or below 4%). With falling interest rates and a recession in the early 1990s, bonds rallied strongly and helped increase net worth. In the late 1990s, with a healthier economy, surging new technology, and lower inflation, the stock market took off and increased sharply. From 1995 to 1999, the Standard & Poors 500 produced 20%+ returns each year, and in some years, returns exceeded 30%. The technology-fueled stock market rallied sharply, increasing net worth to a level in excess of \$40 trillion by late 1999.

After the peak in early 2000, declines in the market over the next two to three years decreased overall net worth to roughly \$38 trillion. By

U.S. Household Balance Sheet



Source: Federal Reserve Bank

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CORRUPTION IN THE MARKETS

by Jim Fox

We are all weary of the stream of investigations, indictments, trials, and sanctions against major players in the corporate and financial world. It shakes one's confidence in the very foundation of our free enterprise system. Since 2002, over 900 individuals in 400 plus companies have been accused of wrong doing. To date, over 500 have been convicted. Clifford's reaction has been disgust, astonishment at the breadth of the breakdown of honor, and yet an acknowledgement that people of wealth and with accumulated retirement investment assets are obvious targets of those whose greed governs their morality. Our very business, indeed the investment counseling industry, is based upon protecting investors from unscrupulous operators. There have always been a few bad apples. It now seems a large layer of the barrel has gone bad. We are sorry to see the days of our early existence, where a deal was sealed on a handshake, disappear.

In the mutual fund arena we have seen violations related to market timing, late trading to favored holders, and abuse of directing brokerage for self benefit. In the brokerage community investment bankers have misrepresented corporate performance to both shareholders and their colleagues on the research side of the house. Corporations and accounting firms have manipulated financial statements and inflated stock values based upon smoke, mirrors, and lies.

There is comfort in the fact that regulators and legislators are aroused and acting to shore up the legal framework that has let us all down. The SEC is receiving increased funding which it has sorely lacked in past years. The Commission is also attracting seasoned, experienced litigators who are aggressively going after the villains instead of shrinking from intimidation by high powered opponents. Congress is now

considering issues like 'should insurance companies be regulated at the national level instead of the state level'. Clearly it makes no sense to have 50 different governing regulations for these companies. Besides the inconsistencies, some of these states are unable to provide adequate funding to enforce meaningful rules. We also are encouraged by many aspects of increased disclosure by the fund industry. Increasing liability of company directors and providing prison penalties for corporate employees convicted of many of the transgressions we have witnessed will provide some deterrent and remove those convicted from the field of play forever. Brokers have been forced to provide customers with third party, independent research in an effort to mitigate the investment banking conflict of interest.

Is all of this enough? In a sense, we are in danger of carrying this crusade too far. We are seeing troubling signs of political maneuvering that has a serious risk of damaging our system. An example is the enormous group of public employee pension plans that hold millions of shares of US and foreign companies. The clout these substantial holders have available is in danger of being abused by trustees who are political appointees with agendas out of touch with the public interests.

Some have suggested that Elliot Spitzer, the Attorney General of the State of New York, is overreaching in an effort to further his personal political aspirations. In other states, AG's are jumping on the bandwagon and trying to replicate Spitzer's early successes. In California, for example, the current Attorney General has subpoenaed records from some of the major fund companies domiciled here in spite of the fact there are national inquiries already underway. In one firm's case, we know several of the principal players and have always felt their reputations for personal integrity are genuine. We feel the firm's longstanding, highly professional stature

has been earned over many years and should not be tarnished in the media by a publicity driven politico.

On the other side, we see instances of over reaction which are costly on all fronts. For example, fund companies have objected to many aspects of the new demands. T. Rowe Price, who hasn't been implicated in any of the scandals and has in fact added billions to its supervision during this period, has had to add 5 pages to its mid cap fund's prospectus. Last year the firm reported they mailed out an extra 40 million pages at an increased cost of \$800,000. Indeed, the SEC alone has imposed or proposed over a dozen new fund rules in only two years.

Clifford has also been impacted by regulators who are tarring all participants with the same brush. We can now anticipate a costly SEC surprise audit much more frequently than we have in the past. Last year we were forced to engage an internet service company whose sole function is to archive and monitor every electronic communication from each of our employees – incoming and outgoing. We have had to establish a formal committee to administer compliance requirements and develop and publish an extensive policy manual that will stand up to regulatory evaluation. An article in Forbes last month referred to the current situation as a rule making orgy.

What does all this mean to clients and other serious investors? Though costly, the purge underway should rid the system of many temptations to cheat. We will have a higher confidence in the companies we invest in. Truthfulness will enhance our ability to make sound decisions. While client trust has always been our most valued asset at Clifford Associates, our hope is that the market as a whole will gain from a renewed sense of well-being that the spoilers are being removed. Though the days when A.M. Clifford conducted business with a handshake are over, the need for the independent, objective financial advise, and the firm he founded to support that need, have never been stronger. §

“..THE SEC ALONE HAS IMPOSED OR PROPOSED OVER A DOZEN NEW FUND RULES IN ONLY TWO YEARS.”

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late 2002 and early 2003, very low interest rates (1% short term and 4%+ for long term mortgage rates) began to fuel a strong increase in real estate prices. This combination of low interest rates, easy availability and terms of funds, attractive tax treatment, and strong initial appreciation fueled further real estate gains. In some areas such as California, Florida, Nevada, New England, and New York, prices have increased 70% to 100% over the last five years. As a result, the most recent boost in net worth to over \$48 trillion (3/2005) was due primarily to a robust real estate market and, secondarily, to a recovering stock market which began in 2003.

WHAT NOW?

Which asset class will be the next to lead the growth curve? History shows us that stocks and bonds go through approximately three to five year cycles, roughly tied to the economy, and

asset classes (stocks, bonds, real estate) have done well, relative to inflation.

Yet, as we appear to be reaching the bottom of this long downdraft in cost of capital, some markets may have become fully valued or even over valued. Federal Reserve Chairman Alan Greenspan commented earlier this year that the current low levels of US interest rates and especially mortgage rates are a “conundrum.” More recent comments indicate that he does not fear a recession or economic slowdown, but attributes the flattening yield curve (and the “conundrum”) to currency reserve buying by foreign central banks. Needless to say, there is a lot of uncertainty at the Federal Reserve, as well as with other economists and analysts. Caroline Baum, an economist and a Bloomberg commentator, notes in a 6/22/05 Bloomberg article that there may actually be a “bond bubble” and a “condo conundrum.” In other words, maybe both the bond markets and the real estate (primarily residential) markets are fully valued, especially

GOT DEBT?

Household net worth is not the only thing that is on the rise. Household debt at the end of the first quarter 2005 stood at \$10.9 trillion, up from \$9.8 trillion the year before (an 11% increase). Mortgage debt stood at \$7.7 trillion, up from \$6.8 trillion the previous year (a 13% increase), and mortgages comprised roughly 70% of all household debt. These growth rates compared with a more modest 8.3% increase in household net worth (\$48.8 trillion vs. \$45.0 trillion).

Given that total consumer debt increased to nearly \$11 trillion and monthly payments are again at high teen levels (relative to disposable income), are consumers in dire financial shape? Actual “personal savings rates,” as measured by the US Department of Commerce, may have been declining over the last 15 years, but when the savings rate is adjusted for realized gains on equities, houses, and mortgage refinancings, the rate has remained relatively stable over that same 15 year time period (Global Commentary, Bear Stearns, 6/9/05). Based on this analysis, it would appear that consumers, taking into account their wealth status and cash flows, may be in far better shape than many economists and analysts thought. §

	Std & Prs 500 Stock Index	Five Year Treasury Rtns	Housing Price Index
1980 to 1984	14.80%	12.40%	4.60%
1985 to 1989	20.40%	11.40%	6.70%
1990 to 1994	8.70%	7.50%	1.50%
1995 to 1999	28.60%	6.90%	4.40%
2000 to 2004	-2.30%	7.50%	8.50%
1980 to 2004 (avg)	13.50%	9.10%	5.10%
1926 to 2004 (avg)	12.40%	5.50%	n/a

Source: Office of Federal Housing Enterprise Oversight (OFHEO); Ibbotson; S&P.
Note: Annual returns.

late 1980s. Assuming that 2005 or 2006 is near a new real estate peak, that time period would put California’s real estate cycle at about 17 or 18 years (and right in line with historical trends). Given that low rates have fueled the real estate rally to a large extent and that bond yields are at significant lows relative to historical averages over the last 30 and 80 years, it is possible that both bonds and residential real estate may not perform as well over the next five years.

HISTORICAL PERSPECTIVE

History may hold some further clues as to what we can expect in the coming years. Over the last 25 years in five year cycles, stocks, bonds and residential real estate have exchanged top

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generally uncorrelated with each other (or at least low correlation). As a result, most managers and planners attempt to build balanced portfolios around reasonable allocations of these two key asset classes. Critical to assessing allocations, in addition to client “risk tolerance,” is the economic and financial environment; past, present, and expected. As noted above, markets and the economy have enjoyed a 25-year decline in overall interest rates and costs of capital. As a result, all three

given the huge drop in interest rates, and may not be the optimum asset classes going forward.

Another observation specific to real estate seems to support this view. The ebb-and-tide cycles on residential properties tend to run much longer, typically as much as 10 to 25 years between peaks due to lack of liquidity, lack of homogeneity, and an individual’s underlying emotional connection to property. In California, the last significant real estate peak was in the



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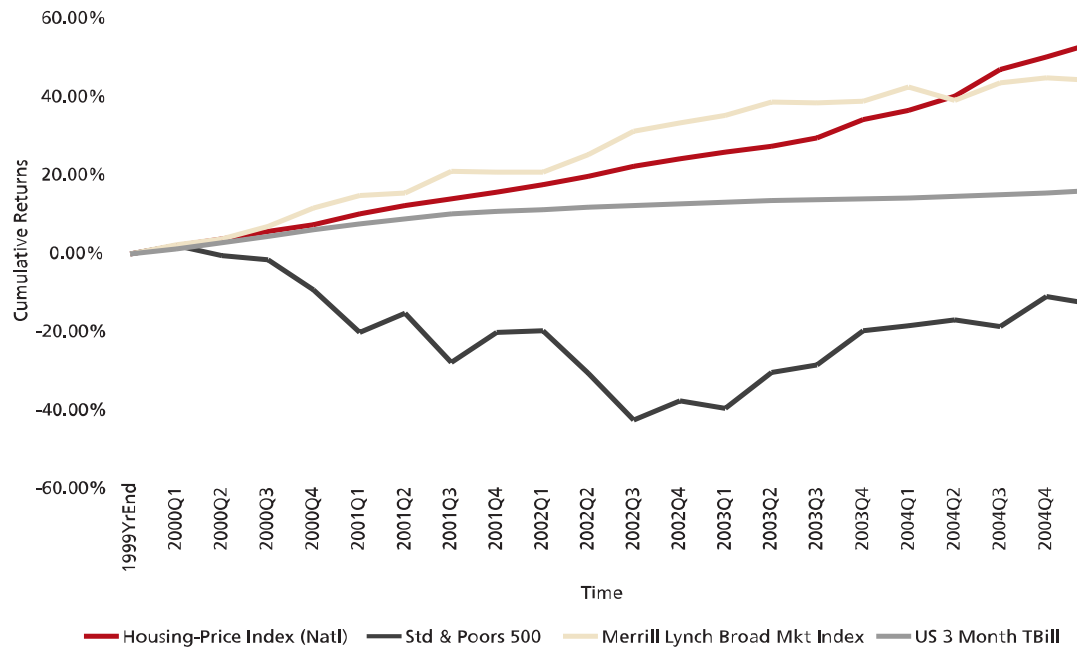
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Returns Comparisons - First Half of 2000s



Source: OFHEO, Merrill Lynch, and Standard & Poors

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billing as the best risk-return investment alternative:

Note that stocks outperformed intermediate treasuries and the housing market in all five year time periods between 1980 and 1999. On at least one risk-adjusted return measure, though, bonds provided the better investment vehicle during the early 1980s and the early 1990s, both periods of economic sluggishness. In contrast, stocks were far and away the best option in the late 1980s (+20.4%) and the go-go late 1990s (+28.6%). Unfortunately, stocks were a negative return option in the early 2000s (-2.3%) while residential real estate provided an increase of 8.5% annually – a significant return over and above stocks during that time period. Bonds trailed modestly at around 7.5%. Taking into account tax consequences for individuals, real estate could arguably have been the best risk-adjusted option over the last five years.

The question, then, is how much longer will residential real estate continue to increase, especially given the strong increases already seen in the last three to five years? Fueling the real estate market the last few years have been low mortgage rates, the tremendous availability of lendable funds, and mortgage banker creativeness. As we discussed above, there is a strong argu-

ment to be made that the real estate market may be at or near its peak, based on historical trends and interest rates. Likewise, history indicates that the bond market, which has rallied strongly over the last 25 years and where interest rates are at generational lows, may be vulnerable to increasing interest rates. It seems almost axiomatic that a sector shunned by so many – that is, the equity market following the stock market decline of the early 2000s – might become the market leader for the next five or ten year time period.

STAYING BALANCED IN AN UNBALANCED WORLD:

Over the last twenty-five years, as noted above, both inflation and interest rates have plummeted from high levels. In Clifford's Spring 2002 article, "Great Expectations and Realistic Returns", we estimated that returns in the 8% to 11% range would seem reasonable for the 2000s. Real estate appreciation is above its 25 year average of 5%, and returns at or below that level might be more realistic over the next five years. Bonds might earn, at best, their coupon (i.e., no price appreciation or depreciation), resulting in returns around 3.5% to 4.5%. In that kind of environment, it would seem apparent that equities provide the better option.

Maybe, all in all, the forecast ahead is for gentler winds and a rising stock market. §