



# CLIFFORD ASSOCIATES

*Investment Counselors since 1915*

THIRD QUARTER 2006

## THE “CRITICAL STATE” OF HIGH ANXIETY

by Randy Zaharia

Oil prices exceeded \$75 per barrel this summer before dropping to \$60 in the last few weeks, a 20% swing. Large cap equity markets were up in the first quarter of 2006, down in the 2nd quarter, and up again in the 3rd. Where the 4th quarter ends up is anyone's guess. Finally, while corporate earnings continue to come in at double digit levels, housing sales continue to slump, and housing prices have begun declining in some regions. Unpredictability? Uncertainty? Incongruence? What should we expect? We are all more or less uncomfortably aware of the current volatile influences pressuring stability in our lives, causing what Mark Buchanan calls, in his book, *Ubiquity: Why Catastrophes Happen*, a “critical state”. He goes on to note, “The human world, at least in the context of the financial markets, seems to share the tumultuous and ever-shifting character of the critical state. As a result, predicting markets may truly be impossible. A change in the mood of even a single investor may trigger a spreading wave of

effects...” (page 155). How then, do we wade through these turbulent waters with a discipline and strategy designed to see us safely to the other side? We believe the best place to begin is by educating ourselves about the whys and hows behind the “critical state”. Let's start by looking at some phenomena in the investment area.

Over time, there are a number of basic investment truisms which have developed. For example, an investor has typically been rewarded for investing in “riskier” growth stocks. Conversely, investors should expect to receive less return for investing in more secure, “lower risk” value

stocks. Another truism is “greed pushes markets up, and fear pulls markets down.” However, since the 1990s, these adages or truisms seemingly have not held, well, true.

In an analysis of these issues, Merrill Lynch's Richard Bernstein (“Risk-aversion growing or risk-taking spreading?”, 8/21/06) notes that in the late 1990s and early 2000s, high beta stocks (proxy for growth stocks) were at substantial premiums (higher P/Es) relative to the market and low beta stocks (proxy for value stocks) were at significant discounts or even lower P/Es - a reversal of these basic *continued on page 2*

## END OF A DYNASTY

*A.M. (Tony) Clifford II  
(1942-2006)*

**T**ony Clifford, the grandson of our founder and third generation investment counselor passed away peacefully last month.

Tony took great pride in the firm and vocation his grandfather founded nearly a century ago. He was both a mentor and tireless advocate for the principles of investment counseling. For those privileged to have worked beside him, we learned by his example the true meaning of disinterested advice to clients, the foundation of this firm's mission. It will continue to be our privilege and duty to protect that heritage.

Our friend and former partner will be greatly missed.

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guideposts in investing. Even today, very high beta (growth) and very low beta (value) stocks are both at premiums, further confusing the situation and placing overvaluation at both ends of the spectrum. Bernstein theorizes that increased risk-taking may have led to these unusual results, and possibly across a broader range of investors. But why?

A couple of explanations or observations might help us gain insight. First, not all investors chasing returns in today's market are motivated by greed; many are motivated by fear. Many baby boomers, anxious about the state of their nest-egg savings and gazing out at their fast approaching retirement, are scrambling to take advantage of the investment markets. Investors are everywhere, looking for anything and everything, hoping to achieve better-than-market returns. So, once again, the old adage that "greed pushes the market up and fear pulls it down" is turned on its head as both greed and fear apparently are working to push some sectors of the market up and leave other sectors overlooked. Baby boomers are not the only ones concerned, as pension funds, both public and private, are focused more than ever on achieving superior returns to erase the funds' unfunded status over the next decade.

Second, over the last five years, there has been an explosion in the growth of alternative investments, especially in hedge funds and private funds, and these alternative investments may be impacting the equity markets. JP MorganChase's Loeyes & Paniqirtzoglou, in a recent article ("Are Alternatives the Next

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Bubble?", 9/8/06), note some of the characteristics of alternative investments today. In total, alternative investments are approximately \$3 trillion in size with hedge funds accounting for \$1.2 trillion (across over 9,000 funds) and nearly \$1 trillion in private equity funds. The balance of roughly \$800 billion is invested in commodities, commercial real estate, and other assets. With over \$2 trillion available between hedge funds and private equity funds, there are also substantial flows that could be distorting the markets. Recent estimates of hedge fund and related trading on the major markets is placed at a staggering one-third of the major exchanges' volume. Is it any surprise then, when a company misses its quarterly estimate by a penny, that it drops 20%, given the huge flows of equity controlled by these funds? It should be apparent that there are forces working in all kinds of directions, both up and down, and some even sideways. But how big might they be?

The seeming distortion in valuations and the huge growth, as well as prevalence, of hedge funds raises the specter of how complex this financial web is. In the larger context, and with the help of these hedge funds among others, the global derivatives market has grown to nearly \$300 trillion in notional value. According to the

International Swaps and Derivatives Association, interest-rate related derivatives totaled roughly \$250 trillion while the fast growing credit-default market had jumped to \$26 trillion. In 2001, by comparison, the derivatives market was just under \$1 trillion in notional size...a massive jump by any measure to today's levels. With all these huge bets and movements of capital, there is undoubtedly an intricate financial structure of countervailing forces affecting valuations, prices, and the risk/return relationships. Not all of these forces are bad, as many are indeed hedges and legitimate allocations of capital. But what of the others?

Financial distresses associated with hedge funds surfaced recently when commodity prices such as oil, precious metals, natural gas, and others, plunged by 20% or more. As a result, Amaranth Advisors, LLC in Greenwich, Connecticut, a reportedly \$9+ billion hedge fund, suffered initial losses of approximately 30% to 35% in its natural

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gas trading activity. Eventual losses appeared to have reached roughly \$6 to \$6.5 billion, and a number of pension funds may have suffered losses including the San Diego County Employees Retirement Association and the 3M Corporation, as well as possibly several Wall Street firms including Morgan Stanley and Goldman Sachs. The hedge fund has shut down to any further withdrawals, and has proceeded to liquidation phase. So far, the damage from this implosion appears well-contained.

On another front, AMBS Investment Counsel of Grand Rapids, Michigan, highlights an example of elevated risk in a leveraged buyout (LBO) involving HCA, the healthcare company. In its September 2006 commentary, AMBS notes that the buyout was highly leveraged, and relied on improved efficiency and increased cyclical business expectations (as opposed to secular forces). AMBS noted that this left little room for error and a heightened risk of financial distress in the future. One might wonder if this echoes the 1980s and those LBOs.

Hedge funds. Private equity funds. Derivatives. Leveraged buyouts. Valuations apparently out of whack. Elevated oil and gasoline prices (vs. two or three years ago). A softening housing market with housing prices starting to decline. Given these, plus a volatile geopolitical situation, especially in the Middle East and in Korea, it is apparent there are a lot of moving pieces, indeed, an entire global mosaic of political, financial, and behavioral forces that investors must process.

With this background analysis in mind, John Mauldin's recent 8/25/06 commentary, "Fingers of Instability" helps to put a frame-

work on all these moving pieces. Mauldin notes that the world economy is "in transition", and if one can see these transitions developing, as well as avoid the problems that accompany change, then one might be able to take advantage of the opportunities. Notably, Mauldin also cites Buchanan's book (noted above), *Ubiquity: Why Catastrophes Happen* to underscore the point that non-equilibrium "critical states" exist in many, many places. A growing pile of sand.....falling snow on a mountain top.....pressures and stress on subsidiary faults to the San Andreas fault....financial booms and busts. In all of these cases, the disequilibrium or "anxiety" within a system grows until that last grain of sand, or snowflake or minor earthquake triggers an avalanche or major quake. The initial basis for some of this thinking came out of chaos theory, an attempt by scientists to find order within disorder.

Bringing all of this home, how do we avoid the chaos and take advantage of the opportunities in our investment world? Given the existence of unstable critical states, and the huge complexity and forces at work in our world today, Clifford Associates has become somewhat more cautious on the markets. Cash levels have been increasing and more defensive stocks are being added to portfolios. Bond portfolios have generally been set up appropriately and extended over the last year. While we are cautiously optimistic, and continue to see positive forces working in the economy to bolster the markets, there are enough uncertainties to create significant caution. Interest rates are up. Commodity prices, in general, have risen over the last couple of years.

India and China are growing at 6% to 10% rates. China is accumulating huge foreign exchange reserves. Thousands of hedge funds and private equity funds are at work in the U.S. and the global economy. There are a lot of moving pieces, and a few things do seem slightly askew. If one throws in the slowing (and unpredictable) U.S. housing market, our caution appears well founded.

Timing the market, however, is ill-advised. During the year, at various times, the equity market was down, and, as of this writing, it is up, though we are cautious and skeptical of this current market for reasons already discussed. While we may have raised some cash, or left higher than usual cash levels, or even become slightly more defensive within the stock portfolio, there is no wholesale liquidation of stocks. One stills needs to remain engaged in the equity markets. Unfortunately, while the markets may be rough over the next six to twelve months, the risk of being out at the time the market begins moving significantly higher again is substantial. To bolster this point, Paul Gire conducted an analysis published in the Journal of Financial Planning in 2005 regarding the loss of return for missing up-market days. According to Gire, during the 1984 to 1998 time period (15 years), the Standard & Poors 500 Index was up 17.9%. However, if an investor missed the 10 biggest days during that period, his return was only 14.2% (79% of index return), while missing the 20 and 30 biggest days returned 12.0% (67%) and 10.0% (56%), respectively (see chart on page 4). Other studies over different time periods have shown somewhat similar results.

Ultimately, we believe the stock  
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**CLIFFORD ASSOCIATES**  
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**PRINCIPALS**

Maye Albanez, CFA  
S. David Andrew  
Peter J. Boyle, CFA  
James R. Brown  
Kenneth H. Dike, Esq., CPA  
James B. Fox, III  
Kathleen Gilmore, CFP®  
Terrell H. Price  
Ralph E. Weil, CFA  
Bruce C. White  
Randall L. Zaharia, CFA

**OFFICES**

*Pasadena*  
200 S. Los Robles Avenue  
Suite 320  
Pasadena  
California 91101  
P 626-792-2228  
F 626-792-2670

*Huntington Beach*  
16902 Bolsa Chica Street  
Suite 204  
Huntington Beach  
California 92649  
P 714-846-2851  
F 714-840-5212

*Evergreen*  
P.O. Box 2945  
Evergreen  
Colorado 80437  
P 720-746-1244  
F 720-294-9896

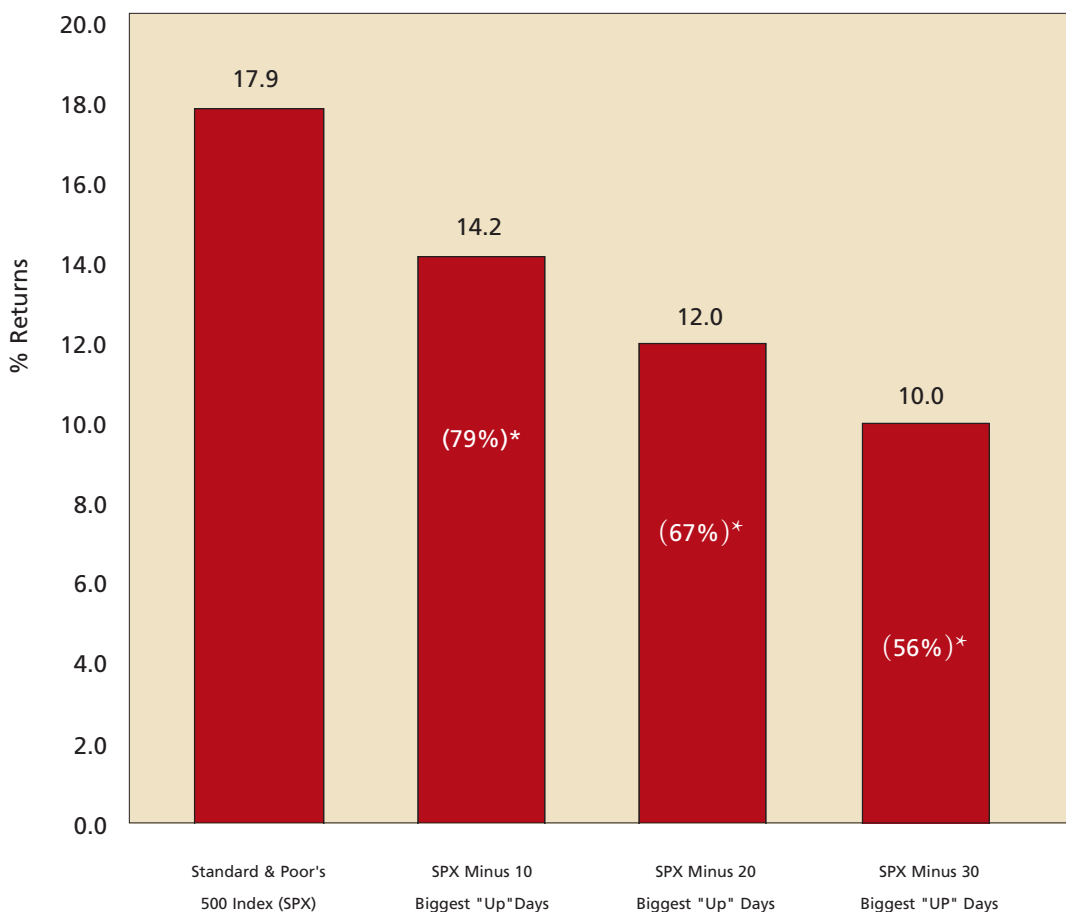
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markets will be much improved by late 2007 and into early 2008. During the interim, our increased allocations of cash allow us to make opportunistic purchases of stocks that are in that

advantage of cheaper stocks if the markets or sectors decline over the next several months and quarters. Opportunities always present themselves if we stay vigilant, maintain our discipline and keep our long-term perspective. In the final analysis, identifying the source of today's "critical

**Equity Market Returns and Timing Costs (1984 - 1998)**



Source: FPA Journal (Gire, 2005)

Note: \*Percentages are the specific return relative to SPX return

currently undervalued middle section (between the extreme beta positions noted by Bernstein earlier) or to take

states" helps us to navigate the chaos and benefit from the opportunities that arise from a stirred pot. §

**"IF WE CAN SEE THESE TRANSITIONS DEVELOPING, AS WELL AS AVOID THE PROBLEMS THAT ACCOMPANY CHANGE, THEN ONE MIGHT BE ABLE TO TAKE ADVANTAGE OF THE OPPORTUNITIES."**