



# ASHBRIDGE

INVESTMENT MANAGEMENT

Quarterly Review

Winter 2003

## *Inside this issue*



Charles B. Grace, Jr.  
Chairman and Chief  
Executive Officer

**N**eed we remind anybody that we have endured one of the deepest and most sustained bear markets in post-war history. The S&P 500 is down over 40.0% since March 2000 and the NASDAQ has lost 70.0%. Since our last letter, markets appear to have steadied, at least temporarily. Everyone knows that bear markets do end, but nobody knows when. In the fourth quarter the S&P returned a positive 8.4% and foreign stocks generally gained 6.5% as measured in dollars. October and November saw a strong rebound of almost 15%, but markets weakened again in December. Mike Kelly provides

detailed commentary on 2002 and the outlook for 2003 in his *Market Review*.

During the bubble of 1998 and 1999, momentum investors looking for high performance, regardless of price, drove the indices higher and higher with absolute disregard for earnings or valuation. The situation has changed dramatically with stock picking being more highly valued now. Jason Taylor reviews the value of actively managed accounts in his piece entitled *Active vs. Passive Investing in Bull and Bear Markets*. The outperformance of managed accounts has been well documented in Ashbridge manager results. Our clients have benefited from substantial outperformance by most of our managers, as well as from broad diversification.

As always, Ashbridge personnel have been presenting at a variety of different forums. Mike Kelly addressed the Beverly Hills Estate Planning Counsel on December 2 in a talk entitled "The Fully Evolved 21st Century Family Office" where he discussed the detailed services provided by family offices. Additionally, in late February, Mike and I will be presenting at the NMS Family Office Forum in Palm Beach. Our presentation, "Transitioning From a Family Operating Business to a Family Investment Entity," will delve into the challenges, both investment and non-investment, families making this transition will face.

We have enjoyed working with all of our clients during these most difficult markets and look forward to more settled conditions in the year ahead. ■

## Year End Market Review

**I**nvestors have never been happier to see the crystal ball drop at midnight in Times Square than they were on New Years Eve 2002. 2002 was another disaster for global equity investors and marked the first time since 1941 that the Dow and S&P 500 declined three years in a row. A strong rally that started early in the fourth quarter abruptly turned by year end as a mixed economic picture, disappointing holiday retail sales and the looming American military conflict with Iraq weighed on investors' sentiment. To top the year off, the ever-irrational North Korean regime decided that they would reignite a nuclear weapons program, causing significant new anxiety in world markets.



Michael D. Kelly  
Managing Director,  
Client Financial Advisor

In a virtual repeat of 2001, the Dow, S&P 500, NASDAQ and MSCI EAFE all declined sharply while bonds rallied. The Fed kept cutting rates, as did other central banks in the hope of sparking economic and stock market recoveries, to little avail. 2002 will be remembered as a year of reckoning for many corporate executives, who committed acts of deceit, fraud and theft from the public corporations they ran. Despite the bad news, in a very positive way, 2002 ushered in the beginning of a new era of corporate responsibility where shareholder interests will be better protected and corporate executives and directors will be legally accountable to the investing public for their actions.

### *Global Economies*

Economic growth in the U.S. slowed to approximately 1.5% in the fourth quarter after 4% growth in the third quarter, bringing estimated growth for 2002 to approximately 2.8%. The

*Continued on page 2*

Market Review, continued

American consumer continued to drive the economy as the long-awaited recovery in business spending failed to materialize. New job creation remained scarce as companies continued to lay off workers to improve financial results. Strong productivity gains and slow GDP growth contributed to stagnant job creation as companies made do with fewer workers. Interest rates remained at their lowest levels in generations, as fears earlier in the spring regarding inflation gave way to new fears of a deflationary trend emerging.

European economies also struggled in the fourth quarter and for the year in 2002, as the U.S. economic recovery slowed. Growth in Europe is estimated at 2% for 2002 and is predicted by the European Central Bank to be as low as 1.1% in 2003. Poor business conditions, geopolitical turmoil contributing to higher energy costs and strong restrictions on government spending as a result of the EU's Growth and Stability Act may continue to weigh on Europe's prospects for growth this year.

The Japanese economy remained extremely weak, highlighted by price deflation and a lack of real reform in the banking sector as the emergence of new bad debts countered write-offs of existing bad loans. Growth in 2003 is projected to be less than 1% and will likely be impacted by the Japanese government's attempt to jump-start exports through a weaker yen, which makes their goods more attractive to foreign consumers.

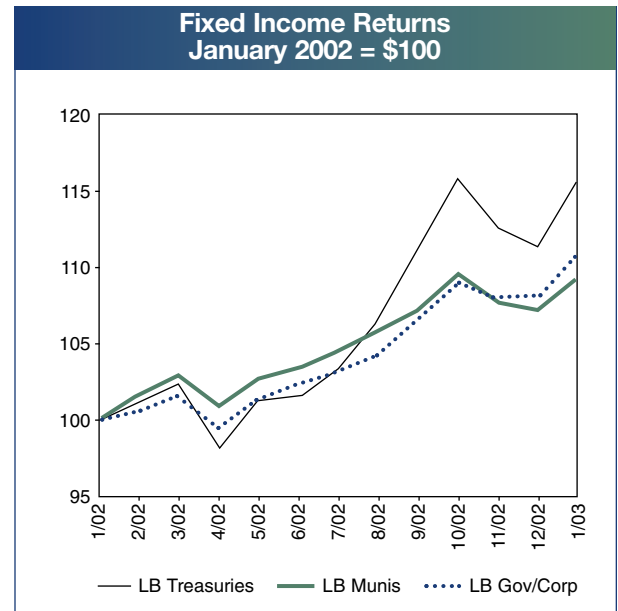
*“... We will continue to employ a measured approach for our clients—an approach designed to provide attractive up-market returns and to preserve significant capital in down markets.”*

Investment grade corporate bonds rallied sharply, although some issues were rocked by corporate accounting scandals and ended the year with junk status. Municipal bonds also rallied sharply in 2002 despite significant new supply as investors fled equity markets. Munis remain extremely attractive to high income earners. The need for professional management in this asset class has become even more important as many states and municipalities are facing significantly lower tax revenues and expanding budget deficits which may lead to ratings downgrades and potential defaults for certain issues.

U.S. bonds rallied sharply in 2002, outperforming stocks for the third straight year. Investors were once again reminded of the benefits of a fixed income allocation in managing portfolio risk. The 10-year Treasury surged 14.6% after beginning the year at a yield of 5.06%. Yields moved higher in the spring, but finished the year at 3.82% having reached a 44-year low of 3.57% in October. In general, invest-

**Interest Rates and Bonds**

ment grade corporate bonds rallied sharply, although some issues were rocked by corporate accounting scandals and ended the year with junk status. Municipal bonds also rallied sharply in 2002 despite significant new supply as investors fled equity markets. Munis remain extremely attractive to high income earners. The need for professional management in this asset class has become even more important as many states and municipalities are facing significantly lower tax revenues and expanding budget deficits which may lead to ratings downgrades and potential defaults for certain issues.

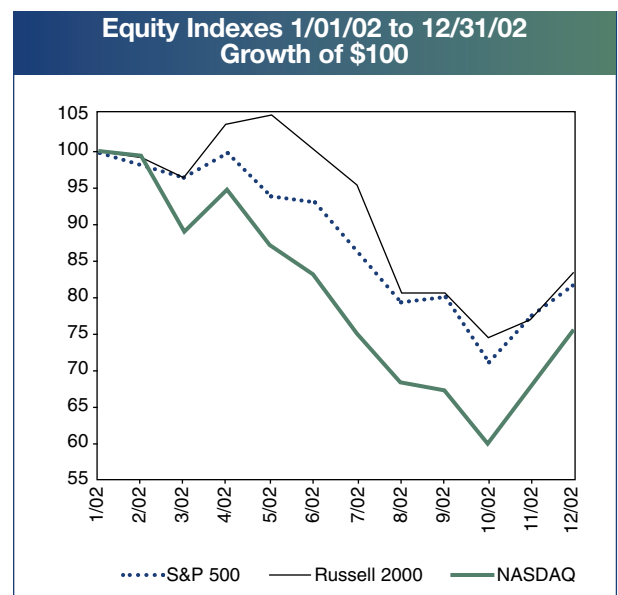


**Equities**

Regardless of market capitalization or geography, equities were pummeled in 2002. In the U.S., value stocks once again outpaced growth stocks on a relative basis. Small and mid-cap stocks, which fared better than large-cap stocks in 2001, had their clocks cleaned, proving that no equity asset class was immune from pervasive negative investor sentiment. Global equities fared no better as weak economies and geopolitical tensions weighed just as heavily on non-U.S. investors.

The S&P 500 rallied nearly 8% in the fourth quarter, bringing the loss for 2002 to 23%. 2002 also ended with losses of 16.7% for the Dow, 31.5% for the NASDAQ

*Continued on page 4*



## Active vs. Passive Investing in Bull and Bear Markets



Jason A. Taylor  
Director of Research and  
Investment Analysis

### Background

In the course of the fourth quarter, we revisited a study on Active vs. Passive Investing that we had initially done five years ago and had updated just twelve months ago. In our most recent analysis, the updated peer group studies encapsulate the latest five years of data available to us, ending September 2002—a particularly volatile period for equity markets. This period, which included a strong market upswing and a subsequent downturn of a similar length, revealed overall results that are consistent with our original findings and compelling to us as long-term investors. Below, we show that active management beats passive over time, particularly in down markets, and the outperformance in the small-cap universe is considerably wider than in the large-cap investment arena, as we might expect for a more inefficient investment arena.

### Introduction

Over the last five years ending September, the major U.S. and non-U.S. indices posted losses of 1.6% and 5.4% respectively. A deeper look revealed that during the bull market period from September 97-March 2002 the large-cap equity indices enjoyed 20% to 30% calendar year returns. This was a challenging bogey for active managers to beat. But tides turned at the end of March 2000 when the equity markets fell precipitously, and this drawdown continued throughout 2001 and much of 2002. Increased volatility, on both the up and downside, once again spurred questions that have been hotly debated over several decades. Do investors benefit more from passively investing their assets in index funds or from placing their assets with experienced investment advisors who actively manage their accounts? Further, which option adds more value to an investor's results during up markets, down markets and over the long haul?

### Methodology

In our review, we analyzed the behavior of several universes of actively managed funds in two broad equity markets compared to their most appropriate benchmark indices. We

assessed the performance of the S&P 500 Index versus the Nelsons universe of 197 Large Cap Core investment managers. We also compared the Russell 2000 Index results to the Nelsons universe of 68 Small Cap Core managers. The study evaluated the performance of the two broad equity markets over three meaningful time periods: 1) the strong up-market from October 1997 to March 2000, 2) the downturn from April 2000 to September 2002, and 3) over the combined five-year period ending September 2002. The universes were filtered to include only managers who had reported a minimum of five years of performance data.

### Large-Cap Analysis

When analyzing the large-cap universe versus the S&P 500 Index, the S&P returned 21.8% during the up-market period, posting a 49th percentile ranking. At the same time, the average manager just topped the index, adding 0.2% for a 22.0% gain. Looking further up the rankings, the average return for top quartile managers was 28.7%, almost seven percentage points above the index. However, the S&P fared even less well during the most recent downturn. The index was a 27th percentile performer, suffering a loss of 20.6% when the universe's average slide was 19.0%. Top quartile managers averaged a 9.8% contraction during the down period. Over the last five years ending September 2002, a significant portion of active managers outpaced the index as the S&P's return fell into the 25th percentile with a 3.1% loss. The median manager beat the S&P by 2.1% per annum during this time, while the average top-quartile manager exceeded the benchmark's return by 5.9% annually. Undoubtedly, the S&P 500 has presented active managers with quite a challenged task over time, most particularly in boom market periods. Nonetheless, our analysis indicates that while 75% of managers outperform the index over the full five-year period, a more telling statistic shows that 31% of managers in the large-cap universe were able to add value above their index in both the bull and bear periods. These findings continue to indicate that while the average active manager can achieve moderately higher returns

*Continued on page 4*

*Market Review, continued*

and 21.5% for the Russell 2000. The Russell 3000 Index, which is comprised of 98% of the investable shares in the U.S., fell 21.6%, its worst annual loss since its inception in 1979. Since January 1, 2000, this index is now down 35%, illustrating the scale and severity of the equity markets decline. In the U.S., the few winners of 2002 were all in the materials sector and included diversified metals and mining, specialty chemicals and gold stocks. The hardest hit sector was information technology including telecom equipment, wireless services, IT services and electronic equipment and instruments. World markets also suffered, with the MSCI EAFE dropping 17.5% and the Nikkei 225 down 18.6%.

**2003 Outlook**

The first few weeks of 2003 have been marked by a strong rally in U.S. equities, particularly in the technology sector. Whether this rebound is a short-term phenomenon or the beginning of a sustainable upswing in shares prices and investor sentiment remains to be seen. Investors should again expect substantial volatility in stocks and bonds in 2003 until market trends and a new *status quo* (if there still is such a thing) become clearer. Positive factors for stocks include low interest rates, fiscal stimulus as part of the new federal tax relief plan including the abolition of double taxation on corporate dividends, high worker productivity and less investor anxiety regarding corporate accounting fraud. The likelihood of another dramatic decline in equity prices has been significantly reduced. The biggest negative factors include the geopolitical uncertainties surrounding war with Iraq, additional terrorist attacks in the U.S. and whether emerging hotspots like North Korea can be contained.

An important driver of stock prices in 2003 will be the high level of unemployment in the U.S. and its impact on consumer spending, the anchor of the U.S. economy. Perhaps 2003 will be the year that the long-awaited increase in business spending also takes place. The corporate profit picture will likely be mixed, although in general should be greatly improved from the last two years. At this point, the ability of companies to raise prices in order to increase profits remains uncertain. The impact that the weaker U.S. dollar will have in 2003 on boosting exports, thereby helping U.S. manufacturers, is also a question mark. What is known is that investors should remain invested for the long term with a prudently allocated and monitored portfolio.

At Ashbridge, we will continue to employ a measured approach for our clients. This approach provides attractive up-market returns and also preserves significant capital in down markets. We expect 2003 to be another “stock pickers” year and one where carefully selected and monitored investment managers should provide better returns and risk management than is typically found in more passive strategies. We think that active management will continue to provide significant value added in the less efficient asset classes, including U.S. small and mid-cap equities, foreign equities, long/short hedged equity and selected fixed income strategies. Customized asset allocation, risk control and portfolio rebalancing to strategic investment policy levels will continue to be our hallmark in 2003 and beyond. ■

*Active vs. Passive Investing, continued*

over a full market cycle such as the last five years, there is a select group of managers who appear equipped to consistently add value to their index in up or down markets.

**Small-Cap Analysis**

Results from the small-cap universe analysis are much more pronounced. Intuitively, we expected this because smaller companies come with more uncertainties and risk and are researched less by Wall Street. They therefore require more analysis and judgment from individual portfolio managers and as a result, this asset class gives the most talented managers more opportunity to shine. During the upswing in the late 1990s, the Russell 2000 Index's 8.4% return fell into the 38th percentile, whereas the universe of managers posted an average gain of 10.5%. The Russell 2000 suffered greater underperformance during the latest downturn, with a 16th percentile return of -13.5%. Relative to their benchmark, small-cap managers performed better than their large-cap counterparts during this period, with the average small-cap manager losing 7.9%. Over the entire trailing five-year period, the Russell 2000 was a bottom quartile performer, falling into the 17th percentile with a loss of 6.3%. The universe's average manager return was 8.3% above the benchmark on a yearly basis with a 2.1% per annum gain, whilst top quartile managers were exceeding the benchmark by at least 14.2% a year, with annualized gains of at least 7.9%. Additionally, 44% of the universe was able to outperform the benchmark in both the distinct bull and bear periods.

**Conclusion**

Discussions of whether to invest with active managers or in passive indices will not end here. Candidly, the weight of statistical evidence in favor of either option is substantial and it seems to fall on one side of the argument or the other dependent upon variables such as time-periods applied or peer-groups used. However, the results of this limited study were all the more compelling than the observations we made last year. Greater numbers of active managers were able to produce better returns than their passive benchmark (in both bull and bear markets) and this differential appeared even larger in the small cap arena. More importantly, active management protected assets better than indexing in down markets, regardless

*Continued on page 5*

## Ashbridge Happenings

- Mike Kelly, Managing Director addressed the Beverly Hills Estate Planning Council on December 2, 2002 with a talk entitled “The Fully Evolved 21st Century Family Office.”
- On February 23-26, 2003, Mike Kelly, Managing Director and Charles B. Grace, Jr., Chairman will be attending the NMS Family Office Forum in Palm Beach, FL and will make a presentation entitled “Transitioning from a Family Operating Business to a Family Investment Entity.” This talk will address the investment and non-investment issues and challenges of families making this type of transition.
- Charles Grace, III, Director spoke about multi-family offices at the IPI’s 10th Annual Investor-Advisor Dialogue on December 12, 2002 at the St. Regis Hotel in New York City.
- Charlie Grace, III, Director will speak at the Second Annual Investors’ Hedge Fund Symposium, March 10, 2003 at the Roosevelt Hotel in New York City. His topic is hedge fund manager due diligence and selection.

### *Active vs. Passive Investing, continued*

of cap size. While indices sat close to the middle of each peer group in bull markets, approximately two-thirds of the managers in the large-cap universe still exceeded the S&P 500 and more than three-quarters of the managers in the small-cap universe beat the Russell 2000 in the bear period. In summary, the consistent trend in the results of this study, last year’s and our initial work six years ago pushes investors to seriously question why they should settle for earning a market return when, in most cases, the average manager can add value to investors’ assets. ■

## Ashbridge Advantage

Ashbridge Investment Management develops and manages diversified portfolios for substantial investors that include our shareholders, other families, endowments, retirement plans and foundations. We are retained to accommodate investors’ unique financial needs, control risk, enhance returns and reduce administration expenses. Our consulting, advisory and management services include:

- *Development of strategic investment policies to meet investors’ individual objectives*
- *Allocation of funds to primary asset classes and investment styles to reduce risk and optimize return*
- *Selection of multiple, independent investment managers with superior performance results*
- *Statistical measurement and periodic reporting of portfolio and market performance*
- *Gradual asset reallocation to reflect changes in financial, economic and investor situations*
- *Comprehensive monitoring of managers and accounts to assess returns and control risk*

Ashbridge Investment Management is independent of all suppliers of financial services and negotiates all fees and commissions on behalf of the investor. For further information contact Charles Grace, Louisa Sellers or Michael Kelly.

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