

Alpha Strategies

Mellon Capital's 2006 outlook by Vikas Oswal, Chief Investment Strategist

During 2005, Mellon Capital's active investment strategies produced impressive results. Our solid alphas are a result of our systematically exploiting inefficiencies across global capital markets. In addition to our robust modelling framework, our ability to continue to generate alpha depends on the availability of opportunities within our investment universe. Before reviewing the prospects for our principal alpha sources, let's take a brief look at the global economic backdrop.

Having grown at a real rate of about 5.1% during 2004, the global economy is estimated to have expanded by approximately 4.3% during 2005. At the same time, global inflation, currently running at 2.2%, has remained tame despite a slight increase over 2004. More important real GDP growth over the next five years is expected to average 4.3%, while current expectations for global inflation over the same period are running at about 2.1%¹. Strong GDP growth coupled with modest inflation is the lifeblood of healthy global corporate earnings. Indeed, a notable characteristic of the recovery since the recession of 2001 has been the vigour of earnings growth.

Today, aggregate earnings are at an all-time high. From their previous peak during the first quarter of 2001, realised earnings are up over 34%, and from their trough in the first quarter of 2003, earnings are up over 99% globally². Helped by the favourable economic backdrop, the strong earnings momentum appears to be continuing. Particularly noteworthy is the resilience of corporate margins in the face of rising costs, indicating an increase in pricing power.

Additionally, corporate profits continue to be underpinned by exceptional increases in global productivity and the expansion of global trade.

Stocks are attractive globally

¹ Source: IMF; Mellon Capital estimates. Growth rates are for global output based on all countries in the IMF database.

² Source: IBES

³ The MSCI World USD Index experienced a price decline of 12.16% between 3/131/00 and 12/31/05.

Globally, we believe that stocks are priced to significantly outperform bonds over the next few years. Our principal guide to gauging the relative attractiveness of stocks and bonds is the expected global equity risk premium (the global risk premium is the difference between our forward-looking expected return on 10 major developed equity markets and our estimate of corporate bond expected returns in these same markets). Currently, the global equity risk premium remains substantially above its long-term equilibrium, indicating significant incremental expected return to global equities. As a result we continue to have a sizable overweight to stocks in both our Global Alpha and U.S Tactical Asset Allocation strategies. It is atypical for us to take large active stock or bond positions in our Global Alpha strategies. Over a meaningful investment horizon, we expect to allocate only an average of 10% of the Global Alpha risk budget to stock-versus-bond positions. Nevertheless, one of the major advantages of our Global Alpha strategies is the ability to dynamically shift the risk budget when opportunities change. As 2006 unfolds, the average capitalisation-weighted equity risk premium exceeds 5% and exceeds 4.5% in each of the 10 major markets in which we invest. We can point to only one period – the spring of 2003 – when the risk premium was above current levels. Today's high equity risk premium is supported by a combination of solid expected earnings growth and depressed global bond yields. Globally, earnings are at all-time highs. From their previous high in March 2001, earnings are up about 36%. Meanwhile, prices in the world's developed stock markets (taken as a whole) are down more than 12%³ from their peak in 2000.

Similarly in the United States, earnings on the S&P 500 Index (expressed in earnings per share) are also at all-time highs. From their previous peak in September 2000, S&P 500 earnings are up 32%. From their previous trough in January 2003, S&P 500 earnings are up 55%. Meanwhile, the S&P 500 Index price is down about 18% from its peak in 2000. In our domestic Tactical Asset Allocation strategy we continue to maintain

a 100% allocation to equities. Although 2005 was broadly flat from an alpha perspective, we expect our domestic strategy to significantly outperform its benchmark in the coming year.

Currently, the global equity risk premium remains substantially above its long-term equilibrium

In order to put today's high risk premium into perspective, Table 1 presents a rough estimate of global and US stock market appreciation required to return the risk premium to fair value under two scenarios:

- Bond yields stay unchanged (we present this scenario in light of the chorus of market participants who believe that today's low yields could be with us for years)
- Change in bond yields contributes half the change in our risk premium required to return it to fair value

Both scenarios assume that earnings and long-term growth expectations remain unchanged. In each case the stock market is expected to rally by more than 20% in order to simply bring the equity risk premium back to fair value.

What about risk?

Despite a solid economic backdrop, some investors remain cautious and point to new risks on the horizon – high oil prices, the Fed's continued tightening of monetary policy and the flat-to-inverted US yield curve, to name a few. Merely highlighting individual risks factors, however, tells us little about the riskiness of the current environment. The question is not whether such risks are new or different but rather whether current risks are significantly higher now than on average.

The United States is the world's largest energy consumer and has grown accustomed to low energy prices. The experience of dramatically higher gasoline

prices and the prospect of paying significantly more for heating oil over the winter have kept investors worrying about the impact on consumption spending, which accounts for more than two thirds of GDP. Oil prices appear to have peaked at just under US\$71 the day after Hurricane Katrina made landfall and have since been drifting down. More importantly however, the market's self-corrective mechanism appears to be working. Not only have SUV sales plunged, but year-over-year demand for gasoline is also beginning to decelerate. On the supply side, oil firms have started to reinvest in additional refining capacity, and higher prices have spurred the development of previously uneconomic oil fields. With these factors taken together, the world is not about to run out of oil, but rather is suffering from a period of prolonged underinvestment coupled with greater geopolitical uncertainty in oil-producing regions.

Another perceived risk facing the market is the Federal Reserve's continued tightening of monetary policy. After the Fed raised rates at 13 consecutive meetings, the yield curve is starting to invert. Many investors look to the yield curve for clues about the outlook for economic growth. Flat-to-inverted yield curves have historically been associated with recessions. Thus, the current flattening/inversion of the yield curve has led some to conclude that growth is set to slump. Such a narrow focus on the shape of the yield curve, however, misses the bigger picture and overlooks the absolute level of interest rates. We believe that the flat yield curve coupled with historically low long bond yields reflects a fundamental imbalance in the supply and demand for long-term, fixed-income assets. An important factor contributing to low long-term rates has been the savings behaviour of the global corporate sector. One recent report (*JP Morgan Research, June 2005, 'Corporates Are Driving the Global Savings Glut'*) estimates that corporate savings for the G4 economies alone were more than US\$1trillion dollars between 2000 and 2004. Increased corporate savings have reduced the supply of long-term corporate debt, which in turn has led to a knock-on effect on Treasury yields. Furthermore, the supply problem has been compounded by the lack of 30-year Treasury issuance since 2001. Moreover, the decreased supply has been accompanied by a simultaneous increase in demand. The introduction of mark-to-market pension accounting in Great Britain and its potential introduction

in the United States has led many plans in both countries to lengthen the duration of bond portfolios in an effort to reduce the volatility of the asset-liability gap. The combined effect of reduced supply and increased demand doubtless is having a substantial impact on Treasury yields. Our analysis is confirmed by the conflicting signals from other asset markets, notably stocks and commodities. Rising commodity and stock prices reflect the increase in global demand and are unlikely to indicate an incipient slowdown.

Dispersion in expected returns offers alpha opportunities

Although we continue to maintain an overall overweight to global equities, our exposure varies from country to country. A major advantage of the Global Alpha strategies is the ability to spread our risk budget over a wide selection of opportunities. In this way, we are able to overweight those countries that present the best risk-return trade-offs while being underweight in countries that continue to be overvalued. Within Europe we prefer the faster-growing economy of Spain, versus France and Germany. Additionally, we believe that valuations continue to favour a recovery in both Switzerland and the Netherlands, versus weaker expected returns in the United Kingdom. Elsewhere, our largest overweights are rounded out by Japan and the United States. Although Japan has had its fair share of false dawns, there is reason to believe that the overall economic climate is reaching a turning point. Recent data has been solid for the most part, indicating broad-based growth momentum. In particular, households remain the key focus, since domestic consumption makes up more than half of GDP. The early signs of income growth are promising. While the pace of change may appear painfully slow to most observers, the pieces necessary for a sustained domestic recovery may be gradually coming together. Given current valuation levels, the Japanese market remains undervalued and should benefit substantially from the continued domestic recovery.

In addition to our country stock selections, we also generate alpha by allocating part of our risk budget to different country bond markets. Although we are underweight in bond markets as a whole, our individual exposures are tailored to target the best risk-return trade-offs. Our largest underweights are to the United States, Canada and Australia. In all three countries the yield curves are flat to inverted, reflecting a

significant overvaluation relative to the rest of our investment universe. Indeed, our bond market valuations are based on the belief that different country yield curves reflect the diversity of risk-sharing behaviours. In this way, we seek to identify those markets that offer the greatest reward for bearing term risk. When yield curves are flat, the premium for holding term risk is negligible even when adjusted for relative growth rates. As a result we believe that only the European and British bond markets currently offer any significant value.

Currency markets continue to offer alpha opportunities

Two distinct structural economic models drive our currency portfolio – a real interest rate differential model and a purchasing power parity model. The combination of the two models enables us to determine optimal relative valuations in the currency markets. One of the key advantages of our approach is the ability to systematically shift the risk budget toward the most attractive misvaluations. Current opportunities in currency markets are below their historical average. This reduced opportunity is consistent with the typical ebb and flow of relative misvaluations and does not reflect a permanent change. As a result our currency allocations reflect the lower dispersion of relative valuations. Exhibit 7 reflects active currency decisions in the Global Alpha portfolios. Despite the reduced overall opportunity in currencies, we believe that the UK pound continues to offer significant value based on its high relative real interest rate. Offsetting this long position are modest shorts in the Canadian dollar, Japanese yen and Norwegian krona. For the first time in more than four years, both the US dollar and the euro are approximately fairly valued.

In conclusion, relative valuations between stock and bond markets strongly favour stocks. Robust underlying global economic fundamentals along with unattractive bond yields, have already proven to be powerful catalysts of global stock outperformance. We are confident that there's more to go in equity outperformance. Furthermore, global stock, bond and currency markets continue to offer significant opportunities to generate alpha. Our Global Alpha process is a robust repeatable and durable source of alpha. We are confident that our Global Alpha strategies will continue to position our portfolios to capitalise on current opportunities and seize new ones as they arise.