

Gaining Perspective

Market Insights from Nicholas Applegate Capital Management

Stick to Your Long-Term Discipline



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9/25/2008— Most investors' assets are, and should be, for the long term. Now is the time to take a look at that long-term allocation, make sure it is the right long-term allocation, and then make sure you stick with it. Probably the single best piece of advice that we can give to any of our clients is: *Stick to your long term discipline.*

Capital at risk

The basic problem in the economy now is that banks have assets on their balance sheets which, if written down to market as the accounting rules now require, will put their capital at risk. It's not just the banks. It's the investment banks, which obviously are now bank holding companies.

Probably the most important thing to come out of this is that leverage in the financial system will decline. We have been saying for well over a year that we felt leverage had to decline. When leverage goes up, it has a very healthy impact on economic growth, now we're on the reverse side of that curve, and it's going to have a negative impact on economic and earnings growth for many companies.

Deleveraging the financial system

There have been a lot of people in this country who have been very happy to accumulate debt on the expectation that interest rates would stay low and asset prices would continue to rise. The basic problem is one of debt accumulation. It doesn't matter who you blame: We as an economy need to delever.

The main thing we are doing at Nicholas Applegate is staying with our investment philosophy. We still are looking for companies that, in a relative sense, exhibit positive change as reflected in better earnings growth than the market as a whole. And we look at sustainable change—change that either happens at the industry or company level. There are plenty of such companies around, and we plan on continuing to search out those companies.

Playing tough defense

Nothing has changed from the investment philosophy point of view. In general, we believe our portfolios are still relatively defensive: We own a lot of consumer staples, utilities, health care—companies that tend to do better during periods when economic activity is suppressed relative to potential. We have also not wandered back into the housing markets. The numbers today still paint a relatively unhealthy picture.

But we have been buying some financials. The reason is still, as always, to find companies undergoing positive, sustainable change. Having said that, we are not yet sure what the government is going to do. As a result we are tempering our risk expectations. So we have, in our view, somewhat more defensive portfolios and have been buying some regional banks we believe are in good shape. But overall the strategy remains pretty much the same.

Growth vs. value

If you look at historical performance, defensive stocks, what I call the “stable growers”—and they are a significant part of the growth indices—tend to do well in an environment where economic growth is relatively tough. So, in the next 12–18 months, while this deleveraging of the economy is taking place, we favor growth over value pretty strongly. We feel that a lot of the cyclical stocks, which tend to be part of the value indices, still have some way to go in terms of adjusting downward to earnings expectations. Remember, a lot of these stocks are trading on peak earnings and on relatively high valuation when compared to growth stocks.

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But we believe that the earnings on cyclicals have to come down. So in the next 12-18 months we would certainly favor growth. Now as we come out of that, and the economy is done with its deleveraging cycle, we think we will see a rotation back to the early cyclicals. So eventually things like homebuilders and retailers and so on will begin to gain some traction. But at this point we think it is still too early.

Testing the waters

As far as dipping one's toes back into financials, it really depends on an investor's time frame. Currently, I think there are some very inexpensive financials—if you are willing to take a chance that the congressional package will be favorable.

I do think something workable will come out of Washington. That is why, in some of our portfolios, to neutralize some of our significant underweight in financials, we have started to buy some retail banks, both in the U.S. and abroad. The latter don't have to delever as much as U.S. institutions and have relatively safe balance sheets.

View on the dollar

The U.S. went into this downturn sooner than other countries. Europe is still slowing. Japan's numbers do not look very strong. Emerging country growth rates are slowing. The dollar has appreciated by about 10%, even with the recent downturn after the \$700 billion package was announced. We think the dollar put in a near-term low about two months ago, and we think it will continue to appreciate.

Europe to slow vs. U.S.

Germany's numbers are relatively poor. The U.K. housing market is in many ways worse than ours. Housing in Spain is fairly bad, as it is in Australia. They were not growing at the pace they were, and if you look at the European central banks, they have been concerned about inflation, which we think is merely a phantom menace. However, that is their mandate: to address inflation through interest rate moves.

So they still have an inverted yield curve, which generally predicts weaker economic growth in the future. We now have a normal yield curve because of the Fed rate cuts, which I think will kick in once all the deleveraging in the system is gone. So Europe is an environment in which economic activity is slowing, and indicators suggest it will slow further.

Emerging markets overstretched

We reduced our exposure to emerging markets as long ago as a year and a half ago. They kept running up valuations, got overstretched, and we had some correction. But think we have more to come. Decoupling—the notion that emerging economies are becoming less intertwined with the U.S.—is not what people have said it is going to be. We see it in data from China, India and Brazil. We have never believed in decoupling, and still think valuations are higher than they should be.

Keep your sights on the long term

We have had many events like this over our history. Now is a time to stick to your long-term asset allocations. The best thing we believe we can do, given our experience, is get people to remain focused on the long term.

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