

Hoisington

INVESTMENT MANAGEMENT COMPANY

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Quarterly Review and Outlook

Second Quarter 2005

CONVENTIONAL WISDOM

The last twelve months have been good ones for contrarians in the Treasury markets. One year ago, and at the start of 2005, conventional wisdom held that interest rates were going to rise. This, indeed, happened as the Federal Reserve raised the Federal Funds rate from 1% to 3 1/4%. Two year notes also rose in yield to 3.6% compared with the 3.1% level at the start of 2005 and 2.7% a year ago. Five year notes remained steady at 3.7%.

While short rates rose, longer dated maturities fell in yield, and the impact on investment returns caused by this twisting of the yield curve was quite dramatic. The Lehman Index returned 2.5% year to date and 6.8% for the past twelve months, while the long Treasury market returned 12.1% and 23.2%, respectively, for the same time periods. A year ago we firmly believed that a rise in interest rates by the U.S. central bank would merely exacerbate the chronic imbalance of global over-production matched against global under-consumption, creating an even wider output gap. Therefore, we extended the duration of our portfolio during the year, resulting in a 14.8% year to date return and a 28% gain over the past twelve months. Yields on some zero coupon bonds, which comprise a large percentage of our portfolios, fell by 132 basis points, returning more than 40% to the investor!

GLOBAL INFLUENCES

The U.S. has been recovering from the 2001 recession in an unusual postwar fashion. Currently, private sector jobs are only 103,000 above the December 2000 peak. From the recession trough in 2001, private jobs are up only 2.2 million compared with previous postwar recoveries when average gains of 7.2 million new jobs were recorded. This staggering shortage of new jobs in this recovery is a direct result of changing global influences.

Globalization will continue to have a dramatic impact on labor markets. The Harvard economist, Richard Freeman, has calculated that the global workforce has doubled since the fall of the Iron and Bamboo Curtains as a result of the effective addition of workers from China, India and the former Soviet Union. According to Freeman, the capital/labor ratio has been lowered to 55%-60% of what it would be otherwise, thereby reducing the return to labor and increasing the return to capital. As Freeman said, "A decline in the global capital/labor ratio shifts the balance of power in markets toward capital as more workers compete for working with that capital." Based on Freeman's calculations, thirty years will need to elapse before the global economy returns to the capital ratio that existed when the Iron Curtain fell. If true, this implies an extended period of low inflation.

David Rosenberg, the excellent Chief Economist of Merrill Lynch, calculates that China and India, in recent years, added roughly 18 million new jobs per annum. If, as Rosenberg assumes, 10% of these jobs resulted from globalization, this would equate to 1.8 million jobs per year, which is roughly equal to a full year of U.S. employment increases. In other words, jobs were created, not in the U.S., but in low wage countries (China and India). Furthermore, Rosenberg observes that while the personal saving rate has fallen to nearly zero in the United States, it is 30% and 40% in India and China, respectively. Accordingly, final demand abroad is extremely weak relative to job and income growth. The recycling of this saving pool has been credited with helping to create the lower interest rate environment around the world.

The lesson here seems to be that first, our \$12 trillion GDP economy can be significantly influenced by the \$44 trillion world economy, and second, long term forces—or secular trends—can, in fact, overwhelm the normal U.S. cyclical economic developments.

SECULAR INFLUENCES

HIMCO has studied secular forces as far back as 1871, the year that the S&P was initiated. Our research article regarding the risk premium that appeared in the winter 2002 issue of the *Journal of Portfolio Management* resulted in highlighting some secular forces that have the potential for overwhelming cyclical developments. Within that time frame, two distinct and different global market places developed—an “open” market and a “closed” market. The “open” or global market lasted from 1871 through 1945, and then became “closed” or restricted from 1946 through 1989. This “closed” period was a result of nearly half the world’s population residing behind the Iron and Bamboo Curtains. The fall of the Iron Curtain and opening of China reversed the “closed” period to another “open” period in the world economy, and the impact of this change back to an “open” global system will continue to be significant in the years to come, as highlighted by Professor Freeman.

OPEN AND CLOSED ECONOMIES

Rising interest rates and inflation were predominant trends from the late 1940s until the late 1980s when the world was a much more “closed” economy. Today’s “open” world economy reflects impulses from the huge population and land masses formerly encompassed by the Soviet Union, China and India. One of the most important considerations in determining cost in economics is economies of scale. Economies of scale can apply, not only to the manufacturing and marketing of goods, but also to the acquisition of the factors of production - labor, natural resources, and capital. The greater the economies of scale, the larger the number of units over which the fixed cost of production can be distributed. This lowers the average production costs, and is translated as downward pressure on prices. Globalization also increases the number of producers of goods and services and suppliers of the factors of production, thereby enhancing competition.

Economic models, therefore, indicate that the combination of large economies of scale and more highly competitive markets should simultaneously produce lower inflation and better real growth than under reduced competition and lesser economies of scale. Indeed, this is exactly what happened.

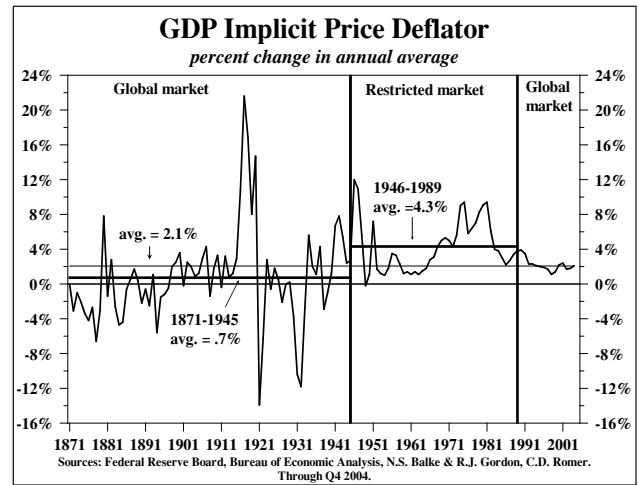


Chart 1

In the global period from 1871 through 1945, the broadest measure of U.S. inflation (the GDP implicit price deflator) increased by just 0.7% per annum (Chart 1). This earlier time span experienced sizeable economies of scale, highly competitive conditions, rapid migration, and large capital flows. During the Cold War, economies of scale and competition were reduced and the inflation rate averaged a far higher 4.3% per annum.

Current conditions may offer even greater economies of scale and competition than did the 1871 to 1945 “open” period. Information and transportation are far less costly today, and the earlier period did have anti-competitive structures such as the Sugar, Tobacco and Oil Trusts that international competition precludes in this global era. In that earlier period, the global era was interrupted by two world wars, as well as by trade wars and competitive currency devaluations in the 1930s. Just before that period commenced, the U.S. economy was converted into a unified market, with the Transcontinental Railroad’s completion in 1869. In the middle of the period the competitive pressures of the global marketplace were considerably enhanced by the completion of the trans-oceanic cable lines and the Panama Canal. We liken many of the current innovations in communications and transportation to these earlier precedents.

Real GDP also followed the economic model script. From 1871 to 1945 real GDP advanced 4.1% per annum, or considerably better than the 3.2% per annum increase from 1946 through 1989 (Chart 2). Population growth was somewhat faster in the earlier period, but real per capita GDP still posted a far superior gain of

Global and Restricted Markets

		<i>Open Economy</i>	<i>Closed Economy</i>
		<i>1.</i>	<i>2.</i>
		1871-1945	1946-1989
<i>1.</i>	Bond Yield	2.9%	5.8%
<i>2.</i>	Inflation Rate	0.7%	4.3%
<i>3.</i>	Nominal GDP	5.0%	7.6%
<i>4.</i>	Real GDP	4.1%	3.2%
<i>5.</i>	Per Capita Real GDP	2.7%	1.8%
<i>6.</i>	M2	6.5%	6.7%
<i>7.</i>	Velocity	2.2	1.6

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, A Half Century of Returns on Stocks and Bonds by Fisher and Lorie, *History of Interest Rates*: Homer & Sylla, N.S. Balke & R.J. Gordon, C.D. Romer, Robert Shiller - Yale University, Peter L. Bernstein Inc., HIMCO.

Chart 2

2.7% per annum during this period, compared with the 1.8% per annum rise recorded during the Cold War.

These two time periods provide strong evidence that inflation, not real growth, determines long term bond yields. Real growth was greater from 1871 to 1945, while Treasury bond yields averaged 2.9% per annum, versus 5.8% in the ensuing 44 years (Chart 3). Remarkably, the Treasury bond yield and the inflation rate were lower by 2.9% and 3.6% per year, respectively, from 1871 through 1945 than in the Cold War period.

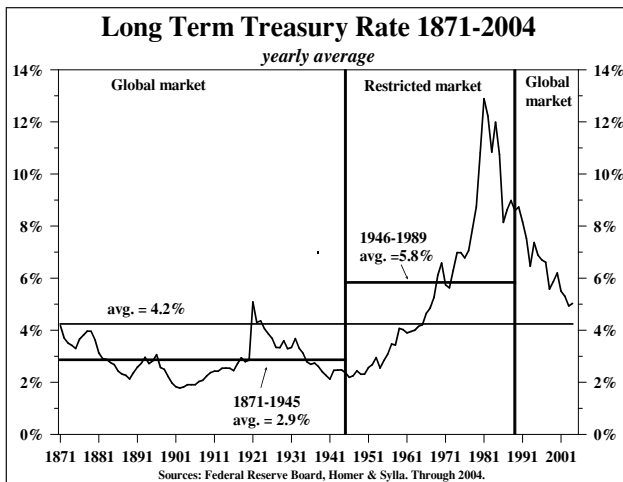


Chart 3

An alternative explanation for the low inflation of the earlier “open” period is that the U.S. was on the gold standard until 1933, but this argument is not supported by the evidence. The M2 money stock grew by 6.5% per annum from 1871 through 1945, virtually identical to the 6.7% pace set during the Cold War (Chart 4). In the fifteen years since the fall

of the Iron Curtain, M2 has grown at a 4.9% annual rate, which was even less than the 5.7% average rate of growth in just the years when the U.S. was on the Gold Standard.

Going forward, global growth should exceed that of the Cold War period, but growth will be skewed toward the low wage countries and away from the U.S., old Europe and Japan. Furthermore, inflation and interest rates will continue to be lower on average in concert with “open” economic conditions.

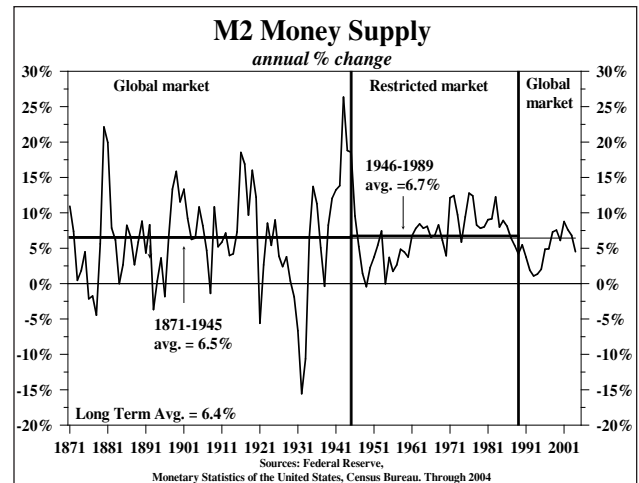


Chart 4

CURRENT CONDITIONS

The coincident indicators of economic activity such as GDP, employment and spending still move forward. This only suggests where the economy is, however, not where it is headed. Interestingly, the anticipatory, or leading, domestic and global indicators are clearly pointed downward and continue to worsen.

The deterioration of leading indicators reflects the impact of a rise in global short-term rates, principally due to increases in the U.S. Federal funds rate plus a surge in energy costs burdening consumers and businesses world wide. This rise in the Federal funds rate has slowed monetary growth dramatically as measured by M2, with the 3, 6, and 12 month growth rates at 1.3%, 2.2%, and 3.5% respectively through the end of June. Indeed, the growth in M2 for the past twelve months is less than half the average rate of increase of the past 135 years. In addition, U.S.

fiscal stimulus has been reduced. The budget deficit will be cut by nearly \$100 billion in the current fiscal year, with the deficit to GDP ratio dropping to 2.5%, down a full percentage from a year earlier. Thus, at present, cyclical forces – both real and monetary - are more likely to strengthen the anti-inflationary thrust of ongoing secular considerations.

BONDS - STILL THE PLACE TO BE

Powerful secular forces are working to lower inflation, and thereby long term interest rates. This process seems destined to prevail for an extended period. While cyclical and transitory influences will surface on occasion, these shorter-term elements may become more infrequent and less powerful. Even though interest rates are at what appear to be low levels, this is only true if they are seen in the context of the “closed” world economic environment between 1945 and 1990.

Downward pressure on inflation and interest rates is likely to persist until, or unless, the elevated level of capital spending and the process of globalization come to an end. Trade wars, restrictive tariffs, or other events could halt the march toward globalization, but currently we have no evidence to suggest such a scenario. With strong secular forces being supported by restrictive monetary conditions and faltering leading indicators, bond yields should continue to irregularly decline.

Van R. Hoisington
Lacy H. Hunt, Ph.D.

PERFORMANCE

Returning 28% in a year when the Fed funds rate rose nine times to 3 1/4% seems inexplicable. Thirty year Treasuries were up 23%, some zero coupon bonds were up over 40%, and our accounts held both issues. Index, or short strategies did not fare as well. Five year notes returned 4.4% and the Lehman Aggregate returned 6.8%. HIMCO's advantage versus the indices continued to widen as our three, five, ten, fifteen and twenty year returns were 8.5%, 4.5%, 3.1%, 3.1% and 3.0% compounded over the widely-used Lehman Aggregate Index. Although HIMCO invests only in U.S. Treasuries, the returns have exceeded the S&P 500 for the past five years, and been remarkably close in the longer time intervals. Our view remains that long dated Treasuries will continue to be a profitable investment for a considerable period.

FISCAL YEAR PERFORMANCE ENDING JUNE 2005 PERCENT CHANGE

	Q2 2005 %	Year to Date %	One Year %	Annualized				
				Three Year %	Five Year %	Ten Year %	Fifteen Year %	Twenty Year %
HOISINGTON MANAGEMENT <i>(gross of fees)</i>	12.1	14.8	28.0	14.3	11.9	9.9	10.8	11.4
<i>net of fees</i>	<i>12.1</i>	<i>14.7</i>	<i>27.8</i>	<i>14.1</i>	<i>11.7</i>	<i>9.7</i>	<i>10.5</i>	<i>11.2</i>
Lehman Aggregate Bond Index	3.0	2.5	6.8	5.8	7.4	6.8	7.7	8.4
30-year bonds *	9.7	12.1	23.2	12.2	10.4	8.2	9.1	9.4
5-year notes *	2.9	1.4	4.4	4.9	6.9	6.0	6.8	7.3
Treasury Bills	0.7	1.3	2.2	1.6	2.7	4.2	4.5	5.3
CPI (est.)	0.7	1.4	2.8	2.6	2.4	2.4	2.7	3.0
S&P 500	1.4	-0.8	6.3	8.3	-2.4	10.0	10.7	12.3

Performance numbers reflect actual composite returns of accounts managed by HIMCO, all performance is in compliance with A.I.M.R.-PPS, the U.S. and Canadian version of the G.I.P.S. standards, and the composite began in 1981. The performance numbers do not reflect custody fees or other fees charged by third parties. Standard deviation of accounts in the composite for Q2, 2005 is 0.89. This composite includes 29 accounts totaling \$3.194 billion, or 74.4% of assets managed by HIMCO at the end of Q2, 2005. No leverage has been used, and HIMCO does not manage any balanced or non-fee-paying accounts. Performance prior to 1992 was calculated using annual weighting according to A.I.M.R. recommended guidelines for retroactive compliance, and a list of all HIMCO composites is available. There is no assurance that past performance is predictive of future performance. The following are required disclosures for the years presented. Standard deviation of accounts in the composite: 2004:0.85; 2003:0.47; 2002:0.80; 2001:0.63; 2000:1.31; 1999:1.10; 1998:0.57; 1997:1.28; 1996:0.61; 1995:1.83; 1994:0.65; 1993:0.92; 1992:0.28; 1991:0.15; 1990:0.12; 1989:0.23; 1988:0.18; 1987:0.25; 1986:0.34; 1985:0.72; 1984:0.94. Market value of composite (\$millions): 2004:3,246; 2003:3,456; 2002:3,377; 2001:3,434; 2000:4,064; 1999:3,599; 1998:3,715; 1997:2,619; 1996:2,551; 1995:2,733; 1994:2,242; 1993:2,600; 1992:1,986; 1991:1,310; 1990:1,160; 1989:884; 1988:682; 1987:591; 1986:540; 1985:490; 1984:700. Number of accounts in composite and percent of firm assets in composite, respectively: 2004:30,97.8%; 2003:33,97.7%; 2002:34,93.8%; 2001:35, 94.3%; 2000:35, 95.0%; 1999:41, 97.6%; 1998:42, 99.3%; 1997:37, 97.7%; 1996:41, 99.3%; 1995:38,96.8%; 1994:41,98.8%; 1993:42,98.1%; 1992:39,95.0%; 1991:28,70.8%; 1990:27,96.7%; 1989:22,85.0%; 1988:17,82.7%; 1987:15,93.1%; 1986:16,100%; 1985:17,100%; 1984:22,100%. Hoisington Investment Management Company has prepared and presented this report in compliance with the Performance Presentation Standards of the Association for Investment Management and Research (AIMR-PPS tm), the U.S. and Canadian version of the Global Investment Performance Standards (GIPS tm). AIMR has not been involved with the preparation or review of this report.

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* current issues linked by HIMCO

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