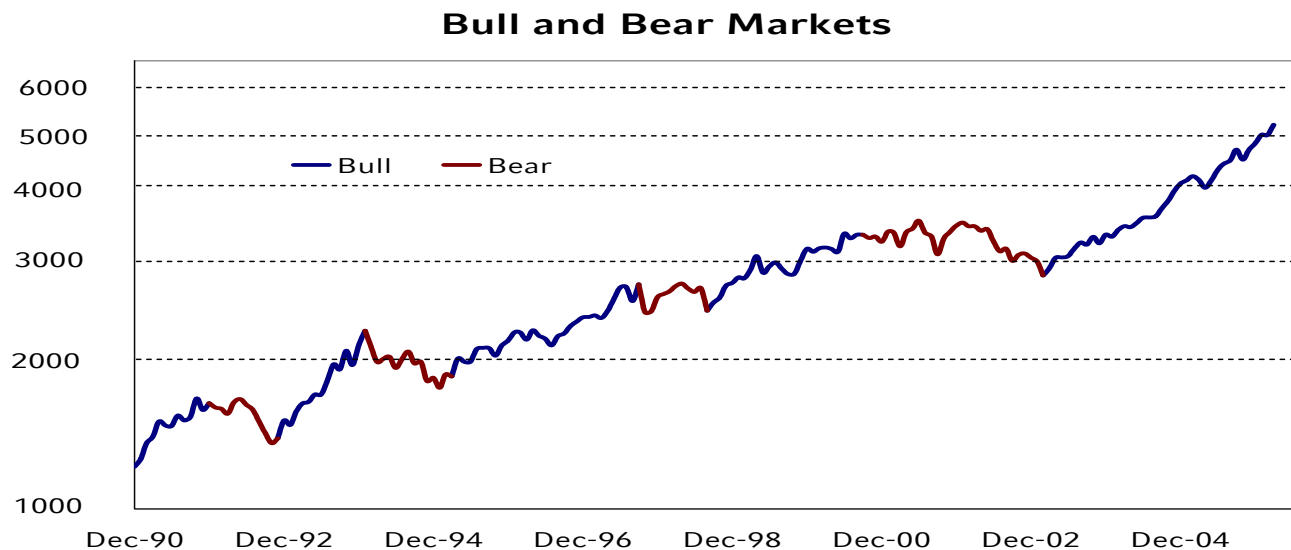


What works in a bull market?

The month of April saw another strong month in the current bull market run which is now three years old. Bull markets can give rise to disparate performance from active equity managers as they tend to disadvantage certain stock selection criteria which are otherwise effective in mixed or bearish market conditions. This newsletter looks at how different stock selection criteria have performed in bull and bear markets over the last fifteen years for which we have credible stock level data. The observations are qualified by the very different nature of market environments over that period.

Classifying bull and bear markets

The chart below displays the last fifteen years of market performance, with bull and bear markets coloured separately. The identification of bull and bear market periods is a little subjective. In this case we have taken into account proximate twelve month market performance, and short-term trends in market highs and lows. The vertical scale is logged to avoid cumulative distortion.



Over this period the various bull and bear markets have not conformed to any classical pattern. The market environments for bull markets have differed widely, as have the market environments for bear markets. The environments can be assessed across a number of dimensions including the behaviour of bond yields, monetary policy, changes in economic outlook, and corporate profitability.

The first three bull markets of the period were driven by the transition to lower bond yields in the 1990's, based on the secular change in inflation expectations. Corporate profitability did improve during the bull market of 1993, but not to the extent seen over the past three years. Easing or accommodative monetary policy has been a common feature of bull markets with the exception of the moderate tightening from late 1999 to 2000. There has been no consistency to changes in the economic outlook or shifts in corporate profitability across the five bull markets identified here. The most important observation is that the current bull market, driven by a significant lift in corporate profitability, is unlike any of its recent predecessors, and also unlike the more classic run up to the 1987 collapse. Likewise the bear markets have been variable in their circumstances. The bear market ending in March 1995 was a simple case of rising bond yields, the bear ending August 1998 was against a decelerating economic outlook, and the bear ending February 2003 was affected by softer corporate profitability. Price to earnings comparisons suggest the current market valuation has remained conservative unlike other bull markets. However on a price to book basis the valuation expansion of the current bull market looks similar to, if not more extended than, other bulls. For

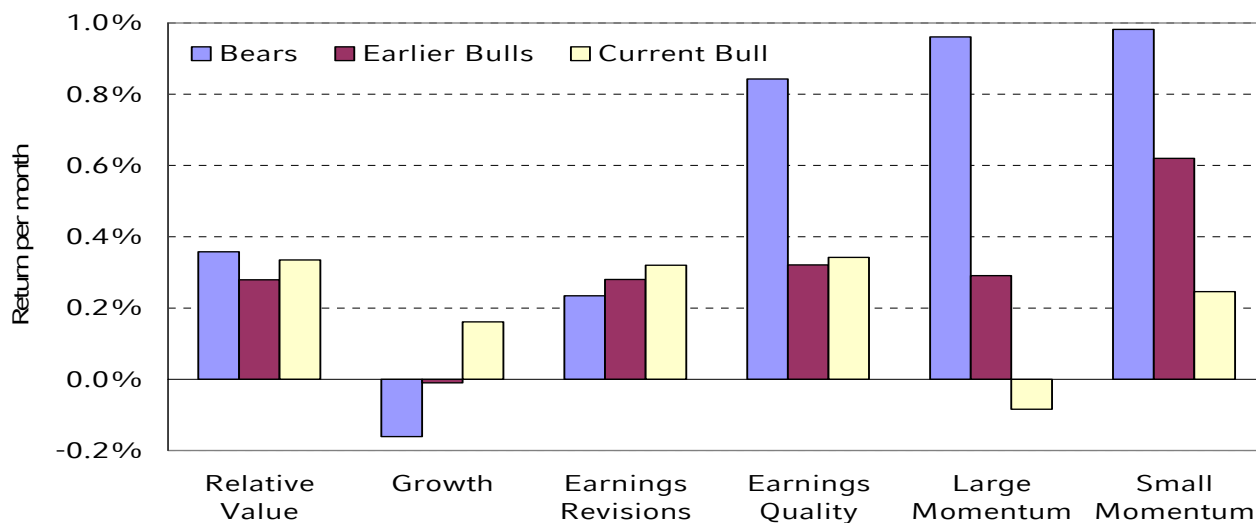
What works in a bull market?

example core industrial stocks now trade on a median price to book of 2.5x compared to circa 2.0x at the end of previous bulls.

Strategies for different market environments

The foregoing discussion cautions against gross generalisations about bull and bear markets because the profile of financial environments is so variable. Notwithstanding this caveat, it is interesting to measure the effectiveness of various equity strategies in these two alternative environments. The metric we favour is the average one month factor return, from a multi-factor model incorporating a range of alternative strategies. We also include sector variables in this model so that results are not distorted by disparate performance of sectors. The chart below looks at the active performance of various alternative strategies in bear markets, previous bull markets, and this current bull market.

Strategies in Bull and Bear Markets



The key observations about the differential performance of strategies are:

- Relative value and earnings revisions are strategies for all seasons with little variation across market environments. Relative value in this analysis is based on earnings yield relative to sector and relative to recent history.
- Growth overall is an ineffective strategy, however this recent bull market has been kind to growth. We have defined growth as the trend earnings growth through a five year period including three prior years and two forecast years.
- Earnings quality, which focuses on the cash flow backing of earnings, is very well rewarded in bear markets, but somewhat less so in bull markets when earnings are subject to less scrutiny.
- Momentum in the past has been more effective in bear markets, and more recently the reward to momentum has deteriorated relative to earlier bull markets.

Conclusion

The observations above help explain why past performance is an unreliable guide. Firstly the simple classification of bull and bear markets overlooks the different financial backgrounds to those market environments. In that respect this most recent bull market is very different to its predecessors, being driven by strongly expanding profitability, particularly in the resource sector. Having taken a less common ascent, it may yet descend by well trodden paths such as contracting profit margins, falling commodity prices, rising bond yields or some combination. When the environment does change, past experience would suggest there will be some rotation of successful strategies, with growth likely falling from favour, and earnings quality coming more into focus. The big question is 'When?'.

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