



Bumpy First Quarter

Stocks rose, dropped precipitously and then recovered, ending the first quarter about where they started.

The S&P 500 index managed a 0.7% gain so far this year while the DJIA lost 0.3%. The Nasdaq rose 0.3% for the three months, while the best performing U.S. index, the small-cap Russell 2000, gained 1.7%. Mutual fund investors who managed not to panic, did better. The average diversified U.S. stock fund ended the quarter ahead 2.1%, while the average World stock fund gained 2.9%.

We have continued to achieve higher returns than the broad market indices by aligning with the stronger areas. And importantly, by following the sell discipline of holding funds only so long as they outperform their peers, we rode through the rough patch last quarter. Most years see market corrections of 5-10%. Last year, the broad market lost 8% and previously strong funds tumbled much further. But that panic also turned out to be short-lived, and by year-end virtually all segments recovered.

The scores that we use to rank funds has a built-in lag that filters out the short-term blips to help us stay the course through temporary corrections. Although it is tempting to react to short-term moves, we attribute a great deal of our success to Upgrading's lack of susceptibility to short-lived leadership changes.

So far this year, average fund performance is higher than broad index returns partly because smaller-cap stocks continue to outperform large cap stocks. The average market capitalization of all stock funds is far smaller than the S&P 500. Mid-cap funds - those invested in companies with market values between \$1 billion and roughly \$20 billion - advanced 4.4% on average in the first quarter, and small-cap funds gained 2.7% on average. Large-cap funds averaged only 0.8% for the quarter, more in line with the S&P 500 index.

Growth funds outperformed value funds in all size categories. Among sector funds, utilities led by a wide margin, followed by natural resources funds. Real-estate funds, the best performing sector over the past five years, sank in March but managed to hold onto decent gains for the quarter. Still, many real-estate funds fell enough in rank to be considered for Upgrades.

International stock funds ended the volatile quarter ahead of their U.S. counterparts. Small and mid-cap foreign funds were the top performers in both the growth and value camps. Both European and Latin American funds ended the quarter with average gains over 4%. After selling off sharply in early March, emerging markets funds recovered and remain highly ranked because of strong performance for the quarter and year. Japan had the weakest market, down in March but slightly positive for the quarter.

Internationals continue to dominate the top ranks in all classes, extending a winning streak that has continued for four years, from late 2003 to date. The rise of the euro against the dollar and European stock market out performance worked in their favor. The Financial Times just reported that, for the first time since before WWI, Europe's 24 stock markets, including Russia and emerging Europe, eclipsed the U.S. in stock market value.

Many conventional portfolios have a "home" bias, but Upgrading leads us to all areas bringing in good returns in U.S. dollars. Upgraders won't be invested internationally when good relative performance is not there. But for the time being, we're happy to harness the good returns.

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P. Michael Valley II

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