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DHJ&A
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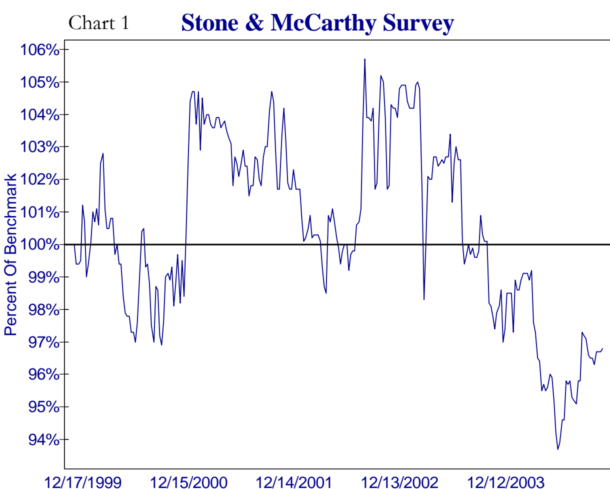
IT'S MADE OF PEOPLE!

One of my favorite actors is Charlton Heston, and one of his best movies is the 1973 classic Soylent Green. The movie depicts a futuristic overpopulated world with little food left on the planet. The people survive by eating a government-distributed wafer named Soylent Green. At the end of the movie, as he is taken away both beaten and bleeding, Heston screams out the infamous line, "Soylent Green is made of people! It's made of people!"

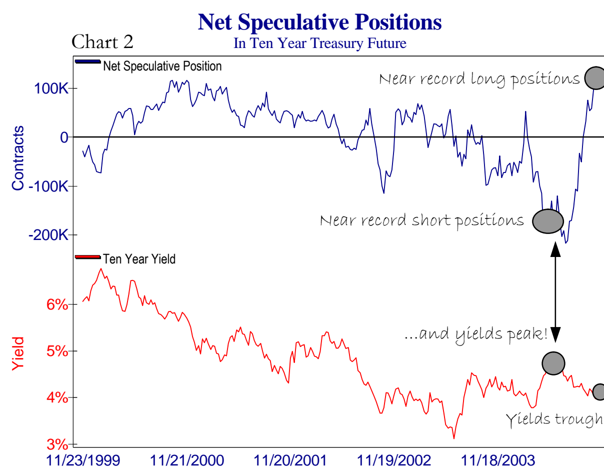
So is the market. The market is made up of people, and therefore reflects their collective wisdom and views, as well as their emotions and fears. People often call this market sentiment. We, at Davis Hamilton Jackson and Associates pay considerable attention to market sentiment, as it is one of the five factors that make up the foundation of our fixed income investment process. The other factors are valuation, inflation, economic, and monetary. We use these five factors along with output from our proprietary models to determine the target portfolios. In turn, these target portfolios guide the composition of all of our client portfolios.

Sentiment, unlike the other factors, is a contra-indicator. In other words, if the market thinks rates are rising, then maybe it pays to bet against the pack. This year, market sentiment has been more important than usual in influencing our fixed income investment decisions.

We use several statistical tools to help us measure market sentiment, as well as anecdotal evidence, such as economists' forecasts. One useful tool is the Stone & McCarthy's Money Manager Survey, a weekly poll of 30 large money managers, controlling over $100 billion in assets. The Survey asks managers what their portfolios' durations are relative to their benchmarks and an aggregate relative duration is determined. Historical results for this year are shown in Chart 1. Another tool is the Net Speculative Positions, a net total of the open interest that large speculators have in 10-year treasury futures contracts. Weekly totals are shown in Chart 2.



Earlier this year, anecdotal evidence, as well as our statistical tools, told us that most market practitioners were bearish on interest rates. For example, at the beginning of the year the Wall Street Journal published various economic forecasts of 54 respected economists, and virtually all of them predicted higher rates by year-end. The Money Manager Survey showed managers starting the year with durations shorter than their benchmarks, and Net Speculative Positions showed managers to be net short treasury futures. And in fact, the 10-year treasury yield, which started the year at 4.25%, did rise over the first six months of this year, peaking in June at 4.87%. This rise in rates caused bearish sentiment to intensify by mid-year. In early June, the Survey reached an extreme reading as managers were invested at only 93.7% of the duration of their benchmarks. In Chart 2, we can see that by mid-July, Net Speculative Positions were at record shorts as well.



The readings on these tools, when combined with the anecdotal evidence of economists' predictions, made us pause. We questioned the market scenarios that could cause new selling and higher interest rates if market practitioners were already short. Thus, we covered our own small short position this summer and went to a neutral duration in our client portfolios.

As economic data in September began to show signs of a "soft patch," the market's negative sentiment began to turn. As a result, the 10-year treasury yield declined to 3.97% by October. The Money Manager Survey, while still showing that managers were short, began to bounce off extreme levels. Meanwhile, Net Speculative Positions moved from record short levels to being near record long levels.

In addition to our tools, anecdotal evidence of a sentiment change began to appear. At least one major investment bank changed their economic forecast from expecting higher rates to expecting lower rates. Furthermore, the Wall Street Journal had a major article in mid-September highlighting how money managers had gotten the recent interest rate cycle wrong and were underperforming their benchmarks.

All of this information was enough for us. We concluded that sentiment was changing and that managers were covering some of their short positions. Thus, by October, we moved to a short duration position in our own client portfolios.

Today, 10-year treasury yields are at 4.13%, still far below the economists' forecasts of 5.17% made at the beginning of the year. It remains to be seen if our short duration position will ultimately save our clients money. One thing is clear. It does not always pay to follow the pack when making investment decisions. And, referencing another great Heston classic, many of us remember what happened to Pharaoh's soldiers when they blindly chased after the slaves through the Red Sea. Moses closed out their positions at a loss.

Gilbert A. Garcia, Principal
November 15, 2004

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