

# THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

## Core Balanced Portfolio Investing



ROBERT F. KEY is Senior Vice President for CCM Investment Advisers. He began his career at the South Carolina National Bank as a Corporate Banker and later moved to First Union Bank where he started and managed the Private Banking Group in Columbia, South Carolina. He subsequently served as the Treasurer of The Seibels Bruce Group, a property and casualty insurance company, where his responsibilities included management of the fixed income investment portfolio, short term cash management, debt management as well as investor relations. Mr. Key joined CCM Investment Advisers in 1998 and his responsibilities include management of client portfolios, marketing and fundamental research in the utility, shelter, raw material, transportation and multi-industry sectors. In addition, he serves as the Chief Fixed Income Strategist for the firm. Mr. Key graduated

from Furman University and earned an MBA degree from the University of South Carolina in 1982. He is a CFA charterholder, a Certified Cash Manager, has served as an Adjunct Professor of Finance at the University of South Carolina and has provided expert consultation on legal matters involving lending and securities.



CHRIS W. ANTLEY is Senior Vice President for CCM Investment Advisers. He joined the firm after graduating from the Honors College of the University of South Carolina in 1988 and then receiving his Master of Business Administration degree from the University of South Carolina in 1990. While at CCM, Mr. Antley has worked in all areas of investment management, including corporate accounting, portfolio accounting, quantitative modeling, asset allocation, macro-economic research, equity and fixed income fundamental research, and portfolio management. Mr. Antley serves as Chief Equity Strategist for CCM and is responsible for development of the CCM Equity Model. His individual areas of fundamental research include the technology and retail sectors. Mr. Antley also has responsibility for the management of client portfolios, marketing support,

and oversight of information technology, portfolio accounting and administration for CCM.

**(YAR500) TWST: Would you begin with a brief overview of CCM Investment Advisers and tell us what you both do there?**

**Mr. Key:** CCM Investment Advisers has been in business since 1986. We were originally founded as a Registered Investment Adviser subsidiary of an insurance company, so that the firm could

manage outside accounts. We've since grown from that point. We originally had \$60 million in assets, and currently have approximately \$1.4 billion in assets under management. Incidentally, when we spoke last year we had about \$1.1 billion in assets under management, so we've enjoyed some growth since that time.

We offer three basic products: a core equity product that has a relative-value tilt; a core fixed income strategy; and a balanced strategy that is a combination of the two with a tactical asset allocation wrapper on top of the two products.

I serve as the fixed income strategist for the firm, responsible for overall fixed income policy, and also carry research responsibilities in four equity sectors. We split up our equity universe into 15 economic sectors and have four analysts covering each of the 15 sectors. I also carry some marketing responsibility.

**Mr. Antley:** I've been with CCM 15 years and serve as the Chief Equity Strategist for the firm. The bulk of my work here is on the analytical and investment side of the business.

would then balance the portfolios based on their overall asset allocation risk tolerance and our tactical position.

Currently we're modestly overweight stocks, in the 10%-15% range, as compared to our baseline asset allocation. That's not so much a function of a very strong belief in a very positive outlook for the stock market as much as it is due to our being perhaps a bit bearish on bonds. Chris will get into that a little more as we talk about the equity product. But at this point we're modestly overweighted in the equity arena.

**Mr. Antley:** It's a very interesting situation right now. It may sound counter-intuitive, but we're actually trying to play a good defense by being overweight on the equity side of the portfolio.

*Antley: Due to valuation issues, we haven't had a chance to own Cisco shares since well before the tech bubble. Despite the fact that Cisco's growth prospects are significantly higher than the market, the stock is only trading at a slight premium to the S&P 500, and actually is in the 97th percentile of normalized p/e relative to its peers. In a nutshell, Cisco is a very attractive stock with little downside risk.*

**TWST: Do you wish to talk about your balanced portfolios? Is that the focus you want to concentrate on?**

**Mr. Key:** We can certainly do that, and we should certainly spend some time on the equity product too. We've had good success with that.

Let's talk about the balanced product first. I'll give a little recap on how we go about developing it, and then we can drill down into the subsidiary products.

Starting with the tactical asset allocation wrapper that we put on the balanced product, we've been doing studies since the foundation of the firm on the relative value of stocks and bonds, and that relative value concept is a consistent theme throughout all of our strategies. Our strategy concerning the relative value of stocks and bonds incorporates the expected return for the fixed income market versus the expected return for the equity market. We have tracked the disparity between those two returns over time and have developed a solid baseline of data. Periodically we compare the current expectation disparity to the historical return disparity to give us an indication as to which asset class we want to overweight. And as backup for that study we also look at the Fed valuation model and then do some fundamental forward-looking analysis just to ask whether the conditions that we see upcoming fit what our data suggests we may see. And based on that collective wisdom, we will make an asset allocation decision for our client portfolios.

We offer several different basic asset allocations for our clients, depending on their risk tolerances that we would ascertain through an initial interview and investment policy drafting stage. We

1-Year Daily Chart of Cisco Systems



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: Does your investment process require a top-down approach before you make the selection of equities?**

**Mr. Antley:** As always, the most important variable for the markets is the economy, so we do overlay a top-down approach to our selections. But when it comes to finding the names to fit the picture, we use a bottom-up approach to security selection. So, technically, it's a bottom-up approach with a clear view of the top.

Starting from the top, the fundamentals for the economy remain very solid. On the consumer side, the labor markets continue to

improve and wages are growing faster than inflation, not to mention the growing wealth effect via stocks and bonds and, importantly, the real estate market. As we saw in last week's Purchasing Manager Survey, the manufacturing sector is on a strong footing as well, and indications are for 4%-5% growth in that sector, particularly in light of the weak US dollar.

In summary, we foresee 3.5% to 4% economic growth this year, but there are some risks to the forecast, primarily rising interest rates, inflation, and oil prices. Of course, the three are highly correlated, but the most significant is the prospect of rising inflation as the year progresses.

The move toward globalization should temper prices, but strong domestic demand with tight labor markets and slowing productivity should drive inflation to over 3% for the year. We believe this will be a big surprise for the market, where inflation expectations remain very low, and ultimately will lead to rising interest rates across the yield curve, with the 10-year trading around 5.25%-5.5% by year's end. Obviously this scenario won't be kind to bond investors, and of course it will raise the bar for stocks as well. What we're hoping for is corporate profits to again surprise on the upside, but we're most likely looking at more "normal" returns for stocks this year, something in the neighborhood of 8%-10%.

*Key: There is some room for further flattening, but we don't think that's going to be the case. What we see is a 30-year Treasury that's a bit too rich at this point. We think it's going to move up just a little relative to the 10-year, and we'll see perhaps more of a shift, but not a dramatic change.*

**TWST: You said that you had received a lot of new inflows over the past year. Are these investors attracted to the balanced portfolio idea? Are they mostly risk-averse, or is it because of your fine performance?**

**Mr. Key:** I'd say that it's probably a combination of the two factors. The equity performance has been very favorable, particularly on a risk-adjusted basis over the last five years, but the balanced performance has been similarly very positive. So I would say that investors are attracted not only by the absolute positive relative strength, but our history and reputation as being a risk manager first, and then an absolute return seeker second. The horror of the 2000-2002 bear market still weighs heavily on investors' minds, and the attraction of a conservative manager, particularly in a market where I think there is general agreement that the outlook is not for a return of the ripping, snorting bull that we saw in the late 1990s. I certainly haven't seen anybody advocating that kind of position. In that sort of environment I think investors are certainly cautious and attracted by the cautious reputation of our strategies.

**TWST: You had a good performance in 2003 and last year you said you were expecting more normal returns. How did you fare in 2004?**

**Mr. Key:** The Core Balanced product, which is benched against a 50% stock/50% bond benchmark, was up 12.1%. The benchmark was up 7.6%, so we had roughly 4.5% relative strength.

**Mr. Antley:** There is one thing interesting about our balanced performance. Throughout the year we were very defensive on the fixed income side of the portfolio and didn't participate fully in the unexpected rally there. We made up the ground on the equity side. We were overweight in our equity holdings, and as far as selections were concerned we had another great year. For our equity composite in 2004, actual returns were 15.4%, versus 10.8% for the S&P 500. So it was another strong year, and we're off to another good start in 2005.

**Mr. Key:** Chris hit on the softness of the bond returns. Our fixed income portfolios were up 2.4% versus the 4.2% for the Lehman Government Credit index and 3% for the Lehman Intermediate Government Credit. So there was a little bit of a performance lag due primarily to our defensive position. There were certainly no problems in the portfolio. In fact, our portfolios are quite clean, which probably played a role in it too, because the lower investment grade credits were a particularly good place to be last year. But

nonetheless, the equity performance and the asset allocation carried the weight for us in the balanced product, and then of course, as Chris said, stocks were good for us.

**TWST: Any fixed income portfolio is going to be driven by interest rate rises. How do you feel those will impact your fixed income portfolio going forward?**

**Mr. Key:** You're absolutely correct. Interest rate movements account for 80%-90% of overall fixed income portfolio performance, period, so any sort of fixed income strategy is going to be greatly impacted by market movements and rates. But over the next year, as Chris said, we are looking for roughly a 1% increase across the curve. We got thrown a little head fake last year, and I'd have to say that we're probably there with 75% or 80% of fixed income managers who lagged last year. We certainly didn't anticipate the curve flattening that we saw last year, but it was there. And, interestingly enough, the longer bonds in the indexes, from 10-30 years in maturity, actually rallied last year when the shorter end of the curve, less than 10 years, had a tougher year. But we don't anticipate that sort of environment in 2005.

Having said that, there is some room for further flattening, but we don't think that's going to be the case. What we see is a 30-year Treasury that's a bit too rich at this point. We think it's going to move up just a little relative to the 10-year, and we'll see perhaps more of a shift, but not a dramatic change. We're just looking for more of a horizontal shift upward, and not in great magnitude. We're not looking for negative total returns in bonds next year, but we're not looking for anything more than just coupon returns.

**TWST: Do you take a long-term investment horizon when you're dealing with bonds and equities?**

*Antley: Further upstream, our most recent addition is Kerr-McGee, a highly diversified exploration company that has done a very credible job of adding to its proven reserves during a period when reserves are becoming an increasingly valuable asset. Like Conoco and Oxy, Kerr-McGee only trades at around 11 times forward earnings.*

**Mr. Key:** Absolutely, and certainly within the fixed income portfolio. You don't see a lot of turnover in the portfolio, because we make a position based on our fundamental economic views, and then we'll stick to our guns until we see a change, something that would alter our opinion. Within the fixed income portfolio we're a fairly low turnover manager, roughly 20% a year.

**Mr. Antley:** On the equity side we've historically had approximately 40% turnover. However, we went through an interesting period last year when we had a valuation "shakeout" in the market. A lot of stocks became overvalued and we took some profits where necessary, and moved into some different sectors, particularly large cap growth. Toward the end of last year turnover did increase, but over the long term we expect turnover of roughly 40%. For taxable accounts, this is accomplished in the most tax-efficient manner that is economically feasible.

**TWST: How often would you consider rebalancing the portfolio? When are the adjustments made?**

**Mr. Antley:** Portfolio strategy is updated each week in our investment committee meeting, but we typically rebalance on a monthly basis if a change is indicated. We are not market timers, and therefore asset allocation rebalances are rarely more than 5% or 10% on the equity and bond side of the portfolio. Within the equity portfolio, we generally will have one or two name changes over the course of the month.

**TWST: Chris, tell us how the equity side of the portfolio is structured now and how its emphasis has shifted since last year.**

**Mr. Antley:** I'll give a broad view of the stock market first and then tell you how we are positioned. The primary theme for this

year's market is a slowing earnings growth rate in the wake of rising interest rates. We're coming off two years of a slam-dunk proposition for the market — a period of historically low interest rates and an extremely powerful profit revival. This year, though, 20%-25% profit growth will be extremely difficult to match, and we are in line with the consensus forecast of 10% earnings growth. Thankfully, price/earnings multiples have compressed significantly, and they appear appropriate based on current interest rates. Of course, that is one of the big risks for the market, that interest rates increase significantly over the year.

1-Year Daily Chart of Kerr-McGee



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

With growth rates slowing, we believe investors will begin to pay a premium for any growth they can uncover, and the best place to search is obviously in the growth sector of the market. Growth stocks have lagged value stocks during the bull market of the past two years, and on a relative basis growth stocks are as cheap as we've seen the group in the past 10 years. We believe growth will outperform this year, particularly in the large cap sector, and that's where we're concentrating most of our efforts regarding new stock ideas. Our typical equity portfolio has a value bias, and with our move toward growth, that's an area where we have shifted.

Regarding another area where we've changed, our equity portfolio is usually comprised roughly of 75% large cap names, 15% mid-cap names, and 10% small cap names. But if you've been watching the market, the relative outperformance of the mid- and small cap names is very obvious. In fact, these names have grossly overrun their true intrinsic valuation, and it's becoming extremely difficult for us to find names for a significant weighting in the mid-cap sector, and we don't even have a small cap name in the portfolio at present.

**Mr. Key:** Even though we talk about the value of growth versus the value of "value," that's not to say we're going to become a large cap growth manager — not at all. It just means that as we drill down into our individual security selections, if our screening process is showing a couple of stocks that are relatively favored as compared

**Cisco** is very interesting at this juncture. Due to valuation issues, we haven't had a chance to own **Cisco** shares since well before the tech bubble. In fact, the last time we held shares in the company was around 1996. But at present levels the stock appears extremely cheap. One of the primary valuation techniques we use in our stock screening process is normalized relative price/earnings, where we analyze a company's multiple relative to the historic channel that the stock typically trades. We then compare that score to those of the company's peers. And despite the fact that **Cisco's** growth prospects are significantly higher than the market, the stock is only trading at a slight premium to the S&P 500, and actually is in the 97th percentile of normalized p/e relative to its peers. In a nutshell, **Cisco** is a very attractive stock with little downside risk.

*Antley: L-3 is one of the leading suppliers of technology to the military in its movement toward "network-centric" warfare. L-3 only trades at a slight premium to the market, despite a growth rate of over 15%, and it continues to be a long-term core holding in our equity portfolios.*

to their peers in a particular industry group, all else being equal, we're going to take the growthier of the two stocks, whereas at another point in time we might have taken the less expensive of the two. So even though we talk about an interest in growth, it doesn't mean that we're going to become a large cap growth manager.

**Mr. Antley:** That's where the bottom-up process takes hold. Certainly from a top-down perspective, large cap growth appears more attractive than the mids and smalls. But when we do our bottom-up work, that's the type of cream that's rising to the top — therefore supporting our thesis.

**Mr. Key:** If you look at our model, average price/earnings ratio and beta, you're going to see that they're less than the benchmarks.

**Mr. Antley:** Currently we're trading at a slight discount to the Standard & Poor's 500 multiple on a forward basis, with roughly the same yield, but sporting a beta of less than 1. So it still is a risk-averse equity portfolio.

**TWST: What are some of the holdings in the portfolio at this time and the reasons why you were attracted to them?**

**Mr. Antley:** At this stage of the market, coming through the two years that we have enjoyed, there aren't that many names that are really jumping off the screen saying, "Buy me." I've mentioned large cap growth, and of course tech stocks and growth stocks are almost synonymous, and we're finding a lot of value in the large cap "go-to" names in tech, such as **Dell** (DELL), **Microsoft** (MSFT), **Texas Instruments** (TXN), and particularly **Cisco** (CSCO). Each of these companies has rock-solid balance sheets and earning growth rates that we believe are sustainable.

1-Year Daily Chart of L-3 Communications



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: How is the technology group as a whole? Is it still rich?**

**Mr. Antley:** I would say as a whole it is rich. We've had a huge run-up over the last few years. It kind of smells like 1999 and 2000, but of course we're not seeing many stocks trading at 50-100 times earnings. I think investors have become much more realistic. But I think there is a seismic shift on the demand side of the equation: corporations want quality, they're looking for one supplier, and they want it from someone they can trust, and they're therefore moving toward the big names. The **IBMs** of the market that run a full-service shop are certainly an attractive business model.

**TWST:** Chris, last year you said your favorite group was energy. Has that changed in your view over the past 12 months?

**Mr. Antley:** There's no surprise that energy stocks have received the bulk of the attention in the market — ever since oil crossed the \$40/bbl threshold — and the stocks climbed 30% last year as a result. We've been overweight in the sector since late in 2003, and it remains our favorite group. Despite the run-up last year and the 20% gain to date for this year, the group still remains very attractive on a relative basis. In fact, the only group in the S&P 500 with a cheaper forward price/earnings multiple is the finance group, and you certainly have to like the prospects for oil versus those for the banks, particularly with the flattening yield curve that Robert mentioned.

*Antley: Anteon provides infotech solutions and engineering services to the Department of Defense, the intelligence community, and the Department of Homeland Security, plus another 600 other government agencies. They have a long-term earnings growth rate of around 18% and currently trade at about 20 times, which is respectable based on that growth rate.*

The path of the group probably won't be without some speed bumps. We believe the price of oil is a bit rich at current levels and will probably cool somewhat due to increasing supply, but longer term you have to like the prospects. The consensus is that oil supplies are intact for the next 50-60 years, but only 5% or so of those reserves have actually been audited. As you know, the Saudis aren't big on transparency, and it's certainly not in their best interest to scare us toward alternate energy sources. So if the actual term is closer to 30 or 40 years, the oil companies with the proven reserves are certainly in a position to profit.

Our favorite oil stocks are **ConocoPhillips** (COP) and **Occidental** (OXY). Valuations remain very appealing for both and both are very aggressive in their push to new discovery areas such as Russia and Libya.

Further upstream, our most recent addition is **Kerr-McGee** (KMG), a highly diversified exploration company that has done a very credible job of adding to its proven reserves during a period when reserves are becoming an increasingly valuable asset. Like **Conoco** and **Oxy**, **Kerr-McGee** only trades at around 11 times forward earnings.

You can pretty much just throw darts in energy and come out with a winner. Everyone in the group has a license to print money with oil trading at current levels, and it's very unlikely that we're going to see \$30-something oil in the foreseeable future, if at all.

**TWST:** Chris, are there any new equities that you've added to the portfolio that you want to talk about?

**Mr. Antley:** One of our new additions comes from the defense sector, a group that we're positive on, and it's **Anteon International** (ANT). **Anteon** provides infotech solutions and engineering services to the Department of Defense, the intelligence community and the Department of Homeland Security, plus another 600 other government agencies. Their products include global intelligence systems, missile defense, modernization of weapons systems, secure identification, etc. They have a long-term earnings growth rate of around 18% and currently trade at about 20 times, which is respectable based on that growth rate. The multiple is also very close to the lower end of their price/earnings range.

1-Year Daily Chart of Anteon International



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

Another of our favorite names in the defense sector, and a name that's been a hold here for some time, is **L-3 Communications** (LLL). **L-3** is one of the leading suppliers of technology to the military in its movement toward "network-centric" warfare. Going back to the World Wars, the overriding goal of the military was to have the ability to fight wars on two fronts at the same time. However, in

today's post-9/11 era, the goal is achieving the ability to deploy segments of the military concurrently, and that puts extraordinary demands on secure communication. L-3 is firmly embedded in this area, and this is not to mention their work in bomb-sniffing technology for airport screening and their unique ability to acquire smaller defense firms and then quickly integrate their products by entering them in the Pentagon's procurement system.

L-3 only trades at a slight premium to the market, despite a growth rate of over 15%, and it continues to be a long-term core holding in our equity portfolios.

**TWST: Chris, have you sold or lightened up on any stocks in recent months?**

**Mr. Antley:** We've been lightening up on some groups, such as financial services and health care, for obvious reasons. But I think a prime example of our sell discipline is **Electronic Arts** (ERTS), which is a name that we mentioned last year during our interview. **Electronic Arts** is the premier gaming software company, and we entered the stock in January of last year and enjoyed a healthy

environment going forward and, as we mentioned, it's probably going to be a more "normal" market in terms of return and volatility going forward.

**Mr. Key:** I might add that we think we're in a period of "normal" equity returns for a number of reasons and we don't see this changing for the next three to five years. We don't think stocks are expensive, but certainly they're no bargain at this point. Because of that and because of some increasingly difficult comparable earnings figures, we anticipate relatively normal earnings growth over the next two to three years. That manifests itself very nicely for active management. We do not see a return to, as I said, the raging, snorting bull that we saw in the late 1990s, and we'll be very pleased, particularly in a low inflationary environment, with 8%-10% returns. I think investors are well rewarded with that sort of progress in their portfolios. But the point is that this is a stock-picker's market and it is a time to very carefully choose the holdings that in your portfolio. This market will reward a disciplined process of selecting attractive equities.

*Key: The challenge is that many investors need to have fixed income exposure. So we have to search out where we find the value in the fixed income environment. At this point it's very difficult when fixed income investors ask us, particularly retirees who live on their investment portfolio, what kind of yield can I expect out of a fixed income portfolio? And you have to honestly look them in the face and say, "4%," and that's not very exciting.*

ride. But in the fourth quarter of last year, the stock went on a tear and climbed almost 40% in a period of three months, and the valuation got well ahead of itself. If there was a very strong fundamental story, we might allow the valuation to overshoot by, say, 10%, but we had a much more significant expansion in the multiple for **Electronic Arts**. Based on the fact that it's high-risk stock to begin with, we felt that it was time to take profits.

**TWST: Last year we talked about volatility. The market has been pretty calm, but how does the volatility affect your decision-making process with equities?**

**Mr. Antley:** I think management of volatility is embedded in our process due to the fact that we are so broadly diversified. We typically hold 40-50 names in an equity portfolio and diversify those names broadly across 15 industry groups. Clearly, as you mentioned, market volatility has decreased. We've had some compression in valuations in the heady, growthier names, and they're trading at more "normal" multiples now. So we're expecting a more stable

**TWST: What is the credit spread outlook for the fixed income portfolio?**

**Mr. Key:** We've had a nice run in the credit space over the last three years. Up to this point we had been overweight the credit sector in our fixed income portfolios. We've brought that back to a market or slightly under market weighting relative to the benchmark. We don't see spreads dramatically opening up, because in fact the economy looks strong. We're starting to get a little late in the cycle, but we don't think we're so late in the cycle that there is any sort of credit scare on the near-term horizon.

For that reason, we are relatively close to the benchmark weightings in the credit sector, and at some point we will underweight those. But in this very low absolute yield and return market for fixed income investors, if you can pick up an extra 75-100 basis points for reasonable risk in the credit sector, we think it's worth having exposure. It's not so cheap and the value is not so compelling that we would want to strongly overweight in the credit sector though.

**TWST: Chris, what about the yield factor with equities? Are you more interested in dividend-paying stocks these days?**

**Mr. Antley:** Slightly. Many investors have been lured to dividends like moths to a flame, but you have to realize that once the dividend is paid, it's deducted directly from the company's market value and therefore comes out in the wash, if you will. You've seen a reaction from the corporate boardrooms and they definitely have a predisposition in favor of dividends. Of course, we all witnessed the bombshell payout from **Microsoft** last year. It's something that's more of a trend that all investors on the equity side will enjoy, but it's not something that we're going to blindly pursue. If we were, we'd be 100% utility stocks by now.

**TWST: Do you want to mention your other products and services at CCM?**

**Mr. Key:** We've covered the balanced, the fixed income and the equity products. We're primarily a money manager. For some of our individual clients, and that's a very small universe, we will engage in some overall financial advisory capacity, but we'll stick pretty slavishly to our knitting, and that is, one, developing a portfolio strategy, and two, executing that strategy through good investment ideas.

**TWST: What is distinctive about the investment approach at CCM that makes you special or different compared with your peers?**

**Mr. Key:** I think there are a couple of things that make us unique. Chris has talked about the relative value of growth and value, and one of the great discoveries of modern equity research has been the return explanation provided by price to book measurements. That discovery is seen in the Barra research in which you have the Barra value universe and the Barra growth universe. One of our studies compares the valuations of value stocks versus the valuation of growth stocks. An unfortunate manifestation of the price to book value research has been that managers are now categorized as value managers or growth managers. You get in that box and you're in the box, regardless of where the market is headed.

We would overall classify ourselves as a core manager with a value tilt. We think the fact that we examine the growth characteristics of stocks in our valuation process does make us unique. We're not slaves to buying low p/e stocks, as you might see with more classic value managers, but we're certainly not interested in jumping on the train and buying high momentum stocks, as you see with many "growth" managers. However, we're not ignorant of the fact that earnings growth is important in stock valuation.

**TWST: If the outlook is good for both stocks and bonds going forward, presumably a portfolio will do well on its own. But what are the challenges that you see ahead in fixed income and equities?**

**Mr. Key:** Clearly the biggest challenge in the fixed income world is the absolute low yield environment in which we live today.

We're at the end of a 20-year secular bull market in bonds. Back in the very early 1980s, we had a 15% long bond, but today we're at a 4.8 yield on the long bond. The question becomes, how much lower can rates go? We're in a very favorable inflationary environment. If you look at CPI, you're anywhere from 1% to 3% on an annualized basis, and of course that shifts around from month to month. Say that CPI is running at 1.5% or 2%. How much additional total return can we get out of a bond portfolio due to favorable interest rate movements? It's an asymmetrical investment opportunity or profile that we see at this point. The odds are not very favorable for much of a rally in bonds through lower interest rates. There's a much higher probability of a higher rate environment, which would be a negative for fixed income investors.

The challenge is that many investors need to have fixed income exposure. So we have to search out where we find the value in the fixed income environment. At this point it's very difficult when fixed income investors ask us, particularly retirees who live on their investment portfolio, what kind of yield can I expect out of a fixed income portfolio? And you have to honestly look them in the face and say, "4%," and that's not very exciting.

**Mr. Antley:** I think Robert covered the key issue for the equity market: rising interest rates. I've already used the analogy that rising interest rates raise the bar for the stock market, and the only way for them to make the jump is through earnings growth. Unfortunately, we're in a period when growth rates are declining. We've enjoyed two really fine years, and comparisons are going to be difficult going forward. So the real issue here is how high interest rates are actually going to go and what's going to happen with corporate profits. What we're hoping for is, again, earnings growth in the 10% range and for that to be enough to support the market with the new valuations that will be implied by higher interest rates.

**TWST: Thank you.**

*Note: Opinions and recommendations are as of 3/14/05.*

ROBERT F. KEY  
CHRIS W. ANTLEY  
CCM Investment Advisers  
1201 Main Street  
Suite 1910  
Columbia, SC 29201  
(803) 254-9500