Commentary - 1st Quarter 2006

It seems like just yesterday that we were writing about the boring returns in the financial markets during 2005. Well, 2006 started with a bang. The Dow Jones Industrials and the S&P500 gained over 4% in the quarter and the small cap indices reached all time highs, with the Russell 2000 Index rising over 13%. The stock market may surprise us this year with double digit gains like we got used to during the roaring 1990s bull market. We think the odds favor a good year, but there are still plenty of hurdles.

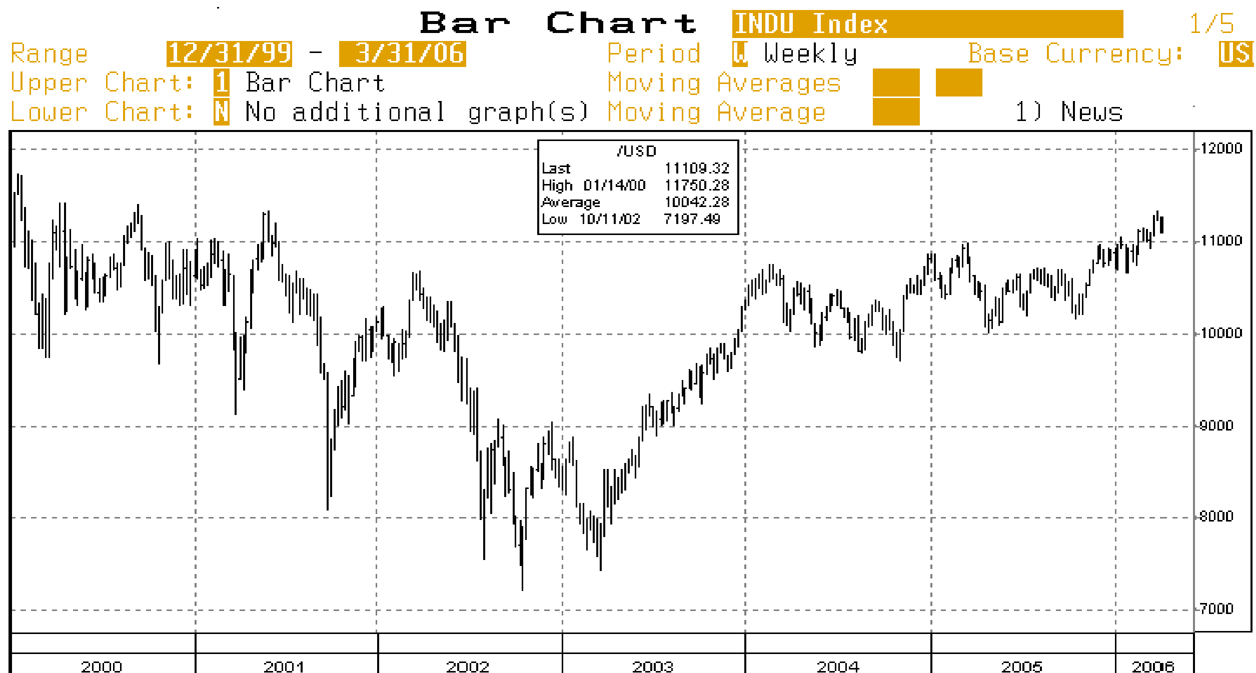
On the plus side of the ledger, the economy is in good shape with economic growth rebounding from the weak 4th quarter of 2005. First quarter GDP looks like it could hit 4.0%. The unemployment rate remains near historical lows. Consumers are adjusting to high energy prices and their spending is buoyant. Personal incomes are growing as the labor market tightens. And the housing sector seems to be losing some of its froth, taking away a reason for the Federal Reserve to keep raising interest rates. It appears that Congress will make another effort to extend the favorable tax rates on dividends and long term capital gains. If this effort succeeds, it should give another boost to the market. On the other hand, we still see some serious concerns such as the turmoil in Iraq, nuclear confrontation with Iran, an easily spooked energy market, rising precious metals prices (a sign that inflation could still take off), and the protectionist reaction against foreign direct investment in U.S. companies that restricts the process of capitalism and free markets. Right now our best guess is that we are back in the "Goldilocks" economic scenario similar to the second half of the previous decade. The economy is not too hot and not too cold.

Last quarter we discussed the implications of the inverted yield curve in the Treasury bond market. Recently, the yield curve inversion has dissipated, with longer term interest rates rising slightly more than short term rates. The money markets are currently predicting that the Federal Reserve will raise the Fed Funds rate again in May to 5.0%. We think the Fed is pretty close to completing their interest rate increases. Since the housing sector has cooled and energy prices seem to have found a trading range, the Fed may be more likely to take a breather after raising rates to 5.0%. Once the stock market perceives that the Fed is cooling

its heels, we could see a powerful rally since we do not expect a five percent Fed Funds rate to cause major disruptions in the credit markets. The Fed will have to remain vigilant for rising inflation pressures, but their previous tightening moves should keep a lid inflation.

As shown on the graph below, the Dow Jones Industrials are about 5.7% below their all time high reached in January, 2000. Six years is a long time to make a recovery, but that points to how overvalued the market was before the bubble burst. Currently the market trades at a much more reasonable price to earnings ratio of 15.6 times estimated earnings versus a ratio of almost 30 times earnings during the boom times. The market has a more normal downside risk of ten to twenty percent if some unforeseen event occurs, whereas when the market was trading at its all time highs in 2000, it had the potential to decline fifty percent.

Chart 1. Price History of the Dow Jones Industrial Average. (Source: Bloomberg)



Here's how our various asset class strategies performed in the first quarter.

Large Company Stocks: The Blue Chip Strategy rose 4.64% in the quarter versus the S&P 500 Index gain of 4.28%. The holding with the largest gain was Caterpillar, up 25%. The poorest performer was Intel, falling 22%. Caterpillar is benefiting from a substantial increase in infrastructure construction projects globally which require heavy construction

equipment. Intel announced that their first quarter sales were not going to meet expectations as competition from Advanced Micro Devices caused them to lose market share. Even General Motors bounced back 10% in the quarter as they raised liquidity through the sale of some overseas operations and parts of GMAC. ExxonMobil reported record earnings for the year ending December 31, 2005 and a record for any publicly traded company in history. Earnings for 2005 reached $36.1 billion. Wouldn't you like to earn the interest on that?

We still expect large cap stocks to take over market leadership (eventually we'll be right). With the global economy exhibiting sustainable growth and potential for a weaker dollar when the Fed stops raising interest rates, large company stocks are poised to continue their earnings growth. The surge in mergers and acquisition activity illustrates that bargains or opportunities are still available in the market.

Small Company Stocks: Our Small Cap Value strategy gained 8.13% in the first quarter. Normally that would be reason for celebration, except that our benchmark index, the Russell 2000, rose 13.65%. As many of you have experienced, our small cap strategy's returns can be lumpy and we fully expect to catch the Russell 2000 this year. The best performing company in the small cap portfolio was American Pacific which rose 33%. Investors see potential growth in earnings and cash flow from last year's purchase of the pharmaceutical chemicals business of Gencorp. Hawaiian Holdings, the holding company for Hawaiian Airlines, was a close second gaining 30% in the first quarter. Hawaiian is benefiting from stronger passenger demand and rising ticket prices. The worst performer in the portfolio was ABX Air whose earnings did not meet expectations for the fourth quarter. ABX Air also announced that DHL was modifying their contract and reducing the services that ABX provides. Ironically, this announcement came less than a week after Barron's wrote a positive article on the company. We recently sold our position in Education Development Corp. as we were disappointed in their earnings growth. We added two new positions during March: Meridian Resources and Universal Corp. (Brett's Research Summary is enclosed for both companies for clients in this strategy.) Meridian Resources is an oil and gas exploration company, headquartered in Houston, Texas with most of its operations located in the marshland and offshore Louisiana. We have been waiting for an opportunity to purchase this position for a while. The company trades at a discount to their SEC reserve valuation, has paid down

debt, and is spending greater amounts on finding new reserves. Universal Corp has operations in building products, agricultural products, and leaf tobacco processing. We have followed them since 1998 when we had a position in Standard Commercial Corporation, another tobacco processor. Universal faced some temporary operating issues last year that reduced earnings. They recently announced that they have received inquiries regarding the potential acquisition of their building products business from outside parties. They pay a 4.68% dividend yield and should show improved earnings this year. As you may have noticed, three of our five most recent purchases for the small cap strategy pay attractive dividend yields. We like companies that offer cash returns to their shareholders if they cannot find efficient, profitable ways to employ their retained earnings.

Convertible Securities/High Yield: The Convertibles strategy rose 7.56% in the first quarter versus a 5.40% gain for the Merrill Lynch Convertibles Index and a 2.85% increase in the Merrill Lynch High Yield Index. We benefited from a recovery in our Callon Petroleum position of 19% and our Continental Airlines bonds gained another 23%. Penn Treaty, a long term care insurance company, was the weakest performer in the portfolio, falling 8% after announcing they would take a charge to increase reserves. There only new position added during the quarter was the Echostar Communications bond that we bought in early January. ETrade recently called their convertible bonds, and since the conversion value is higher than the call value, we will be converting our bonds into stock and maintaining that position. One of our long-time holdings, Inland Fiber Group (formerly U.S. Timberlands), announced an agreement that was reached with the bond trustees to repurchase their outstanding bonds at $690.00 per $1,000 face value. This resulted in a 15% gain in market value for our position. We are still seeing 6.0% to 8.0% yields in the market and are closely monitoring a few situations that may be attractive additions to the portfolio. We do not foresee a substantial widening in credit spreads since the economy is still relatively healthy.

Intermediate Bonds: Our Intermediate Bond Portfolio rose 1.01% versus a decline of 0.32% for its benchmark – the Citigroup 1-10 Year Government/Corporate Index. We benefited from a recovery in our GM bond position and the short average maturity of our portfolio. We have been adding short term Federal Agency securities and are looking for long maturity corporate bonds with short term put options. The Intermediate Tax Exempt Bond Portfolio rose

0.32% for the quarter outgaining the Merrill Lynch 3-7 Year Insured Bond Index that fell 0.07%. We are starting to purchase longer maturity municipal bonds near the 4% yield level after keeping our purchases shorter than two years for the last few quarters. We expect the Fed to raise rates one or two more times and then take a break. We are looking for opportunities to extend the average maturity of our portfolios, but we are being very selective.

Sometimes we like to express a little editorial commentary in our quarterly letters, so here goes. The issue that seems to top everyone's list of concerns is rising health care costs. There are many different views on how to limit costs and increase the number of people covered by health insurance. When you step back and look at the big picture, the real reason that healthcare costs rise faster than other sectors is because it is not a free market. The consumer does not know what he is paying for because third party insurance companies make the payments. Healthcare service providers do not publish the costs of their services to the consumer. No wonder costs are out of control when the consumer does not have any control over the transaction. Why can't the Wal-Mart approach of "Everyday Low Prices" be applied to the healthcare sector? Allow healthcare providers to compete based on price and service quality. Put the decision making responsibility back in the hands of the consumer with the insurance company providing a "line of credit" for major expenses. We think you would find that competition would work in this sector too. For that matter, someone should propose that Wal-Mart start their own hospital system that applies free market economics. No one handles inventory and purchasing better than Wal-Mart, and they now how to tweak their prices to maximize sales and profits. The key is pricing transparency and competition. Just an idea, but the current system is a mess and too many universal health ideas are being offered that limit consumer choice and maximize bureaucracy.