

LETTER FROM THE PORTFOLIO MANAGERS

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It's Easy to Be Negative, And That May Be A Positive



Eric M. Kobren

It's easy to be negative. With energy prices and geopolitical tensions running high, and with housing and the economy starting to slow, is it any wonder that consumer and investor confidence levels in recent weeks are at low levels?

Yet, our recommendation has been to stay the course. As we mentioned last month, some individual investor sentiment surveys were at their lowest (most bearish) levels in years. To us, that was a contrarian signal. August ended up being the 2nd best month of the year for the S&P 500 with a 2.4% gain (it was up 2.7% in January).



Rusty Vanneman

Also, despite a general sense that the market really hasn't done much this year, it's fairly remarkable to note that the S&P 500 has been positive in 7 of the 8 months so far in 2006.

Seasonal Patterns

We have been hearing a lot about "bearish seasonals" from clients and prospective clients, and we have talked about them ourselves. To note, since 1900, the Dow Jones Industrial Average typically has had its worst month of the year in September. The average return in September is -1.2% (February and May are the only other months with negative averages – at a mere -0.1%). September is also the only month that is positive less than half of the time (41%). In sum, September is typically not a friendly month to stock market investors.

Yet, as with all rules of thumbs and averages, they are not infallible. The last two Septembers have been positive. Nonetheless, there has been hesitation on the behalf of some to invest in the market because of this bearish seasonal pattern. While those investors could be right this year, it could be argued that September is actually the BEST month of the year to buy the market.

First off, buying on price weakness – when stocks are on sale – is better than buying them when they have already risen. Second, the fourth quarter of the year is typically the strongest of the year. For example, a glance at the table to the right shows just how important the fourth quarter has been over the past five years to the full year's result.

	S&P 500 Total Return		
	4th Quarter	Full Year	ex-4th Quarter
2001	10.7	-11.9	-20.4
2002	8.4	-22.1	-28.2
2003	12.2	28.7	14.7
2004	9.2	10.9	1.5
2005	2.1	4.9	2.8

Wall of Worry

So why is the stock market making gains when the housing market is slowing, oil is still around \$70 a barrel, no solution seems clear in Iraq, terrorism is disrupting our lives and Iran and North Korea are rattling their nuclear sabers?

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Interestingly, the stock market often posts gains in angst-ridden environments.

In fact, it is so common that Wall Street has a phrase for it; climbing a “Wall of Worry.” Today it’s not too difficult to dream up scenarios of the future that look sort of scary. Yet, the market is currently on track to post its fourth consecutive positive year (knock on wood).

Another example of climbing a wall of worry is the 1950s. That decade was one of the best decades to own stocks, but from a geopolitical basis everyone was scared of nuclear war. Remember all the school drills where you had to run into the bomb shelter or hide underneath your desk?

Housing

Housing is indeed a concern to us. If housing really does flip over hard, then it’s no reach at all to think that consumer spending will also turn lower. How deep can the correction be? While some suggest that housing could have a soft landing, soft landings are usually built on the back of hope and not hard data.

Nonetheless, some of the crucial variables to housing are the general level and trend of interest rates. Currently, with the Fed on hold regarding short-term rates, and with longer-term rates a half a percentage point off recent highs, the interest rate backdrop is more favorable for housing and consumers than it was a few months ago. In addition, in an historical context, the absolute level of interest rates is not high — either in nominal or real (inflation-adjusted) terms.

Another encouraging sign to us is that the stocks of homebuilders, which have lost approximately half their value over the last 12 months, have actually stabilized and risen a bit in recent weeks, just when the news on housing has been its darkest. Typically, if a security or market holds up well when the news is bad, that generally means that better prices are ahead for that particular security or market.

In sum, the impact on the economy and markets of a deep and prolonged slump in housing remains a concern and we will continue to look for signs that things are getting better or worse. But right now, the news is not all bad.

Peter Lynch’s Eight Rules

In recent commentaries, we invoked some of the sage advice from legendary money managers such as Sir John Templeton and Warren Buffett. For good reason, their writings and actions have influenced the way we think about managing money.

Another is Peter Lynch, who achieved his fame by averaging a return of 29% per year running the Fidelity Magellan Fund from 1977 to 1990. Peter’s approach was opportunistic, he turned over “lots of rocks”, and his portfolio was widely diversified.

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At an investment conference in New York City well over a year ago, Peter provided some of his rules for investing (our comments in italics):

1. Know What You Own
Do your homework
2. It is Futile to Predict the Economy, Interest Rates and the Stock Market
Diversify broadly
3. You Have Plenty of Time
Be patient
4. Avoid Long Shots
Invest, don't speculate
5. Good Management is Very Important and Buy Great Businesses
Meeting with management is important
6. Be Flexible
Be humble and adaptable
7. Knowing When to Sell is Hard
Have a sell discipline

And perhaps most important, and appropriate, for today's environment ...

8. There is Always Something to Worry About
Yet, the market has a powerfully positive history! As Peter has said, forget about all the bad news because the crucial variable to good investing is not having great intellect, but having a strong stomach.

Sincerely,



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