
LETTER FROM THE PORTFOLIO MANAGER

January 9, 2006

Surprise, Surprise



Eric M. Kobren

Last year, as has now become our custom, we listed several potential “surprises” to the consensus view of the investment landscape. To be considered for inclusion on our list, the particular event must, of course, be outside of the consensus, but it also must have a reasonable chance of occurring — at least in our minds. And in fact, we do take each of these potential surprises into account when developing our asset allocation strategy.

Sometimes these surprises actually reflect our view and we position our portfolios to reflect that. Others may not reflect our actual view, but they certainly influence our assessment of the risks to our asset allocation strategy. And they are definitely issues that we monitor closely as the year progresses.

Before I outline the potential surprises we see for 2006, let’s review our 2005 surprises.

- **The dollar gets stronger.**
Result: the buck was up nearly 13%
- **The stock market disappoints.**
Result: the Dow Jones was up (including dividends) only 1.7%, the S&P was up 4.9%, and the NASDAQ was up 2.1%. All well below long-term averages.
- **Large caps outperform small cap stocks.**
Result: The S&P 500 was up 4.9% and the Russell 1000 was up 6.3% (both are common benchmarks for large cap managers) while the Russell 2000 (small cap benchmark) was up 4.6%.
- **Long-term interest rates don’t move higher.**
Result: although short-term rates did move higher, long-term rates did not. The long Treasury bond interest rate (proxy for 30-year bond) actually dropped from 4.82% to 4.53% while the 10-year Treasury did increase in yield from 4.21% to 4.39%.
- **Potential Recession in late 2005 or early 2006.**
Result: well, we still have early 2006 to see a recession, but it appears that this call was off the mark.

All in all, we were pretty fortunate last year. What’s in store for 2006? What would qualify as a surprise, at least to most people on Wall Street?

The Economy Slides Into A Recession

For starters, we’re going to stay with the one surprise from last year that hasn’t worked out yet: a recession in the economy in 2006. While we are not positioning our portfolios for a recession, we are positioning them for a slower economy than most expect. To be fair, the economy has displayed a fair amount of steady economic momentum in recent years. In fact, economic growth as measured by real

Continued ...

GDP, or corporate earnings growth, have each witnessed the most consistent above-average quarter after quarter growth in decades. Nonetheless, some of the leading reasons for this growth have now been diminished, including low short-term interest rates, low energy costs, and massive fiscal and monetary stimulus from the government. Interest rates and energy costs are now higher, and while this sometimes takes a few quarters to start impacting the economy, eventually they do bite. The debt-laden consumer is already vulnerable to softening housing prices.

In addition, there has been a lot of talk lately about the yield curve getting flat or even inverted (when long-maturity bonds are lower in yield than short-maturity bonds of the same credit quality), with most of the discussion centering around why the market signals from a flat yield curve (typically bearish) are no longer as effective. While some of these arguments have merit and suggest that the economy doesn't necessarily have to go into a recession, it should be pointed out that an inverted yield curve has actually predicted a *profit* recession 100% of the time.

Once Again, The U.S. Stock Market Disappoints

Partially due to our view of the economy, we believe that the stock market will disappoint most of Wall Street, again. From a contrarian standpoint, it is interesting to note that Wall Street strategy allocations are very bullish in the aggregate, with some of the highest recommended equity allocations in recent years. This is the case despite three years of consecutive gains, valuations still being high, earnings peaking a few quarters ago, unfavorable liquidity conditions, and short-term interest rates being substantially higher than they were a few years ago. Granted there are some clear positives as well for the stock market, but it appears that most of Wall Street is emphasizing those factors more than the not so positive factors.

Of course the market can go up short-term, or a sell-off could create buying opportunities, and stocks still appear to provide the best long-term total return prospects. But, we just think that, in general, expectations remain too high for the U.S. stock market.

This Year, The Dollar Does Worse Than Expected

Despite the strong gains in the dollar in 2005, we think that the dollar will do worse this year than many market analysts think. First and foremost, the U.S. still has substantial trade and federal budget deficits. Typically, these are reconciled through a weaker currency. In addition, a big plus for the dollar last year was global interest-rate trends. In the U.S., short-term interest rates essentially doubled while the rest of the world's short-term rates remained basically the same. When this happens, it makes U.S. bonds and notes relatively more attractive than foreign bonds, thus attracting foreign capital into U.S. investments and therefore, the dollar. At this point, however, there are hints that the Federal Reserve may soon end their round of interest rate hikes, while at the same time central banks across the world are suggesting that rate hikes may be in the offing. In the absence of the favorable interest-rate trends, the emphasis very well could go back to the twin deficits. All else being equal, a weaker dollar means that international investments should do better than domestic securities.

Continued ...

The Energy Sector Will Remain Strong

At first, it may not seem so contrarian (and may even appear to clash with our typical valuation-driven approach, given the strong gains in this sector in recent years) to say that the energy sector will continue to do well, relative to the rest of the market. Yet, most market forecasts on crude oil are for lower prices in 2006 (there are some exceptions of course). Stock prices generally reflect these lower estimates. Even with these relatively low crude oil price estimates, energy companies are still expected to display strong earnings growth. What would energy stock prices actually do if energy prices hold steady at current levels – or go up? Another positive factor for this industry is that the high cash levels on many energy company corporate balance sheets will likely lead into significant mergers and acquisition activity.

Inflation Will Be Less Than Expected

Given that we are bearish on the dollar, and not bearish on energy prices, one might expect that we think inflation will increase in 2006. While we are concerned that inflation could uptick (then again, we always are), we generally disagree with the typical economic forecast on inflation. We think Wall Street inflation expectations are too high. As mentioned above, we are in the camp believing that economic growth will soften in 2006. This should keep the edge off of wage pressures and the ability of many companies to raise prices. Also, the largest capacity expansion in the global economy in our lifetimes (think China and emerging markets) should continue to be at least *disinflationary* (if not deflationary). Lastly, the economists and market strategists may say one thing about inflation expectations, but the markets say another. Absolute long-term interest rates (which are low), the yield curve (flattish), and break-even yields (the difference in yield between Treasury Inflation Protected Bonds and nominal Treasuries is low) all suggest low inflation expectations.

At this point, we would like to point out that there are probabilities and possibilities. While we think it is more likely than not that inflation will be contained, if not drop, we do recognize the possibility that we could be wrong. As a result, we continue to pursue some positions in client accounts that would benefit more in a reflationary environment (such as TIPS). We like to think of it as buying a little life insurance, though we intend to be around for awhile.

High quality should outperform low quality in 2006

Given a potentially softening economy, combined with companies not being able to raise prices, it is likely that companies more levered to the economic cycle will underperform less cyclical companies (energy being the exception). Not only does our fundamental view support the notion that high quality companies/securities should outperform low quality companies/securities in 2006, but so do valuations. In equities, where most relative valuations differentials are reasonably tight between conventional classifications of value vs growth or large cap vs small cap for instance, the relative valuation difference between high quality companies (typified by low debt ratios, high profitability, and stable earnings streams) and low quality companies is at multi-decade highs. Not only do we see relative value favoring high quality companies in the

Continued ...

stock market, we also see it among fixed income securities with high-yield bonds looking very rich relative to government bonds.

Geopolitical risks will reassert themselves in 2006

Surprisingly, most 2006 outlooks rarely talked about geopolitical risks. In past years, it was one of the first things that the annual outlook pieces addressed. Nonetheless, what has really changed, except that nothing has directly impacted our economy or markets in a few years? While we won't predict that something tragic will happen, we will go with the assumption that geopolitical headlines will reassert themselves as market factors in 2006.

The Biggest Risk To The U.S. Market Is Political, Not Economic

Another bullet point missing from most outlooks is that perhaps the biggest risks to the markets in 2006 are political and not economic. Populist campaign strategies appear to be emerging for the year's mid-term elections. Generally speaking, trade barriers, for instance, are not positive to economic growth. In addition, what happens if the dividend tax cut is removed? In sum, the political landscape will also become a factor this year.

What Is Not A Surprise: The Value Of Diversified Portfolios

If conventional stocks and bonds have below-average returns moving forward, the classic investment strategy of maintaining a diversified portfolio remains a prudent course of action. A diversified portfolio should have an appropriate mix of asset classes, including stocks, bonds, cash and alternative investments. Each asset class serves a role in a well-diversified portfolio. As for what determines if an asset allocation is appropriate, it first and foremost depends on a particular client's unique investment objectives and risk tolerance and secondarily it depends on market conditions.

In a lower return environment, there are additional ways to add incremental return. First, attempt to identify superior money managers. Second, utilize a larger investment universe, including the use of unconventional investments. Third, shift asset allocations in a disciplined and gradual manner depending on market conditions. Lastly, pay attention to costs, including transaction and tax costs.

Again, thank you for your confidence. If you have any questions, please feel free to contact us.

Sincerely,



Eric M. Kobren
President
Portfolio Manager



Rusty Vanneman, CFA
Director of Research
Co-Portfolio Manager