LETTER FROM THE PORTFOLIO MANAGER

April 7, 2006

Do The Best Stocks Come In Small Packages?

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The stock market had another fine quarter to start off the year. We participated in the market's gains, but continue to remain cautious of the market going forward due to a variety of mixed market factors.

For instance, corporate earnings are above-trend, but likely to weaken. Interest rates are low, but have risen of late. Valuations have improved a lot in recent years, but still remain elevated compared to long-term measures. Some sentiment measures are clearly bullish, but others are clearly bearish. Cash balances remain high on corporate balance sheets, but other liquidity measures are not supportive. Add it all up, and we remain as before, cautiously optimistic.

More Exposure To Small Caps?

While our portfolios delivered solid gains, driven in large part by our emphasis on foreign securities they would have performed even better had we placed a greater portion of our portfolios in small-cap securities. While domestic large-cap stocks were up a solid 3-4% (depending on the benchmark), small-cap stocks were up a blistering 14% in the first three months of the year. As you know from previous *Portfolio Manager Letters*, over the past several months, we have reduced our exposure to small caps in favor of larger caps.

Should we reverse field and buy more small caps now?

We don't think so. While we still maintain exposure to the small-cap space, we are not comfortable adding to those positions at present. In prior comments, we talked about how large caps generally do better in a slowing economy and in weaker dollar environments (as large companies tend to have international revenue streams while small companies do not). With the Fed hiking interest rates two more times so far this year to 4.75% and showing no signs of stopping there, energy costs holding at high levels, and the housing market beginning to slow, we continue to believe that an economic slowdown is in the cards for the second half of the year.

In the case of the dollar, downward pressure from our twin deficits has been offset by the large interest rate differentials between the U.S. and other developed nations (which causes overseas money flow into dollars to take advantage of our higher rates). But with the ECB and Japan now likely to embark on their own round of rate hikes, that gap should narrow. Also, more countries are announcing plans to diversify their currency holdings away from dollars. In fact, the dollar did decline slightly (1.5%) in the first quarter.

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But another important reason to favor large caps is relative valuations. The table below comes from one of the more astute market observers, John Hussman. In this table, he examines the median price earnings ratio for the stocks in the S&P 500 by market cap.

Median Price Earnings Ratios For S&P 500 Stocks By Market Cap (Largest to Smallest)

Market Cap	March 2000	March 2006	6-Year Change	Discount to Top 50 In 2000	Discount to Top 50 In 2006
Top 50 Stocks	35.6	17.3	-51%	0%	0%
Top 100 Stocks	30.8	18.1	-41%	-13%	5%
Top 250 Stocks	22.9	18.3	-20%	-36%	6%
Bottom 250 Stocks	12.9	18.8	46%	-64%	9%
Bottom 100 Stocks	11.5	19.8	72%	-68%	14%
Bottom 50 Stocks	10.1	20.3	101%	-72%	17%

In March 2000, the stocks with the 50 lowest market caps were trading at 72% discounts to the stocks with the 50 highest market caps. Now, they are trading at a 17% premium! To restate another way, the median price earnings ratio for the stocks with the 50 lowest market caps in the S&P has risen over 100% in the last 6 years while the median prices/earning ratios of the stocks with the 50 highest market caps has dropped 50% during that same time.

Of course, this doesn't mean that large caps will begin to outperform small caps next week or next month. But it does suggest that larger caps have a better risk/reward profile and are more likely to outperform small caps in the coming years.

What Is The Right Small Cap Exposure?

We see a lot of investment portfolios of self-directed individual investors. Some of the portfolios are well constructed. Many of them, however, could be better diversified. Often well intentioned investors think they are properly diversified between large-cap and small-cap stocks by splitting their equity exposure evenly between the two.

The problem, here, however, is that the overall market doesn't break down like that. Looking at the entire stock market by market capitalization reveals that approximately 70% of the overall market is made up of large caps, mid-caps make up 20%, and the remaining 10% is considered small cap. So, in the example above, the investor is actually overweight small caps by 40% (big bet!), underweight large caps by 20%, and underweight what has been the real "sweet spot" of the market in recent years, mid-caps, by 20%. Just missing out on that mid-cap exposure can hurt. In 2005, for instance, mid-caps were up 13%, while large caps were up 4% and small caps were up 5%. It pays to have a truly well-diversified portfolio.

While using this 70/20/10 rule of thumb can be very helpful when constructing a diversified portfolio, remember that each mutual fund is really a combination of various market caps. For instance, the typical large-cap fund has approximately 25% of their portfolio outside of large-cap

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stocks; the typical small-cap fund has about 30% invested elsewhere; and the typical mid-cap fund holds around 40%+ in non-mid cap stocks. In other words, even if you your portfolio is made up of 70% large-cap funds, 20% mid-cap funds and 10% small-cap funds, your actual allocation to those market segments may be quite different, depending on which particular funds you use. Not only does it pay to have a diversified portfolio, but it pays to know exactly what makes up each fund, something we pay a good deal of attention to here.

Why Value Matters

The best argument for small caps at this point is price momentum. The idea of "not fighting the tape" is like Newton's first law: an object in motion tends to stay in motion. Or, using yet another old market cliché, "trees don't grow to the sky." At some point, the small-cap rally will end, and keeping with this cliché-heavy paragraph, given that the rally is now a very mature six years old, it's likely we're in the "late innings of the ball game."

Valuations are tricky, however. One who simply invests based off valuations will typically be early on their market calls, and in some cases, very early. Yet, valuations offer a valuable starting point for working with expected returns. Sticking with the baseball analogy think of a team's roster as their portfolio. Unless you are George Steinbrenner, you have a limited amount to invest in your "portfolio" and you have to decide how to allocate it. One of your players who has performed very well for the past several years is up for a new contract — and he wants a lot of money over several years. He has been a great player no doubt, but is he worth the money he is asking for now, or is it better to invest it elsewhere, that is the tough decision you have to make.

In the case of our home team Boston Red Sox, they faced that decision with Pedro Martinez before last year, and decided the cost was too much and let him go to the Mets. Last year, it didn't look like such a good move -- they were early. But Pedro still has three more years to go on his contract and he is not a young man (in baseball terms) so their valuation call may still prove correct in the end.

Sincerely,

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P.S. If you have any questions on this article, comments on how we can improve our website, service or any other matter, please feel free to call, email or stop by the office.

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