
LETTER FROM THE PORTFOLIO MANAGER

June 6, 2006

When Expectations Get Too High, Disappointments Are Sure To Follow



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“The main purpose of the stock market is to make fools of as many men as possible.”

— Bernard Baruch

Bernard Baruch obviously had his tongue somewhat planted in his cheek when he uttered that famous quote. The main *purpose* of the stock market is, of course, to provide capital to corporations — not to inflict material or emotional pain on investors. But his quote does contain a very important message, which if I may paraphrase is: “the markets usually move in the direction that makes fools of as many people as possible.”

Bernard Baruch (American financier and statesman, 1870-1965) was a savvy stock market investor. He had a real understanding of how the stock market operated. He recognized that over time, investors’ emotional excesses were not positively rewarded by the stock market. He knew that the key to genuine long-term investment success lay in controlling both greed and fear. And he is perhaps best known for using that understanding to exit the stock market prior to the 1929 crash.

More Baruch: “Never follow the crowd.”

“I never lost money by taking a profit.”

“Don’t try to buy at the bottom and sell at the top. It can’t be done except by liars.”

“I made my money by selling too soon”.

These messages resonate with our investment philosophy and process — and drove some of the portfolio moves we made in May.

We believe in, and build, diversified portfolios. When making investment decisions, we try to avoid getting too high or too low. For long-time clients and followers of our approach, it should be no surprise that we often seem cautionary on the stock market when bullish emotions are running high and more constructive on the market when the general mood in the market is more bearish.

Reducing Emerging Market Exposure

For example, in May, we essentially cut our emerging market positions in half for our more growth-oriented accounts — where we had positions in dedicated emerging market funds. The primary factor behind these trades was the extreme bullish sentiment we had witnessed in the asset class.

This bullishness is well demonstrated by the recent explosion in assets invested in emerging markets. According to the ISI, the Emerging Markets ETF capitalization *grew almost a thousand percent* in just two years: from \$1.1 billion at year-end 2003 to \$10.2 billion at the end of 2005. A similar pattern can be

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observed in the asset growth in emerging market mutual funds. For example, here are the asset levels and the respective percentage increases from the prior period for the Fidelity Emerging Markets Fund¹:

12/2002: \$265 million

12/2003: \$484 million (+82%)

12/2004: \$760 million (+57%)

12/2005: \$1.99 billion (+162%)

04/2006: \$3.59 billion (+81% – in only 4 months!)

That's a cumulative increase of *over 1200 percent* since the beginning of 2003. Granted some of this increase stems from the appreciation in security prices, but the majority of it is driven by fund flows from investors chasing performance. Remember that eventually the markets move in the direction that makes fools of as many people as possible.

In May, emerging market equities (EM), as defined by the MSCI Emerging Market Index, lost nearly 11%. At one point in early May though, EM was up approximately 5% for the month and 25% for the year. From the peak in May, EM lost approximately 15% over the remainder of the month.

Despite our current concerns, we remain attracted to the long-term return potential of the emerging market asset class (the main reason why we sold only half of our positions). Valuations are still at 15% discounts relative to the S&P 500 for 2006 and 2007, while earnings growth expectations are still 5-10% higher. Higher growth at lower prices sounds like a good deal to us, particularly if we can pick up a kicker in return from a weaker U.S. dollar.

Granted, those relative valuations and relative growth rates are not as attractive as they have been in the recent past, but it could be argued that the overall quality of emerging markets is better than it ever has been.

In sum, our total return expectations for emerging markets over the next 5-10 years ranks at, or near, the top of all asset classes. We just think that it is prudent to wait for better prices before increasing our exposure to this area once again. Patience is in order.

A Shift In Commodity Exposures

Another area we became more cautious on, and for basically the same reasons as stated above, is the commodity asset class. Bullish sentiment was off the charts for some commodities just weeks ago — just before many commodity markets came tumbling down hard.

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In more growth-oriented accounts, we exchanged our exposure linked to a commodity price index for an exposure to natural resource stock prices. It may sound like exactly the same exposure, but it's not. There is an important twist.

For commodity indices to rise, they need commodity prices to rise. A barrel of crude oil, for instance, needs to rise in price. In aggregate, metal, energy, and agricultural prices need to rise. Commodity-based companies, however, can still make money even if underlying commodity prices drop from current price levels.

Dan Rice, portfolio manager of BlackRock All Cap Global Natural Resources explained the case for higher energy stock prices as follows: "I have no idea about the next month or two. But we look at models [showing how] these stocks have traded during the last 10 years [relative to their cash flow]. Today's energy-stock prices currently [reflect an average price of] \$45-a-barrel oil through 2012. That is what the market's long-term expectations are. And natural-gas stocks assume a long-term price of \$6.25. But our expectation is that long-term oil prices will be at least \$55 a barrel, on average [approximately 24% *less* than today's price], and around \$7 for natural gas. We don't speculate on how long the market will take to get to these levels, but if we get there, the average oil stock can go up 40%-45%, with gas stocks going up 20%-25%."

Taking On A Bit More Interest Rate Risk And Hedging Inflation

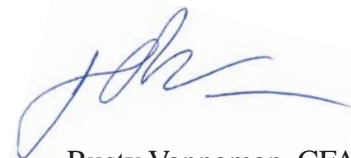
Yet another move we made last month, this time generally more focused on conservative accounts, was to increase the interest rate sensitivity (duration) of the fixed income mutual fund exposures by increasing our exposure to Treasury Inflation Protected (TIPs) bonds (which were one of the few pockets of the bond market that was actually in the black last month). Not only did this trade increase our exposure to high-quality, longer-duration bonds, but we also continue to like the additional feature of the inflation-protected yield from TIPs.

As for our overall outlook on stocks and bonds in the face of increasing volatility, the primary message of recent commentaries remains the same: we are staying diversified, while continuing to upgrade the quality of both the equity and fixed income exposures in your portfolios.

Sincerely,



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¹The Fidelity Emerging Markets Fund is used as a proxy for emerging markets and does not represent a specific recommendation to buy or sell this security. This report was produced by Kobren Insight Management (KIM) and although all data was gathered from sources believed to be reliable, it cannot be guaranteed. This report should not be considered investment advice and the opinion of KIM can change at any time.
