

QUARTERLY MARKET COMMENTARY

Fourth Quarter 2006

Common stock prices rose in 2006 for the fourth straight year. On the fixed income front, short-term interest rates rose from the 4% neighborhood at the beginning of the year to near 5% today. That hurt bond prices, and the total return on most bonds was below that of risk-free short-term cash equivalents, a condition that has now prevailed for more than three years.

Predictably, investor sentiment has followed market performance. Despite higher interest rates today, investors are far less enthusiastic about owning bonds than they were three years ago. And with stock prices well above their levels of four years ago, the vast majority of investors are currently optimistic about the prospects for stocks, quite a contrast with the sentiment picture at the 2002-2003 stock market lows.

Although not a very strong rally in terms of percentage advance (far below historical recovery norms), the advance since March 2003 is the longest in U.S. history without at least a single 10% correction. So persistent is the current rally that we have not experienced even a 2% correction over the past six months. In such an environment it's easy to understand how investors can be drawn into casting caution to the winds. It is important to remember, however, that markets' normal action consists of an alternating ebb and flow. Lengthy moves in either direction tend to pull sentiment toward anticipation of a continuing current trend. The eventual break in the trend is often sharp and severe, catching most investors unaware.

We have no way of knowing when the current rally will end. In fact, we have been wrong during the current advance by staying in concert with the historical norms that would have interjected at least one or more significant corrections long before now. Obviously rallies don't have to conform to historical norms, although most do. Rallies far lengthier than normal are poor probability bets, especially if we remain in an extended weak cycle dating from early 2000.

I have written and spoken frequently about the stock market's unbroken pattern over more than 200 years of alternating long strong and long weak cycles. Every long strong cycle has provided double-digit annualized returns even after subtracting out the effects of inflation. By contrast, the average long weak cycle has seen stocks just barely earn the rate of inflation. The shortest of the three long weak cycles in the twentieth century lasted 16 years. And the combined 53 years that make up those three twentieth-century weak cycles saw stocks on average underperform risk-free cash equivalents. That has been true again in the current weak cycle that we date from the first quarter of 2000. The S&P 500 has returned a compounded 0.8% compared to 3.0% for short-term U.S. Treasury Bills over that 6 ³/₄ year period. Parenthetically, clients for whom we

have had asset allocation responsibility over that full span have seen annualized returns above 5%. After fees, their portfolio values are a third larger today than they were in early 2000 despite the intervention of the greatest stock market decline since the 1930's.

The end of any pattern, even one with over two centuries of history, is always possible. If, however, the weak cycle that began in 2000 ended after just three years in early 2003, it would not only have violated 200 years of precedent, it would have marked the first time ever that a major market advance began with stock valuations well above their long-term averages. Throughout history every long weak cycle has ended with stocks at far below average ratios of price to earnings, dividends, book value, sales and cash flow. In 2003 those ratios were not only not below average, they were at levels more typical of the U.S.'s major stock market peaks. Believing that "it's different this time" is a time-honored prescription for eventual stock market losses.

In a typical week we review literally hundreds of studies of stock market conditions, albeit some very briefly. Those currently exhibiting the most bullish readings are the shorter-term, more speculative studies. The most bearish are the longer-term, more fundamental studies. Positive price momentum is a powerful force and has been the single most dominant driver in the second half of 2006.

That puts investors in a difficult place. If their primary concern is to perform in line with stock market returns on a year-to-year basis, they may have to accept a higher level of speculative risk than they desire. On the other hand, if they truly desire to invest in concert with long-term valuations, which have always ultimately proved right, they may have to endure even multiple year underperformance of equity indexes elevated periodically by shorter term speculative forces. As the investor sentiment studies mentioned earlier testify, the longer a positive market trend continues, the greater the number of investors who move over to the speculative camp.

While we have some clients who want us to lean to the speculative side, our basic investment process is designed to keep our portfolios in tune with measures of sound value. While that has contributed to recent underperformance in the rally phase, it has led our portfolios to significantly outperform most others through the better part of the past decade.

We correctly identified an unsustainable stock market condition toward the end of the 1990's. While speculative excesses are not as generally prevalent today as they were seven or eight years ago, they are even more severe in some important areas. The country's debt and deficit conditions have continued to worsen. Consumer savings have diminished, and in 2006 we descended to a condition in which the U.S. population is spending more than it earns; in other words, we are withdrawing from savings to support our spending patterns. Home prices are under pressure in many areas of the country, and we do not yet know what will happen to the marginal homeowner as the interest rates on over \$1 trillion in variable rate mortgages are ratcheted higher in the year ahead. All of these factors reduce the ability of the economy and the markets to withstand the shocks that periodically appear. That concern is heightened by the uncorrected length of the current market rally.

Ex-Federal Reserve Chairman Alan Greenspan has recently warned about risk being mispriced. Essentially he is saying that we have all become too complacent and that we're not properly assessing outstanding risks in pricing financial assets.

After well more than a decade of stock overvaluation, the prospect of the inexorable "reversion to the mean" pattern should give pause to long-term investors. This internal market concern notwithstanding, there are external concerns as well that should command the attention of long and short-term investors alike. Warren Buffett and several securities market regulators have voiced concern about the danger of a derivative blowup. On a more tangible plane, intelligence experts continue to warn of the prospects of a grand scale terrorist incident.

The latter two concerns would pose a danger to portfolios even if valuations were cheap. At today's levels, which are more typical of conditions at market highs than lows, any significant external disaster could lead to a dramatic reduction in asset values which could take many years to recoup.

While such external events are not forecastable, they have realistic potential. Because they are not conditions we are used to considering, however, most investors have simply chosen to ignore them. Besides, it's much more fun to concentrate on liquidity-fueled positive momentum. I suggest that readers assess such risks as an insurance company would. You have a given pool of assets. In a worst case, how much of that pool could you afford to have disappear for any reason, even an untoward event to which you have assigned a low probability? Govern your risk exposure accordingly.

We continue to look for companies that meet all of our valuation-based selection criteria. Fortunately, the stocks we have owned have for the most part provided excellent returns. We are, however, currently finding very few that look attractive at today's prices. This has often been the case in years past when markets go uncorrected for any length of time. When markets pull back, we inevitably find more stocks to buy at purchase prices that meet our standards.

We have no firm conviction about the near-term direction of interest rates. However, because the negative consequences of rising rates are much more significant than the potential benefits of rates declining from present levels, we are keeping our fixed income investments at the short end of the yield curve. We remain alert to a change in that picture.

Although interest rates have at least temporarily halted their three-year rise, essentially risk-free cash equivalents provide a return of over 5%. Liberal use of cash equivalents provides a base return that guards against negative stock or bond returns and leaves assets available to take advantage of opportunities that may arise in either of those segments or in some of the non-traditional areas that we continue to monitor.

During the quarter it appeared that a profitable, relatively low-risk opportunity presented itself in gold. We were looking to build a gold position in the \$550 to \$575 per ounce range. Prices reached the top of that range at the end of September, and we began to build a position in Newmont Mining, a leading gold mining company. As it turned out gold prices did not descend fully through our accumulation range, so we acquired only the beginning of our intended

position. Gold prices and Newmont rose from there, but the advance appeared to falter two months later, and we closed our position with just under a 20% gain. We continue to believe that there may come a time for a much larger advance, and we will remain attentive for circumstances that might indicate potential for a considerably larger gain.

Despite popular U.S. dollar bashing in the press and among investment analysts, the U.S. dollar is more than 6% higher than it was two years ago versus a basket of world currencies. We do believe that if debt and deficit conditions in this country are not improved, foreign currencies will eventually be more attractive than the U.S. dollar. We invested quite profitably in Canadian and Australian government bonds in 2003 and 2004, and we are looking for a similar opportunity ahead. We first want to see signs in the market that the dollar is losing its potential to rally further. We expect that such an opportunity may arise again in 2007.

The stock market has been in a one-directional four-year rally which has brought the S&P 500 close to its year 2000 price peak. We expect 2007 to break the calm of the past few years and to be characterized by sharp stock market moves, which should provide more attractive opportunities for our value-based investment process.