First Quarter 2006 Commentary—The Blue Chips Have Life After All

The larger stocks in our universe showed some decent life this quarter as ***the Dow and S&P 500 both increased by more than 3%***. This was the best first quarter performance for both indices in several years.

We have always been fond of large, stable companies that have dominant positions in a global marketplace. Investing in companies of this nature has been more predictable while providing for good growth opportunities. For some reason, these companies have lagged the market the past two years despite the fact that these same companies continue to increase their earnings, increase their dividends and improve the quality of their financial statements. In fact, ***U.S. corporations had their strongest increase in profits in four years at the end of 2005.***

Knowing this, it is difficult to remember that sometimes investors must suffer in the short term to profit in the long run. The end result is that ***these companies are now some of the best bargains we see in the overall market***.

In fact, our research indicates that of the more than 5,000 stocks that trade in the U.S. on a daily basis, the best value and quality opportunities reside in the largest 350 companies. Furthermore, ***the largest companies in the U.S. now trade at Price to Earnings ratios that are the cheapest they have been in 20 years and have dividends that are at 20 year high levels***. This sounds pretty good to us.

We have always looked for companies with strong cash flows and strong franchises. This does not typically include cyclical companies. Too often, the cyclical company is easy to replicate and has low barriers to entry. As such, once the opportunity exists to make good money, the market is flooded with new entrants and the opportunity to make good money vanishes.

The oil industry has historically been one of these cyclical businesses. It is a very capital intensive business and it is very difficult to identify when the cycle will begin and when it ends. While we continue to embrace this ideology, we acknowledge that it has left us out of some of the recent market gains. Longer term, however, our philosophy has suited us, and more importantly, our clients, well.

On the topic of oil, we continue to believe that ***$66 per barrel cannot be justified from an economic perspective***. We had a warm winter and oil inventories are now at their highest levels since May 1999. Despite that, oil is still trading for $66+ per barrel.

Our estimate is that there is a $15 per barrel premium as a result of current or potential geopolitical events. Although we believe this to be true, we don’t think you can merely discount the cost of geopolitical issues. In fact, we will go so far as to say that in the future the “geopolitical premium” will most likely remain. Therefore, we anticipate that the extra $15 per barrel premium above “normal” supply and demand is here to stay.

Natural gas prices have been a different story. Post Hurricane Katrina we saw natural gas prices spike to $15 per MMBTU. Since then they have fallen 50%. The delivery of natural gas is contained strictly within North America. As such, many of the geopolitical instabilities are not present. Also, natural gas storage is full due in large part to the warm winter. This has helped to ease many burdens for natural gas users.

So if oil is pretty much where it left off last year, natural gas is down substantially and the government continues to tell us the Consumer Price Index is only increasing at 3.7%, why do we feel like our expenses are going up more than this?

First, remember that the ***CPI is merely an average***. It measures the change in prices in a basket of goods and services—but it matches no one person's shopping list. For instance, medical care accounts for 4.8% of the overall CPI. However, if you are the one with a serious illness I promise you it will most likely increase your monthly expenses far more than 4.8%.

College expenses are another good case. College tuition accounts for a miniscule 1.1% of the overall CPI calculation. Why don't you ask a parent who is funding a child's education if this cost has only increased their overall expenses 1.1%? We doubt it.

And then there is the cost of housing. Believe it or not, the cost to buy a house is not even factored into CPI! Instead, a national average of rental rates for housing is used. Currently, there is a large differentiation between rental rates and mortgage expenses (for those of us buying a house).

You can quickly see why the CPI is missing the mark. The point to remember is that CPI is an average—and a national one at that. Your personal experiences (especially in one of these high cost areas) can be substantially different.

Our advice for clients is to ***factor 4% to 5% future increases in their budgetary need*s**—regardless of what the CPI says.

So much for the boring discussion on CPI. However, CPI and inflation have a large impact upon the Federal Reserves posturing with interest rates.

The Bernanke era of the Federal Reserve is now under way with Ben raising rates a couple of times. ***The prime rate now stands at 7.75%*** and we can see room for at least another increase of one quarter of a percentage point—if not more.

With the ***U.S. Treasury bond market hitting 22-month highs***, the market now provides some decent opportunities. We are seeing ***high quality fixed income investments yielding upwards of 5%,*** while only tying up a clients funds for 6 months. Additionally, the Federal Reserve has indicated that they will continue to raise rates for the foreseeable future. This move is a continued effort to hold off inflation, while not stifling the economy.

If you have any questions on this or anything else please call or stop by.

Finally, please mark your calendars for Thursday April 27th. We hope you will join us for snacks and drinks from 5 P.M. to 7 P.M. at Fossati's as we celebrate our eighth year in business and take the time to thank everyone who has helped us to make our success a reality.

Sincerely,

Dave

Dave Sather, President
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