Sather Financial Group, Inc.
Registered Investment Advisor

Third Quarter 2006 Commentary

For quite some time investors have continued to chase commodities and the stocks of companies that produce them. Even though oil, gold, silver, copper, etc., have generated virtually no inflation-adjusted returns in over 100 years, large pension funds and other institutions have committed billions of dollars to them. None apparently had the slightest interest at half the price or less a few years ago. It is claimed that these natural resource assets, when blended in a broadly diversified portfolio, will dampen volatility and boost returns, since their fluctuations ***theoretically*** won't correlate with those of domestic stocks and bonds.

Loosely translated, this theory means no matter which way your other investments go, commodities won't necessarily follow suit.

That concept escapes us. Why expose yourself to losses (over time there'll be plenty), just to avoid volatility, when it has nothing to do with risk in the first place? As far as enhancing returns is concerned, the history of commodities clearly points to the likelihood of an opposite outcome.

In spite of this reality, their current popularity is just what we would expect: a telling contra-indicator, given the tendency of institutions to load up on assets that have already risen sharply in price, and sell those that have either done nothing or gone down.

Unfortunately, a lot of the funding for this activity has come from the sale of high quality, large capitalization domestic stocks. This has effectively kept a lid on their values, giving the impression that something's wrong with them. Nothing could be further from the truth.

A similar pattern surfaced in 1998, when investors piled into vastly inflated tech/telecom and dot.com stocks, while nearly everything else suffered. ***Just as that cycle reversed, this one will too***. At that point, money should flow back to the safety and liquidity of high quality growth companies, bolstering their long-sagging valuations.

So how have domestic stocks performed compared to these alternatives? The answer is 'great' but you have to stay with them a long time to prove it. (That means no jumping in and out of the market on hunches about its direction, no hedging, and no portfolio rebalancing. These strategies may seem promising in retrospect or on paper, but over time they'll cost you money.) A look back will help put things in perspective.

Charles Dow's Industrial Average debuted May 27, 1896. The original list contained just 12 stocks, grew to 20 in 1916, and then 30 in 1928. At the turn of the 19th century, the Index stood at 65.73, and now, over 100 years later, hovers around 11,000. That works out to 5.3% compounded annually. Adding dividends, the return averaged 9.9%.

120 E. Constitution, Victoria, Texas 77901 (361) 570-1800

Tellingly, ***the Index's price gain over this long period directly matched the growth in earnings of American businesses***, supporting a point we've made for years: ***rising earnings alone cause stocks to appreciate***. Despite the financial industry's efforts to convince us otherwise, investors, as a group, cannot outperform what the economy delivers. Had there been no growth or additions to the list, the Dow would still be at 65.73.

Inflation has taken a major toll on stock returns, slashing the century-long nominal 9.9% rate to 6.3% in constant dollars. It has punished commodities and fixed income assets even more.

Since the introduction of the Consumer Price Index (CPI) in 1921, ***gold has increased only 1.5% annually***, and that's after a 150% advance over the last several years. ***Silver has risen less than 0.5% per year since 1792, and copper has dropped from $4.50 a pound in 1855 to around $3.50 today***. Since 1869, oil's averaged $19 a barrel in 2005 dollars yet sold as low as $10 in 1998. Oil's history is one of booms and busts--not compounded earnings and free cash flow.

Comparable measures of emerging and developing markets cannot be made due to their relatively short histories, and the same is true for hedge and private equity funds. Investors should approach these 'opportunities' with caution. The long-term record of domestic stocks clearly bears no resemblance to what the public came to expect in the 1990s when the S&P 500 compounded at 18.3% for 10 years (it’s second best showing ever) and 28.5% for the last five. The same thing happened during the decades of the 1920s and 1950’s when returns averaged 15% and 19%, respectively. ***Who could have guessed that each of those booms would be followed by 20 years of single-digit returns?*** **History is now repeating itself.**

Though it may seem otherwise, none of this should concern you. The time to worry was six years ago, not today. The market's performance since early 2000 has been a correction of vast speculative excesses--nothing else. ***The economy is strong, employment robust, and earnings have grown from $360 billion to $890 billion, cutting the market's P/E ratio from 37 to about 15, and a projected 13.5 next year***. ***That number is below the average dating back to 1871.***

With this backdrop, it's ironic, that investors, so eager to buy stocks when valuations were 2 ½ times higher, now reject them.

We've been living in one of the most discouraging periods on record for investors and, at this point, a lot of people probably believe things will *never* get better. ***But things always get better, most often when least expected***. Sooner or later, it doesn't matter which, optimism will return, most likely triggered by good news now waiting in the shadows or around the corner. When that happens, everyone will be talking about how cheap stocks are, yet only perceptions will have changed.

Call with questions.

Sincerely yours,

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™