2006 Year In Review

Despite a variety of challenges and troubles throughout the year, 2006 finished in a very respectable manner. Along the way, however, it was an interesting ride.

Federal Reserve Chairman Ben Bernanke took over for Greenspan on February 1st and subsequently survived his probationary period.

Mid year saw oil spike to $78 a barrel and characters such as legendary Texas oil man T. Boone Pickens started calling for $100 per barrel oil. Oil has since fallen by 20% and speculators have backed off. We continue to think that ***oil is a bit overpriced***. While it feels a bit like crying wolf, we still think we'll be right in the long run.

As we accurately predicted, the housing market tanked. On August 31st median home prices fell for the first time since 1995. It is hard to tell whether or not the worst is behind us. The Texas market has held up remarkably well and is considered a bargain by many.

Recently, former Fed chairman Alan Greenspan made a few interesting comments regarding real estate. He stated that he believed the real estate market had hit its bottom (if he is correct, don't look for a bounce back anytime soon). However, he went on to explain that there would still be a ***large drag on Gross Domestic Product resulting from people no longer being able to pull extra money out of their homes to spend***. We agree.

The first week in November saw the Democrats snatch control of Congress in a nasty midterm election. Although the press, in their usual dramatic manner, made tremendous noise about this victory it shouldn't lead to much change. The Democrats do not have enough votes to override a Presidential veto so you can ***expect continued gridlock in Washington***. We also ***don't expect substantial changes in tax policy before 2010***, despite what Nancy Pelosi thinks. Hopefully, the politicians will just stay out of the way of the capitalists since the capitalists are the ones who actually create jobs.

And, of course, Americans were assaulted daily by reminders of a tough situation in Iraq.

Through it all, except for a brief spell last summer, our clients have enjoyed nice returns.

The ***Dow Jones Industrial Average and S&P 500 both notched double digit gains*** that were more than double the total return for the Dow Jones Corporate Bond Index and triple what 10-year Treasuries delivered.

The Dow Industrial's hit a new all-time high in October, more than six years after first surpassing 12,000. And while lagging a bit owing to the sluggish performance of mega-cap technology shares, even the Nasdaq Composite produced respectable gains.

To have exploited the year's twists and turns fully, one would have had to bet heavily on a commodity boom until May, a sharp slowdown and commodity bust into summer and a recovery led by consumer spending this fall. While that sounds great in theory, we're not market timers or speculators and we will not blow our clients up in an attempt to employ these questionable strategies.

The market's gains are all the more impressive given that all the year's upside, and more, has come since midyear, when concerns about slower economic growth and commodity-fueled inflation culminated in an 8% pullback in the indexes, the largest decline of the bull market that began in late 2002.

This winning streak so far has exceeded the forecasts of most of Wall Street strategists. Growth is moderating, inflation pressures are abating and the Federal Reserve is expected to maintain a friendly stance.

The economy is in a classic mid cycle slowdown, engineered by the Fed's seventeen rate increases through last June and abetted by slumps in the housing and auto markets. ***Expect economic growth to slow***, but hopefully, ***a recession will be averted***. Inflationary forces will cool and interest rates will stay tame.

Corporate-earnings growth will recede from its torrid double-digit pace into the mid-single digits. However, liquidity is abundant, companies are flush with cash and buyout activity is accelerating.

Stocks look cheap relative to bonds at current levels. When you have a ***6.5% earnings yield (the inverse of the price-earnings ratio), and a 4.5% bond yield, we want to own equities***—and that is before factoring in the ***advantageous tax implications of owning stocks***.

We are not calling for huge upside to stocks going forward, but continue to ***expect gains of 6% to 7% per year over the next five or ten years***.

We see ***10-year Treasury yields floating between 4.5% to 5.10%*** and think the ***Fed will seriously consider easing interest rates by mid year***.

Given the interim volatility of this years equity markets it is worthwhile to revisit a few of our favorite investment principles.

The stock market is a long term proposition—meaning a ten year plus commitment. Over the short term the stock market is merely a popularity contest—and an irrational one at that. Over long periods of time the stock market is a scale that weighs the value associated with increased corporate earnings.

As this past year shows, **we have no idea when the value associated with a particular investment will be rewarded—especially over short time periods**. Therefore, **it is critically important to invest in strong companies and remain invested for the long haul**. **Patience is a must**.

Had people made their investment decisions for the second half of the year based upon the first half of the year, they would have been very disappointed.

Finally, as we close out another year, we offer a word of thanks. ***Thank you for the opportunity to work for you and to all who have supported us***. We truly appreciate the many opportunities and wish everyone a healthy and prosperous 2007.

Sincerely yours,

Dave

Dave Sather, President
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