

## **QUARTERLY LETTER**

### **First Quarter 2006**

The early months of 2006 saw common stock and investment-grade bond performance on divergent tracks. The major stock indexes rose moderately well in the first quarter, with the S&P 500 up 4.21% and the Dow Jones Industrials up 3.65%. Investment-grade bonds, on the other hand, were down slightly during the quarter. The broad Lehman Brothers Aggregate index lost 0.64%. Intermediate government bonds declined a bit less; long bonds lost more. U.S. Treasury bills provided a return of 1.08% for the quarter with money market funds yielding just under one percent.

The March quarter continued a pattern that has been in place for more than a year in which smaller cap and lower quality stocks have significantly outperformed larger cap and higher quality stocks. The same phenomenon has prevailed in the bond market as well. While high quality bonds have barely provided any positive return, low quality “junk” bonds have done extremely well for the past three years. Essentially, aggressive speculation has been rewarded in both stocks and bonds over the past year or two.

James Montier, chief investment strategist for Dresdner Kleinwort Wasserstein, pointed out in an April article that the lowest quality stocks, those with a C rating by Standard and Poor’s Corp., have returned 17% year-to-date. In the same period, the very highest quality A+ stocks returned a mere 1.2%. Over the long pull that is an aberration. High quality stocks do better than lower quality stocks in the long run.

Montier further emphasized the gambling mentality that currently prevails in the markets by pointing to the volume explosion for stocks on the OTC Bulletin Board. This is a quotation service for the smallest, lowest quality stocks. In the first quarter of 2000, just before the NASDAQ market collapsed by 80%, the average daily volume of OTC Bulletin Board stocks spiked up to over 20 billion shares traded per day. In the first quarter of 2006 that volume skyrocketed to over 140 billion shares per day, dwarfing 2000’s speculative surge.

While such phenomena do not necessarily point to an imminent end of the rising stock market pattern of the past three years, they are end-of-cycle characteristics. The stocks that we have owned during this highly speculative period have done extremely well, up 46.3% on average over the past twelve months. Because we buy only high quality, deeply discounted value stocks, however, we have found relatively few issues that meet all of our purchase criteria in such a gambling-oriented environment. We will find many more in more normal market environments.

While there is still ample liquidity and a positive flow of cash into common stocks, this is now a very long-in-the-tooth bull market rally. The rally is also running into the headwind of rising interest rates, the negative consequence of which often lasts past the peak in rates.

As longstanding clients know, we devour vast quantities of economic and market data, much of it historical. One of our resources, Ned Davis Research, does excellent studies on thousands of economic and market measures. One of their studies has summarized the behavior of the Dow Jones Industrials during the four-year presidential cycle over the past 106 years. On average the Dow peaks in April of the mid-term election year, like the present year, and the subsequent two quarters typically show negative returns. Of course, any single year may or may not conform to the average.

Many analysts have been vocal in their bullishness for stocks on the premise that the Federal Reserve is likely nearing the end of its interest rate tightening cycle. While we may be approaching the point at which the Fed stops raising rates, there is no guarantee of that happening at the next Fed meeting or two. That peak in rates, whenever it occurs, is not a signal that stocks will suddenly surge. In fact, after the 16 prior final rate hikes since 1920, stocks on average declined by 8½% in the ten months following the final Federal Reserve tightening actions.

The single most ominous market behavior precedent also relates to the rise in interest rates. Since 1920, the Fed has raised the U.S. discount rate to 6% only seven times. It is currently at 5.75%, and almost certainly will move to 6% at the Fed's May 10 meeting. Each of the prior hikes to 6% has either immediately preceded or occurred during a significant stock market decline. Those occurrences are listed below.

<b>Initial Rise to 6% or Above</b>	<b>Start of Bear Market</b>	<b>Dow Jones Industrials Bear Market Decline</b>
01/23/1920	11/13/1919	-46.6%
08/09/1929	09/03/1929	-89.2%
04/03/1969	12/03/1968	-35.9%
05/11/1973	01/11/1973	-45.1%
10/26/1977	09/21/1976	-26.9%
09/04/1987	08/25/1987	-36.1%
05/16/2000	01/14/2000	-37.8%

Seven consecutive predictive signals do not guarantee that subsequent discount rate hikes to 6% will forecast any given outcome as accurately as in the past. It would be foolhardy, however, to ignore such precedent, especially in light of the severe consequences that have followed each of the last seven signals.

Because we believe that the rally of the past three years is merely a rally within a larger secular weak cycle, another significant decline would be consistent with the expected longer-term pattern. A decline need not occur now, but the danger exists. We are finding few stocks that meet all of our valuation criteria and, in the present environment, we are not tempted to stretch for more ownership. When market levels decline, we fully expect that patience will be rewarded as many more companies should fall into an attractive price range.

We are likewise unenthusiastic about extending toward longer bond maturities. An overdue bond market rally notwithstanding, the path of least resistance for interest rates is upward, which would penalize longer bonds. The Fed's actions have pushed risk-free short rates near five percent. That level will provide a stable base for portfolios during a period in which risk-bearing securities could be unrewarding, perhaps punishing.

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