

## **QUARTERLY LETTER**

### **Third Quarter 2005**

We are pleased that our portfolios continue to grow despite a difficult environment for both stocks and bonds. In the third quarter, common stocks had their best quarter so far in 2005, the S&P 500 gaining 3.6%. That brought the return for the year's first three quarters to 2.8%. Having subsequently lost more than 3% in the first two weeks of the fourth quarter, the S&P has joined all the other major stock market indexes in negative territory for the year to date.

The bond picture is barely better. Although bonds declined in the third quarter as interest rates rose, their total return for the first three quarters of 2005 was slightly positive. With some deterioration since the end of the quarter, most major bond indexes are slightly above or slightly below 1% for the year to date.

Negligible as returns on short-term cash equivalents have been for the past few years, cash returns have actually beaten stocks and bonds through today in 2005. There is, however, one positive feature for investors in this year's rise in rates. Today we can make two- to four-week commercial paper loans to top-rated corporations at about 3.7%. That is hardly an attractive long-term strategy, but it helps to protect capital and to maintain portfolio return in periods in which stocks and bonds offer little return.

Clients with us for at least the past five years have seen volatile markets in both directions for stocks and bonds. Net of all the fluctuations, bonds (about 5.5% per year) beat cash (2.3%) and stocks (-1.5%), which still demonstrate a negative return. We avoided the decline in the equity market, and, while maintaining a highly conservative profile, we have been able to produce returns that approximate the 5.5% from bonds, the highest returning asset class over that five-year period.

Looking forward, we expect the Federal Reserve to succeed in damping down the speculative attitude of American investors. Alan Greenspan will be leaving the Fed in early 2006, and he seems intent on posting cautions about what he terms "speculative excesses." Now admitting that the Fed permitted a stock market bubble to develop in the late-1990's, it appears that he does not want to leave a real estate bubble as his legacy. The Fed has raised short-term interest rates eleven times in less than two years bringing the federal funds rate from 1% to 3.75% in that period of time. Chairman Greenspan voiced his concern earlier this year about the "conundrum" of the yields on long-term bonds declining while short rates were rising aggressively. It now appears that the Fed has finally gotten yields rising across the board. That is hurting the holders of long

bonds; it will increase costs for business and personal borrowers; and the Fed hopes that it will discourage rampant speculation in the real estate market. Some recent real estate practices, like condo flipping, look suspiciously like the day trading mania that became the poster child of the late-1990's stock market bubble. Such activities never end well.

The danger that attends all Federal Reserve rate-raising campaigns is that they will go too far and will precipitate a significant business slowdown. The prospect of rising rates leading to a recession could damage the outlook for both stocks and bonds.

In earlier letters we have discussed at length the importance of knowing whether the equity markets are in a long weak or a long strong cycle. Having completed the greatest long strong cycle in U.S. history in early 2000, the stock market suffered its largest decline since the Great Depression of the 1930's. From the triple bottom to that decline which stretched from July 2002 to March 2003, stocks rallied into the middle of this year. We can't know that that rally is finished, but there are a number of factors pointing in that direction. The rally is already among the longest in modern history. Investor confidence, which is an excellent contrary indicator at extremes, is at levels that often mark the beginnings of declines. And a considerable amount of technical damage has been done in the last five weeks with stock prices breaking below important areas of support, meaningful trendlines, and widely followed moving averages.

The long stock market weak cycle that began in 2000 will almost certainly reassert itself after this rally concludes. Such long cycles, both weak and strong, average about a decade and a half in length and are characterized by a succession of mini-bull and mini-bear markets. While the three year old rally could attempt another run up, there is more risk than probable reward in the near term picture. We will continue to buy individual equities that meet all our selection criteria, but we are not finding large numbers of them.

On the bond front, we are not eager to extend to longer maturities while interest rates are rising. We are content to remain in short maturity treasuries until it looks more likely that interest rates have stabilized. We continue to monitor the potential for foreign bonds and anticipate that they may offer greater opportunity in 2006 when we expect the U.S. dollar once again to weaken relative to many other currencies.

Thomas J. Feeney  
Managing Director  
Chief Investment Officer  
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