

QUARTERLY LETTER

Fourth Quarter 2005

2005 offered little to investors in the traditional major stock, bond and cash categories. Common stocks, as measured by the widely followed Standard and Poors 500, rose by 4.9%. The Dow Jones Industrial Average earned an even less robust 1.7% total return. The more speculative NASDAQ Composite returned just 2.1%. Except for long-term U.S. Treasury bonds, which provided a 6.5% return, bonds offered minimal rewards. Intermediate term U.S. Treasuries earned 1.6%, while the Lehman Brothers Aggregate index came in at a tepid 2.4%. By comparison the risk-free short-term U.S. Treasury bill return of 3.2% was better than most risk-bearing investments. Money market returns averaged 2.5%.

In this context we are pleased that our clients' portfolios grew by more than the major stock, bond or cash indexes. In an era in which the financial risk levels remain high, we have produced that return with relatively minimal risk exposure.

As always, we continue to search for value. On the equity side we are finding few stocks that meet all of our value-based selection criteria. Fortunately, the stocks that we did own performed extremely well in the year just concluded. While corporate income grew quite nicely in 2005, the S&P 500 still sells at about 19 times earnings. Admittedly that is well down from the peaks seen in the bubble years of the late-1990's, but it remains far above normal levels that characterized the vast bulk of the twentieth century. Longer-term returns from similar market valuation levels have typically not been strong.

On the fixed income side, most analysts believe that the Federal Reserve Board is nearing the end of its multi-year process of raising short-term interest rates. During the Fed's tightening phase, Treasury bill rates rose from below 1% to above 4%. The markets are almost unanimous in pricing in one more 25 basis point increase at Alan Greenspan's final Fed meeting at the end of January. The jury is still out on whether or not the Bernanke Fed will continue that course of action. The statement from the Fed's most recent meeting hinted that additional rate increases would depend upon future economic conditions.

As the Fed pushed up short rates, Chairman Greenspan warned bondholders that higher long-term interest rates were almost certain to follow. He was wrong; they did not. In fact, the yield on 30-year Treasury bonds is lower today than it was two years ago when the Fed began to raise rates. While long rates could still decline from current levels, especially if business conditions deteriorate markedly, the path of least resistance is to higher levels. As a result, we prefer to keep bond investments in highly secure, short-term maturities. Because of the widely reported yield curve inversion (two-year rates briefly above ten-year rates), investors earn essentially the same yield on short bonds as on long bonds, minus the attendant risks of interest rates rising from current levels.

The Fed's upward pressure on rates has pushed risk-free returns above 4%. While that is hardly an attractive long-term return, it is helpful income on assets held in anticipation of safer, more attractive longer-term opportunities.

Clients who have been with us for a few years recall that we earned significant returns in non-U.S. dollar denominated investments. In 2003 we believed that the U.S. dollar would decline relative to other major world currencies. At that point we bought Canadian and Australian government bonds in those respective currencies. We closed those positions in 2004.

In 2005 the U.S. dollar staged about a 13% gain against a basket of major currencies, so the anti-dollar trade was no longer attractive last year. We anticipate that the 2005 dollar rally may have more to go, but we fail to see a permanent change in fundamental conditions. U.S. monetary authorities continue to expand the supply of dollars faster than our country is increasing its output of goods and services--especially goods. More and more of those dollars are going overseas, as U.S. residents buy more from foreign sources than we sell to them. This unstable situation notwithstanding, it is difficult to put a timetable on when it will again put downward pressure on the dollar's value. Should our expectation that the dollar rally may end in 2006 prove true, we will again be looking for opportunities to diversify portions of portfolios into foreign government bonds to benefit from anticipated dollar weakness.

The tremendous supply of available dollars, supplemented by the lowest interest rates in a half century, has certainly kept the U.S. consumer buying and the economy humming. On the surface all looks good. Unfortunately, beneath the surface, profligate spending has led to record levels of debt in both the personal and government sectors. As many people know from their own experience, debt doesn't create a problem when times are good. Debt becomes an untenable burden when something goes wrong.

What could go wrong? First, recognize that things always go wrong. Economies go in cycles with weak phases inevitably following strong and vice versa. Surprisingly, during strong phases like the present, economists rarely foresee the next weak phase. Yet it always comes. Remember the biblical reference to seven fat years followed by seven lean.

A wise financial steward prepares for the lean years during good times. Today's stewards apparently believe, however, that the lean years will never come. The personal sector of the U.S. economy has dropped savings to its lowest rate in history. Recently the rate of savings as a percentage of disposable income went negative. In other words, the U.S. population spent more than it earned.

While our government has been doing this for the better part of the last 20 years, it has the privilege of being able to print money to pay its debts. As U.S. debts to foreign holders continue to rise to ever-higher historic levels, however, it is logical to ask how long such creditors will smilingly accept the paper that we print at will. What can't continue indefinitely won't continue indefinitely. Two years ago Warren Buffett wrote an insightful article (*Fortune*, November 10, 2003) questioning the long-term stability of the dollar should the United States not soon begin to correct its rapidly expanding trade deficit. The trade deficit has worsened since.

Most of us have lived our lives in an era in which the U.S. dollar has been the accepted world reserve currency. The pound sterling and other currencies earlier held that privileged position. There is no guaranty that others around the world will continue to accord the dollar that designation. While it is perilous to forecast the end of an era (and I am not doing that), there are obvious growing risks attached to the monetary status quo that has provided the foundation for the economic and market growth of the past two decades.

Since nobody rings a bell when risk-bearing securities are about to decline, and since equities remain at historically high valuations, the risk-reward probabilities for stocks remain in the danger zone. In an era in which terrorists have vowed to wreak havoc on our economy and to kill as many Americans as possible on our own soil, and in which intelligence agencies acknowledge probable success of such nefarious adventures to some degree, investors should weigh the risk-reward probabilities more carefully than ever before.

We pray that the dire consequences of terrorist activity will never again be felt in this country. The threat is, however, real, and the consequences could be great. In such an environment, we find no compelling reason for stretching to pay above-average prices for a dollar of earnings, dividends or book value. When faced with a non-investment-related condition like terrorism that could severely depress prices, we prefer to buy selectively only when individual securities dip to attractive valuation levels. Such caution would not necessarily eliminate losses from a serious economic or geopolitical event, but it would certainly lessen the risk assumed. Fortunately, our conservative approach has led to portfolio performance for clients with us over the span of the past six turbulent years better than performance of the major stock and bond market indexes.

Thomas J. Feeney
President
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