Market Review and Outlook—July 12, 2006

Back in April the US economy was looking solid, with positive news in areas such as consumer confidence, expanding payrolls, retail sales, wage growth, and new home sales overwhelming a few weak areas including durable goods orders. The stock markets were hitting 5 and 6 year highs, partially on positive comments from the new Fed Chairman Ben Bernanke.

In May and June, however, the Goldilocks story turned sharply south. Economic news was uniformly disappointing (consumer confidence fell), and the Fed no longer appeared finished with raising rates. Economic forecasting is a tricky field, as some growth is good, but too little, or even too much growth is bad. For this reason, the very strong (5.3%) growth in GDP during the 1st calendar quarter was viewed, not as a good thing, but rather as an area of concern, perhaps leading to strengthening inflation, for example. The Fed governors began talking about strengthening their efforts against rising inflation. Stocks took it on the chin, with markets suffering their worst May in 22 years! June saw a stock recovery by the end of the month, which permitted the month to end with flat results.

During the quarter, most stock funds fell, over 2%. Tech funds fell almost 10%, Japan funds fell almost 8%, while small-cap growth, health/biotech, telecomm funds, and most growth funds fell from 5 to 7%. While stock funds emphasizing value fared better than their growth peers, value funds still lost money during the quarter. Four specialty-fund classes made money, with Utility funds up 4%, Natural Resource (energy) funds rising 3%, and Gold funds up 1.55%, and China funds up 1%.

With the Fed raising the alarm about continued inflation worries, bonds fell yet again, although not as much as in the prior quarter. Most bond funds fell from ¼ to ½%, while very short-term bonds managed a slight gain.

The following data, reflecting results through 6/30/2006, comes from Barron's and Morningstar's Principia Pro.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Money Market—Taxable	+1.03%	+3.43%	+1.77%	+1.70%	+3.40%
Intermediate Term Bond	-0.19%	-0.92%	+1.76%	+4.39%	+5.50%
Intermediate Muni Bond	+0.01%	+0.14%	+1.71%	+3.69%	+4.60%
Large-Cap Core Stock	-2.49%	+7.47%	+9.52%	+1.10%	+6.65%
Mid-Cap Core	-3.31%	+12.26%	+16.47%	+7.62%	+10.68%
Small-Cap Core	-4.64%	+13.80%	+18.56%	+9.46%	+10.34%
International Stock	-0.69%	+26.38%	+21.90%	+8.08%	+6.35%
Real Estate	-1.14%	+19.71%	+26.00%	+19.38%	+15.25%
Natural Resources	+2.96%	+38.60%	+36.11%	+19.00%	+14.92%
Science/Technology	-9.64%	+8.98%	+10.16%	-4.42%	+6.66%
Multi-Cap Growth	-5.23%	+10.46%	+12.02%	+0.75%	+6.58%
Multi-Cap Value	-0.75%	+10.23%	+14.46%	+6.08%	+9.18%
Balanced	-1.10%	+6.02%	+8.03%	+3.80%	+6.81%

An economist from Putnam Investments at the NAPFA National conference that Paul and Pam attended in May noted that **business expansions do not die of old age, they can, however, be assassinated**. By this he meant that for the past ten to twenty years we have avoided the 'regularly scheduled' recessions which had occurred every five years or so. Instead, the US economy naturally expands and contracts is a fairly smooth manner, largely aided by the Fed with measured changes to the 'Fed rate', and on its own, the US economy has been largely immune from business-cycle-driven recessions. Rather, recent recessions have been generally attributed to external shocks (the invasion of Kuwait by Hussein, the 9/11 terrorism attacks).

Currently, the consensus view is that the US economy will cool over the next year, but will not decline sharply. The Fed is expected to increase rates no more than one time, in August. This, of course, assumes that we suffer no significant external shocks (North Korea comes to mind this week).

In this environment, **'business as usual' appears to be warranted**. At Mallard that means keeping portfolios close to long-term targets, but keeping an eye out for areas where prices are unreasonably high or low. At this time, we are increasingly being tempted by the line of 'growth is the new value'. By this we mean that growth stocks were beaten down so much in the Dot.Com bust, and have largely been on the sidelines during the past three year recovery, that they appear to offer some compelling value at this time (attractive upside with fairly limited downside). As such, **we are willing to lean a bit towards growth** at this time, and to keep value a bit light. Similarly, large US companies have not enjoyed the stock market recovery as much as smaller US stocks. Again, as such, **we are willing to lean a bit towards large US companies** at this time, and to pare back on smaller stocks.

Energy and real estate stocks and funds have accumulated an extremely strong run in the past three (and more) years, and the story of Icarus comes to mind (in Greek mythology he built wings using feathers and wax and as he approached the sun the wax melted, his feathers fell off, and he fell painfully). For this reason, when an investment sector goes up, our first reaction is to look downward. Whenever a market or sector goes up and up and up, we tread very carefully. **We are currently less cautious about energy/natural resources than with real estate, where we continue to recommend that investors sharply limit their exposure.**

Foreign stocks have enjoyed a wonderful rebound in the past few years. Unlike energy and real estate, however, their recent success comes on the heels of very weak prior results. As such, we are not as concerned about limited future prospects with foreign stocks as we are for real estate stocks, for instance. **We therefore continue to recommend that investors build their portfolios with meaningful positions in foreign stocks**. We currently recommend that one-third of the stocks in clients' portfolios be invested overseas.

To review a **good strategy for investing in bonds today**, we looked at three Vanguard corporate bond funds. The short-term one currently yields about 5.2%, the intermediate term one 5.7%, and the long-term one 6.1%. For similar municipal bond funds, the corresponding yields are 3.6%, 4.1%, and 4.2%. The GNMA (mortgage) bond fund yield 5.2%, and the high-yield corporate bond fund yields 7.5%. Given that we do not expect any sharp increases in interest rates, and given that we feel that there is a reasonable chance that intermediate and long-term interest rates will modestly decline over the next year, **we are comfortable with intermediate-term bonds (5-10 years in maturity)**. We do not feel that current yields are high enough to justify investing in long-term bonds at this time. We continue to favor supplementing a high-quality core of bonds with high-yield and foreign bonds (preferably unhedged, and able to profit from further weakness in the US dollar). **We generally utilize a 'multi-sector bond' fund for this complementing strategy.**

A financial planner in California, William Bengen, has performed innumerable studies into having retirees' portfolios last throughout their retirement. His studies suggest that if your goal is to maximize the likelihood of your portfolio outlasting you (not on maximizing the portfolio's returns), then your 'bond money' can simply be invested in very short-term bonds: three to twelve month CDs or treasury bills. We are still 'digesting' this insight and do not currently recommend that clients keep their bond investments in such short-term vehicles. As the table on the prior page illustrates, in the past ten years, intermediate term bonds outperformed money markets by over 2% a year, a fact that we consider to be compelling.

Good luck in your investing travels.