

## **QUARTERLY LETTER**

### **Third Quarter 2006**

Dramatic crosscurrents are affecting both the stock and bond markets as we head into the final months of 2006. Following the losses suffered in this year's second quarter, both stocks and bonds bounced back in the third.

A significant part of the bond market's second quarter gains has been given back in the first half of October, and most high grade bonds have provided virtually no return through calendar year 2006. Stocks, on the other hand, have continued to forge ahead. Equity investors are now faced with the dilemma of either maintaining their commitment to the asset class that has been most productive over the past four years, or lightening equity exposure as a mounting volume of indicators flash caution.

We all remember the principle of physics that a body in motion tends to stay in motion. That principle of momentum holds true for stock prices as well and is, in fact, the most bullish factor currently propelling prices higher. The recent dramatic proliferation of hedge funds, most of which are trend followers, has served to accentuate market moves in either direction. The flip side of that, however, is that with so many hedge funds positioned in the same direction, major changes of trend are likely to be characterized by huge numbers of institutional investors attempting to get through narrow exits simultaneously. In recent months leading world financial regulators have been warning loudly about possible disruption of the system caused by hedge funds retreating en masse from any single investment area. That risk notwithstanding, momentum investors today continue to push stock prices higher.

On the fundamental side, the economy remains strong and corporate profits continue to grow at double-digit year-over-year rates. While interest rates have skyrocketed over the past three years, there is great hope that the Federal Reserve Board has come to the end of its interest rate tightening cycle. Even while they were raising rates, however, the Fed injected plenty of money into the economy, much of that helping to push up stock prices.

Another influential factor on the positive side is that stocks tend to do quite well on average in the year after mid-term elections; 2007 is such a year.

Clearly there are reasons to be bullish, and there always are. We remain highly skeptical of aggressive stock ownership, however, because we believe that the preponderance of evidence dictates caution. When equity overvaluations rose to unprecedented levels in the late-1990's, we cut back significantly on our equity holdings in our controlled-risk flexible allocation portfolios. With periodic variations, we have kept our equity allocations far below normal since the late-90's. That penalized performance somewhat over the most recent three years, but it led our

portfolios to well above average performance for the past six or seven years, the recent rally notwithstanding. We remain cautious today, expecting the eventual renewal of the bearish long cycle that began in 2000.

Let me explore potential reasons. In the very short term the persistent stock price rise has led to a significantly overbought condition. In most sentiment surveys investor expectations have reached levels of extreme optimism. Current levels of complacency evidence very little fear of stock price declines. Such surveys are contrary indicators, and current readings mark the areas from which declines, either small or large, tend to begin.

Despite the intermittent, but persistent, stock price ascent since early 2003, the measures of momentum of that ascent have declined since early 2004. While such a divergence has very little timing value, it is quite reliable as an indicator of coming change in price trend. We saw a similar long divergence in the late-1990's forecasting the massive stock price declines that began in 2000.

The Federal Reserve continues to point to inflationary readings that are above the Fed's stated comfort level. Because of that the Fed has kept open the alternative of additional hikes to short-term interest rates. From the stock market's perspective, neither hiking nor halting is an attractive short-term alternative. Historically stocks perform well below average when interest rates are rising. Conversely, stocks perform well above average when interest rates are declining. Since 1920, however, the Fed has ended an extended interest rate tightening cycle 15 times. In 12 of those 15 instances, stock prices were down six months later. On average the Dow Jones Industrials were down almost 10% ten months after the final rate hike. In other words, while the market likes declining interest rates, it has typically performed poorly in the first year after the Fed takes its foot off the interest rate brakes.

On a fundamental basis stocks remain extremely expensive as gauged by traditional measures of valuation. After four years of economic strength, ratios of price to dividends, book value, earnings, sales and cash flow remain typical of valuations at the major stock price peaks of the past 80 years.

With American consumers continuing to spend freely and forego savings, their debt levels continue to reach historic highs. Many have borrowed and spent much of the equity in their homes. Many others stretched to buy houses out of their financial reach but for adjustable rate loans and other means of creative financing. Over \$1 trillion of such loans will have their interest rates reset higher in the next year. Many marginal homeowners will find it difficult to make the new payments. Vast numbers of consumers have viewed growing home values as their savings accounts. Should home prices decline even mildly, consumers, who represent about two-thirds of the economy, are likely to become more circumspect in their spending. Should the economy slump into a recession, the inevitable increase in unemployment could wreak havoc with debt-strapped, savings-short consumers.

Depending upon whether one dates the start of the current rally to July 2002 or March 2003, it is now either three and one-half or four and one quarter years old. Over the years stocks have, in several instances, rallied strongly after major declines. The most dramatic such rally followed

the worst bear market in U.S. stock market history, the 89% decline from September 1929 to July 1932. With only brief interruptions, prices rose for four years and eight months after that crash.

The market's decline from 2000 to 2002/2003 was the most severe since the Great Depression. The current recovery rally is second in duration only to the rally that followed the Great Crash. In any case, it is very long in the tooth. What followed the 1932-37 rally was not pleasant. Stock prices fell by more than half into April 1942.

We cannot know when the current rally will end, nor do we know what will follow. As we have explained in numerous talks and reports, however, we believe a long weak cycle commenced at the market peak in 2000. Over the past two centuries market historians have clearly identified seven extended strong cycles alternating with seven extended weak cycles. Both weak and strong cycles lasted an average of almost a decade and a half. The shortest of the extended weak cycles in the twentieth century lasted 16 years.

The specific reasons for strength or weakness varied from cycle to cycle. In general, however, market excesses at the end of the strong cycles led to corrective declines that played out through the weak cycles. As weak cycles dragged on, excessive pessimism developed, valuations became depressed, and the conditions were once again in place to spawn the ensuing long strong cycle.

The greatest strong cycle in U.S. history effectively covered the decades of the 1980's and 1990's. By the end of the century, valuations reached levels never even approached at prior market peaks. While dotcoms became the poster children of the bubble era, even as august an investor as Warren Buffett admitted that he and most of the rest of us failed to recognize that the great companies of American industry had also reached bubble prices as we entered the new century.

Stock prices were obviously pummeled from 2000 to 2002/2003. The S&P 500 declined by 50%; the NASDAQ Composite fell nearly 80%. Remarkably, despite those losses, stock valuations came nowhere near the depressed levels that have marked all major stock market bottoms. In fact, valuations never declined below levels characteristic of major market tops.

We do not believe that the long patterns have ended. On the contrary, we expect to see them play out in similar form in the decades ahead. This does not indicate that the current rally cannot go farther. It does indicate, however, that we are in an extended period in which significant, lasting stock market gains are a low probability. In such a period price declines have typically wiped out all prior valuation excesses. During the three extended weak cycles in the twentieth century, which covered 54 years, risk-free cash equivalents provided a better total return than did common stocks. With cash equivalents today yielding more than 5%, we are still looking for stocks that will provide better than average returns. We are willing to accept that essentially risk free return, however, rather than accept the risks of large allocations to equities at historically unattractive valuation levels. Market declines will lead us to more equity purchases at more attractive prices -- perhaps sooner, perhaps later.

Besides characteristics inherent in markets, there are other large potential problems on the horizon. Geopolitical concerns exist in Iraq, Afghanistan, Iran and North Korea. Securities market regulators have worried out loud about a breakdown in a derivative chain that could cripple one or more giant institutions. Major investors have voiced fears about how the world's securities markets could handle a simultaneous failure of several large hedge funds.

Risk has not been realized in the last four years, but unrealized risk is not necessarily risk eliminated. As explained earlier, one can always find reasons to be bullish toward stocks. In long strong cycles investors should be aggressively bullish. We believe, however, that the vast weight of evidence today shows more risk than probable reward to the major stock indexes over the next few years, notwithstanding the current market rally.

We stand ready to move aggressively into common stocks if prices and valuations should reach attractive ranges. That could happen rapidly if we experience a market-shaking event. On the other hand, we are patient and are willing to accept a better than 5% income return as we look for more attractive longer-term investments. As has been the case in prior long weak cycles, that risk-free return may well exceed the return on stocks over the next few years.