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Financial Markets Commentary

1st Quarter 2005

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Summary

The first quarter of 2005 was very difficult for investors. All of the major asset classes; U.S. stocks, foreign stocks, U.S. bonds and foreign bonds – declined. Even real estate sold off (6.7%). In most cases the declines were modest, but the broadness of the market weakness illustrates how hard it was for investors. Outside of the very volatile energy sector and somewhat volatile emerging markets (and cash of course), no sector made money. The markets were caught last quarter between strong current economic growth and rising oil prices on one hand, which put upward pressure on interest rates (and downward pressure on bonds) and fears of a future economic slowdown on the other. These economic concerns were driven by the same rising interest rates and oil prices which were cited in cautionary comments from the likes of Wal-Mart, Harley Davidson, General Motors, and others.

In the bond market, the first became last and the last were still not very good. Last year's winners were high yield corporate bonds and non-dollar foreign bonds. This quarter both sectors took big hits. High yield bonds were hurt by warnings from the automakers (among others) which led to a widening of the yield spread over Treasuries as investors had to price in a greater likelihood of defaults now that the economic cycle had possibly passed its peak. International bonds declined due to a rise in the dollar. Investors had bid the dollar down to unreasonably pessimistic levels at the end of 2004 on fears of our growing deficits. However, the growing interest rate differential between the U.S. (economic strength, rising yields) and Europe + Japan (economic stagnation, flat yields) makes the U.S. currency more attractive (as long as the deficits do not widen too rapidly). Even if you avoided those sectors, you still didn't make any money in bonds. With yields that are mostly below the annualized rate of inflation, treasury and mortgage bonds are just not very attractive.

Strategy

We made a number of changes this past quarter, both to reflect the changes in the benchmarks and because we were at a point in the economic cycle where portfolios needed a greater degree of change. Often times we will change one position in a portfolio due to performance, but that will not reflect a change in our outlook on the overall market. This time, we saw the economy at the late stages of the market cycle where bonds and small company stocks will probably

not perform as well as they do in earlier stages in the cycle. International and emerging market exposure may help portfolios if fewer and fewer domestic sectors are advancing. All portfolios saw some changes, but the Balanced Portfolio (where there are the most holdings) changed the most.

Performance

Returns last quarter were negative for all portfolios, though in all areas except aggressive portfolios the losses were less than one percent. This compares to losses of about 1.5% for the Balanced benchmark and 2.4% for the Aggressive benchmark. Our favorable performance was large due to superior fund selection, especially in the real estate, international stock, and large cap value areas. Only one holding (Calamos Growth) performed more than one percent below its category average.

Outlook

Much of this will be expanded upon in the Commentary section, but the key issue is that we are heading into a part of the market cycle that tends to be fairly unfriendly for investors. We were cautious at the beginning of the year, because while the economy was doing well, valuations were fairly high such that there was little margin for error. If the economy continued to do well, stocks were priced to return high single digits. If the economy were expected to falter in any way, returns would obviously have to be lower. We didn't know then (and still don't) if the current expansion was going to last throughout 2005 or end sometime during the year, so we could only react as conditions dictated. As the quarter progressed, economic reports suggested the expansion may end sooner rather than later. This has negatively impacted stock prices, and caused us to take the actions described above. However, just like with the dollar at the end of 2004, I believe sentiment has become too negative. That gives us an opportunity to rally at least back to the February highs.

Commentary

Just like nature, the stock market tends to have seasons. Investors can make money any hour of any day of the year, but statistically, stocks tend to do less well between May and October than they do from November to April. The numbers are not even close. In a similar vein, markets tend to do better in the third and fourth years of a presidential cycle and less well in the first two. Also, markets tend to do much better when the Federal Reserve is more than six months into a cycle of lowering rates, and they are poorest statistically when the Fed is well into a tightening phase. Lastly, cyclical bull markets last two and a half years on average. If you date the beginning of the bull market to October of 2002, when the market put in its cyclical low, we are about there. If you date it from March of 2003, when the lows were briefly tested, the cyclical bull should end somewhere around September.

The point in bringing all of these statistical pieces of information up is that it is entirely possible that we are heading into the market equivalent of December. Even if that is true, it doesn't mean that the market is going to decline every week or every month. It is just going to be harder to make money. There is an explanation behind each of the tendencies described above. Stocks tend to do better when interest rates fall (because the cost of borrowing is lower and the availability of credit tends to be easier). Stocks usually do better when politicians are throwing money at the economy trying to get re-elected as opposed to after elections when they are busy trying to show how financially prudent they are.

It tends to be harder to make money in the summer because business purchasing decisions are more often made in the part of the year when everybody is at their desks than when a third of the office is on vacation. Finally, stocks do better earlier in the business cycle than later because the rate of change is better going from negative growth to ten percent growth than it is trying to maintain ten percent growth (Note: rate of change is everything to investors. It is almost always better for profits to be low and rising than high but falling. This is because markets are constantly trying to discount the future, and they tend to do so by extrapolating the recent past).

This leaves us in a position where we want to be a little more conservative. This means having a little bit more cash in each portfolio, and having more and smaller positions in each portfolio so any one position can't hurt the overall portfolio as much. We will still be able to participate in the rallies that we will certainly get from time to time (especially as sentiment is currently more negative than conditions warrant). Like winter in Minnesota, however, next few months are probably going to be more of a time to endure than a time to thrive.

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