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Financial Markets Commentary

1st Quarter 2006

Summary

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Stocks did very well last quarter on the whole. The widely followed S&P 500 stock index rose 4.2%, but that was quite a bit less than what one might have earned in the riskiest areas of the market. For example, small company funds gained more than 12%, China funds gained 20%, Latin America funds gained 16%, gold gained 20% and natural resources gained 10.6%. While investors embraced the more volatile sectors of the market, they continued to turn their noses up at dividend paying high quality large companies. Consumer staples, health care, media, and insurance stocks barely budged. It is understandable that investors want to be where returns have been the strongest, but performance chasing is starting to take on 1999-like overtones, more on that later.

The bond market experienced another difficult quarter. The Federal Reserve raised rates in both January and March, forcing prices on existing short term bonds lower. However, investors believe this will have the effect of reducing long-term inflation; they might be willing to buy long term bonds. This was the case in the first three quarters of 2005, but not recently. Long term bonds have underperformed short bonds for the second straight quarter, this time 0.2% versus -1.0%. Inflation-protected bonds dropped 2.2% as interest rates went up faster than inflation. Bond investors tended to prefer “equity-like” areas of the fixed income market (high yield, convertible, and emerging market debt) because their performance is tied more to economic health than interest rates. While this makes sense in the short term, it reduces the effective diversification of a portfolio. In other words, if the economy weakens, these bonds will fall along with stocks.

Performance

Returns were skewed toward risk as dramatically as they were in the late 90s. Bonds were a drag on performance, so our Balanced Conservative and Balanced portfolios were impacted even though we featured short maturity bonds (Vanguard and Calvert) and emerging market debt (PIMCO). The Balanced Aggressive and All Equity portfolios were better able to take advantage of high risk niches in the market with such funds as Oppenheimer Developing Markets and Rainier Small-Midcap Equity. We continued to hold an above average level of cash in our portfolios. Cash is a favorable alternative to bonds during period of rising interest rates (especially when the Federal Reserve is actively raising rates).

If stock prices continue to rise despite deteriorating fundamentals, it makes sense to substitute cash for stocks as well. We can put that cash to work buying stocks later at lower prices.

Outlook

We are always pleased when the markets give us better returns than we expect. We would feel better if that excess performance came as a result of an improved environment for corporate profits. If debt levels were falling, if commodity prices had stabilized, or if there were better sales and earnings news from the largest companies in the economy – GE, Coca-Cola, Intel, Johnson & Johnson or Microsoft are all flat to down on the year – we would be happy to say that we were bullish. That just isn't the case right now. Regardless of how much their stock prices might rise, there is only so much of your money that we are ever going to put in an Indonesian cement company or a Canadian gold miner. (And that isn't much)! That might mean we lag the market a bit until more normal conditions prevail.

Commentary - A Looney Tunes Market?

For those of you familiar with classic cartoons, there is one Roadrunner cartoon that I have found myself thinking of fairly often recently. Wile E. Coyote is in theory more intelligent than the Roadrunner, albeit less physically gifted. In one particular episode, Coyote uses rocket-propelled roller skates to make up for his lack of speed. To his delight, he discovers he can not only match the Roadrunner's pace but exceed it. Just as he is about to catch Roadrunner the bird abruptly stops and steps aside revealing a cliff. The Coyote, unable to stop, speeds past the Roadrunner and sails over the cliff edge. There is a moment where the Coyote stops in midair and realizes his predicament is not going to end well. This analogy comes to me when I think about how investors are ramping up the risk in their portfolios even as stocks are getting more expensive (and therefore offer less value).

Any students of market history will tell you that it is hard to get people to buy the market at the beginning of an uptrend because recent history has been negative and investors are skeptical. On the other hand, as the move becomes well established everyone becomes enthusiastic. Take gold, for example. In 2000 it sold for less than \$300 per ounce. Nobody had made any money in gold for twenty years, so it was severely under-owned. Eventually, due to the absence of central bank selling and demand from Asia, prices started to improve. While the price gains were gradual through 2004, they have been very sharp recently. Its close just above \$600 on April 13th was a 25-year high. The very next trading day gold soared another \$18.

Once a rally really gets going it can seem like it will never stop. Yet, if you think about it, there are far fewer potential purchasers today. If things always look darkest before the dawn, as the saying goes, they may also seem the brightest right before the sun sets.

I don't mean to pick on gold in particular; a similar case can be made for emerging markets, real estate, and small company stocks. There is no reason to expect the rally in any of these asset classes to end tomorrow. The point is these rallies all will end at some point. And if we learned anything from the end of the rally in technology and telecom stocks six years ago, it is that bull markets can reverse in a big hurry.

Like the Coyote, one can chase the goal (market) so aggressively that they are in no position to react to a significant change in the landscape, and suddenly find themselves in free fall. We've done well in many of these asset classes (especially in the more aggressive portfolios), but we know it is prudent to start slowing down (taking profits, redeploying assets to other areas) while we are still on solid ground. We can't wait until the cliff is evident to everyone. By then it is too late.

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