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Financial Markets Commentary

2nd Quarter 2006

Summary

July 21, 2006

In the previous quarterly report we addressed in our Commentary section our concern that the stock market here and overseas had gotten ahead of itself. This concern was borne out by the markets' performance after May 10th. Reports showing rising inflationary pressures on a global basis led to an understanding among world central banks that the excess liquidity they created in order to stimulate certain economies needed to be reined in. Very low interest rates are an invitation to risky behavior. There were no better examples of that than the performance of emerging markets (up 46% in the year ended March 31) and gold (up 78% in the same time period). As world central banks began to make credit harder to obtain (or certainly more expensive), stock markets began to fall worldwide. Declines were roughly in proportion to risk. Emerging markets lost more than established markets, small companies lost more than large companies.

Because of this "flight to safety" response, the biggest stocks lost little or nothing on the quarter. The Dow Industrial Average gained 0.9% (largely due to speculative buying of General Motors), the S&P 500 lost 1.4%, and the smaller company oriented Russell 2000 lost more than 5%. Similarly, while the average international fund lost just 0.7%, emerging markets funds declined almost 5%. Since small companies have outperformed large companies every year since 2000, the average mutual fund was really tilted towards small caps. That is why the average U.S stock fund lost 3.3% in the second quarter. Utilities (traditionally the most defensive sector) gained 3.8%, while technology was by far the worst sector with a 9.6% loss.

The bond market recorded a small loss last quarter, but the outlook there has improved. There were two additional interest rate hikes during the quarter, and with higher gas prices and rising inflation it is not difficult to see why bonds have struggled. However, with evidence emerging in recent reports on retail sales, home prices, and payroll growth that the economy is starting to slow, bonds have done better of late. June's gain left the bond index with a loss of just 0.08% on the quarter. As with stocks, the flight to safety impulse was evident in the bond market. Emerging market debt was the weakest part of the bond market, and short-term high quality bonds performed best.

Performance

We had already made some moves in since late last year to increase the cash positions in all but our most aggressive portfolios. For this reason, we did not have to make radical changes when the market began to sell off. However, we did make some fund substitutions in May. The purpose was either to replace funds with strong up market track records with ones that lose less on the down side, or simply because a fund wasn't performing as well versus its peers as it had in the past. Oppenheimer Developing Markets and Calamos Growth have very strong track records but each was eliminated last quarter because we don't believe their future performance will be nearly as good.

Outlook

The Federal Reserve is either done or just about done raising interest rates. Based on the slowdown in the economy that we are seeing, they should be done. If this is the case, sentiment in both the bond and the stock market will be improved. The test will be how the economy responds. Interest rate moves affect the economy with a lag of up to 18 months. If moving short-term rates to 5.25% or 5.50% impacts inflation without too much impact on the economy, they we will look back on July of 2006 and say stock prices were pretty inexpensive. On the other hand, if it turns out that the Fed either raised rates too much or failed to get the current increase in inflation under control, then today's stock prices will not have been a bargain at all. Bonds, most of which have actually lost money over the last 12 months, almost certainly will do much better.

Commentary - The Psychology of Investing

It is always surprising how fast sentiment in the market can change. On April 30th we were wondering if we had gotten too conservative, and on June 15th we began to think we were not conservative enough. Of course, this is what everybody was feeling at those times, and knowing that provided us some comfort. Doing the right thing during sharp market moves can be difficult, because one's natural impulse is to be fearful when markets are declining and aggressive when markets are strong. People tend to believe that whatever the market is currently doing it will continue to do in the future. Behavioral psychologists call this linear thinking. Intellectually we know that markets generally move upward in a zig-zag fashion over time. However, during periods where the market is moving strongly in one direction we often forget what we know and act on what we feel.

Centuries of human history have taught us that blending in is favorable (if not essential) for survival. Even today, we take psychological comfort from dressing the same way other people dress, or speaking with the same dialect or inflection or slang. Ask a junior high student how hard it can be to be different.

In the majority of the areas of human endeavor, realizing one is “out-of-step” should cause one to at least re-examine one’s convictions. In the realm of investing, however, running with the herd is usually not a successful strategy. In fact, the herd isn’t even average. Investment results are not a “bell curve” where roughly equal numbers of participants do better and worse than average. The investment curve is asymmetrical. A decided minority earn much more than average and a large minority does moderately worse.

Most people are not psychologically equipped to be good investors, because they cannot resist the herd, especially at market extremes (when it is absolutely essential to do so). Understanding the psychological component of investing can help us understand why there is such a strong pull to be in step with the market, but the important thing is this: if one is to be a successful investor there are critical points when one absolutely has to be able to sell when others are buying and buy when sentiment is poor.

Our investment approach involves making the most informed assessments of market conditions as we can, and then having the courage to act on these convictions even if the market is not cooperating. Like anybody else, we are very pleased when the market is moving in the direction that agrees with how we are positioned. However, we have learned to become uncomfortable when our convictions become the consensus, because that cannot lead to superior returns. To perform better than the market you have to move before it does. At first this will mean not only being out of step but also underperforming.

At Capital Strategies, we have been successful over the long-term for our clients because we have been able to resist the emotional pulls of the market and make objectively sound decisions which have resulted in excellent investment performance for our clients.

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