



7705 TANGLEWOOD COURT ■ EDINA, MN 55439 ■ 952.926-3000 ■ www.capstratcorp.com ■ e-mail: capstrat@mn.rr.com

Financial Markets Commentary

4th Quarter 2005

January 20, 2006

Summary

Stocks rose again last quarter, but the advance was not nearly as broad as it was in the previous quarter. In fact, some of the sectors that performed well earlier in the year, such as utilities and energy, posted losses. Small company stocks gained only 1%, trailing large companies (+2.1%) for the first time in quite a while. On the other hand, international stocks widened their performance advantage over U.S. stocks. Japan, Latin America, and Russia once again did much better than the rest of the world. Mid-cap stocks, those companies with market capitalizations between \$2 billion and \$10 billion, continued to be in the sweet spot for market returns. Their return (almost 2.5%) exceeded that of both large and small caps on the quarter and for the entire year (approximately 9% vs. 5% and 5.5% respectively).

World stock markets were again the big story last quarter. Because of the 12.6% gain in the dollar, US investors only saw about a 14% gain for foreign stocks last year. In local currencies, however, world markets were up 27%. Japan benefited from a weaker currency, which made their finished goods more competitive. Russia and Latin America profited from gains in natural resources prices; soaring oil prices lifted Russia and a broad range of commodities (including copper and coffee as well as oil) supported Latin America. Behind all this is China, of course. It is Chinese demand that has lifted raw materials prices so dramatically in recent quarters.

The Federal Reserve has been the major driver of stock and bond market performance in the US in recent months. Indications that the Fed might be close to the end of its credit-tightening campaign sparked a rally over the summer. Later, stronger economic data called that into question, leading to a sell-off in October. The Fed itself hinted in November and again on January 3rd that they may be close to done, both times sparking rallies. Markets that move on hints and rumors are harder to manage than those that move on concrete economic data.

Bonds gained less than 1% once again last quarter. In return for very low volatility, investors are stuck with modest returns. Without volatility, it is difficult to add return even by trading actively. Many investors have opted for money market funds or short term bonds, since the yield differential from a 3-month Treasury to a 10-year Treasury is almost non-existent. High yield corporate bonds did only slightly better than government bonds (0.84% to 0.56%). Emerging market bonds were the only sector of the bond market to top 1%.

Strategy

We took advantage of the modest rally in stock prices to reduce stock exposure by up to 5%. The economy is likely to slow down as the effects of the two year interest rate tightening campaign take hold. Markets are cyclical; this cyclical rally began in March 2003 and is rather long in the tooth. If you sell a rally a little early, you do give up some upside – and we did give up a little upside last quarter -- however that is usually preferable to selling a little too late. That said our performance was still very competitive with market benchmarks.

Performance

Performance last quarter was generally in line with the CSFC Benchmark. We made portfolios modestly more conservative last quarter by trimming back the more aggressive positions and by raising cash. We saw a number of concerns both economically and politically. Because we stress capital preservation, we are always going to risk being early to avoid being late. Some of our managers seemed to be thinking the same thing, because returns have tailed off lately for a number of managers, including Hotchkis & Wiley and RS Investors. We have not trimmed the international positions because interest rates have not been rising anywhere else in the world as long as they have been here.

Outlook

Markets have started 2006 positively. There seems to be some hope out there that the Federal Reserve can slow the growth of inflationary pressures without negatively affecting the economy or corporate profits. That would certainly be bullish, but it is a little like expecting to have your cake and eat it too. Since the Fed has never successfully pulled this off before, I'm not going to bet on it now. I expect mid-single digits return on both stocks and bonds. Doing better than that will likely require skillful fund selection, an overweight in international markets, and the ability to shift from offensive to defense and back when valuations warrant.

Commentary – The Importance of Valuation

The U.S. stock market rose about 6% last year on average. The Japanese stock market gained 43% (in yen). Europe gained 22% (in euros). Interestingly, the U.S. experienced a higher degree of economic growth than did either Japan or Europe. From this we can conclude that market returns are not closely correlated to economic growth. Other than growth, the other components of investment return are yield and risk premium. Since companies typically change dividend policies very little from year to year, that doesn't explain wide stock price fluctuation either. That leaves us with risk premium.

Risk premium is a measure of how risky the market views a particular investment. In other words, if I can earn 4.25% on very safe Treasury bills, how much more do I need to make on a less safe investment to compensate me for the added risk? If I

want to have \$100,000 five years from now, I have to put \$81,212 into T-bills today (assuming a constant 4.25% return). Suppose I would like to deposit less than that. If I assume my stock and bond portfolio will average 7% over the next five years, I only have to contribute \$71,299 now. Even better, I decide to put all my assets in small company and international stocks, which I figure will do 10% per year. Now I only have to put down \$62,092.¹ The more risk you assume an investment has, the less its present value is. Incidentally, this is how corporate retirement plans work.

Imagine it is the first day of 2005. You have the choice of investing in the United States or in Japan. You reason that since the US has a faster rate of growth, a more stable economy, and a better regulatory environment, the US should do better. Therefore, based on the extra risk you would have to take to invest in Japan, Japanese stocks should be priced substantially lower. And so they were. By year's end, you note that the American economy performed well. Unfortunately, it was priced that way. US stocks were regarded as relatively low risk assets and when they delivered on that assumption, the market basically said "ho hum". On the other hand, the Japanese economy far exceeded the very low expectations investors had on it, allowing investors to reconsider the risk premium. Arithmetically, a super risky asset that carries a 15% return requirement would appreciate 24.9% if investors suddenly consider it only a moderately risky asset and require just a 10% rate of return.

Right now most stocks and bonds are just not priced to deliver high rates of return. The Federal Reserve, in trying to stimulate the economy, made credit (money) cheap and easy to obtain. This extra money sloshing around has lifted stock prices because investors have been willing to accept lower future returns (partially on the belief that stocks are inherently less risky since the Fed will lower rates to bail them out whenever economic conditions deteriorate). By tightening credit (raising rates), the Fed is trying to combat this belief.

Ultimately, this would raise the potential return on stocks and bonds. In the short run, as indicated in the Outlook section, the only way to improve returns is to find sectors of the market that might not turn out to be as risky as investors currently perceive them.

Capital Strategies Financial Corporation

Mark A. Carlton, CFA Eric C. Graber, President

¹ (Of course, five years from now either of the portfolios could be worth substantially more or less than \$100,000. As investors, all we can work with are assumptions, which are based on historic investment returns and historic relationships between asset prices and economic factors such as interest rates and GDP growth.).