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## AT A GLANCE

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## Don't Look Now, but People are Better Off

Prior to digging into the first quarter, we wanted to address an important study that was published by the Fed in February. Because the news was largely good about the increasing wealth of the citizens in this country, we feel it has been underreported.

### Bad News "Sells"

The press seems to live by the credo "Bad News Sells." And a standard political theme for the opposition party in this country has been "Are you better off today than you were four/eight/ten years ago?" Based on the 2004 Survey of Consumer Finance, released by the Fed in late February, the answer is "yes." Americans are better off than they were in 1995. However, the study was not highly publicized because it is boring when the news is good. Much of the information from the following summary is from Ed Yardeni at Oak Associates, one of the many research firms we use:

- 1 Based on income alone (excluding capital gains), the median family income is up 14% since 1995 and mean family income is up 29% since 1995. The mean is the average of all the incomes. The median is the middle person in the survey (if there were 1,000 people in the survey, the median would be the family income of the 500th person).
- 2 One of the main items the press likes to espouse is that the rich are getting richer while the poor are getting poorer. Not really true according to the survey. The ratio of mean to median family income has bounced between 1.45 and 1.70. The mean is the average income and the median is the middle person in the survey. A higher ratio might mean all wage earners were not benefiting from the increase in salaries—just the most highly paid.

- 3 The median net worth of all families rose 44% from 1995-2004 to \$93,100 while the mean rose 72% to \$448,200.
- 4 The median net worth of those who own homes rose 44% from 1995-2004 to \$184,400. The mean rose 67% to \$624,900. A noteworthy statistic is that in 2004, 69.1% of families owned homes, up from 61.3% in 1995.
- 5 On average, American families tend to have roughly one-third of their assets in residential real estate, including both primary residence and other residential property. On average, American families tend to have about 17% of their assets in their own businesses.
- 6 About a third of financial assets are in retirement accounts. In 2004, the share of these was 32%, up from 28.1% in 1995.
- 7 In 2004, American families had median unrealized capital gains of \$23,000, up 238% from 1995. The mean unrealized capital gain was \$161,700, up 94% from 1995.

### And How About Debt?

- is there really a growing consumer debt crisis? Not really:
- 8 The debt of American families accounted for only 15% of their total assets in 2004, not much different from 1995.
  - 9 Most of Americans' debt is in mortgages, which accounted for 75.2% of total consumer debt in 2004, about the same as in 1995.
  - 10 The percentage of Americans who are debt-distressed was 18% in 2004, not much more than in 1995.



Thanks for all of you who took time to fill out our client surveys. The surveys continue to be a valuable tool for us to figure out where we might improve.

### What Do Our Clients Expect?

How do our clients feel about things? Based on the responses to the "guess the Dow contest" we run each year clients are optimistic, but not wildly so. The mean and median guesses were very similar both around 11,500 which would mean a rise of 7.3% in the Dow for 2006.

The market has been fairly volatile for much of 2006, finally gaining some good traction the week ending with St. Patrick's Day. Stocks had a good week—the price appreciation of the S&P 500 Index was 2% last week through March 17th, and for the year to date price appreciation for the S&P was 4.7%. The Dow stands at 11,722.98 which is 510 points or 4.3% from its all-time high. The environment has been good for stocks—good GDP growth, good earnings reports (generally speaking, but as always dependent on the stock market sector) and less than scary inflation.

Prior to last week, the market had been held back by the continued malaise over the international scene and, more importantly, the unease over the direction of the US economy. The Federal Reserve has to walk a very narrow tightrope as it manages the US economy with increases and decreases in the Fed Funds rate. Too much economic growth leads to inflation worries, which leads to more increases in the Fed Funds rate which can hold back stock market growth.

The best environment and the one the Fed strives to attain is one with moderate growth and low inflation. The stock market tends to rally on slowing economic news and then can rally further as the economy slows even more because of the increasing odds that the Fed will start to decrease the Fed Funds rate. In 1995, the Fed started decreasing rates only five months after the last rate increase. The big IF, however, is if the country does not head into a recession because of the rate increases. The tightrope the Fed walks is that there is a lag in the impact of the rate increases. Not overdoing the rate increases and causing a recession is obviously important.

On Friday, March 17th, the Fed issued the periodic Beige Book report which seemed to indicate that inflation has moderated. Economic activity was solid and continuing to increase across the country in January and February. Also, employment increased in most locations and sectors of the economy. There was good inflation news as well with retail prices increasing only at a moderate rate and labor cost pressures little changed. Oil inputs and materials continued to be the primary inflation concern. However, to cap an already fine week for economic data, oil prices moved down as well.

An additional area of concern has been the overheated housing market. It is clear that housing is slowing significantly. The California Association of Realtors reported that sales in January were down 24% compared to the previous year and there was a decline in the University of Michigan's housing survey through late February. This suggests that the froth is coming out of the housing market. Because of high employment and solid wage gains, we have not been concerned about a housing bubble. As the froth comes out of the housing market this should help moderate economic growth also.

As we stated in December's newsletter, the year in which economic growth moderates and the Fed stops raising rates after a period of significant increases tends to be a year of double digit growth for the stock market. Right now, investors are counting on an increase to the Fed Funds rate in March from 4.75% to 5% and based on Fed Funds Futures the odds of a May increase are approximately 80%, but lessening after the Beige Book report.

What is the bottom line and what does it mean for our client portfolios? We have not changed our outlook on 2006. The economic data continues to support a slowing but still growing economy, reasonable inflation and one or two more increases in the Fed Funds rate. Barring an international disaster or an abrupt change in the economic or inflation data, this should bode well for the stocks in your portfolio.

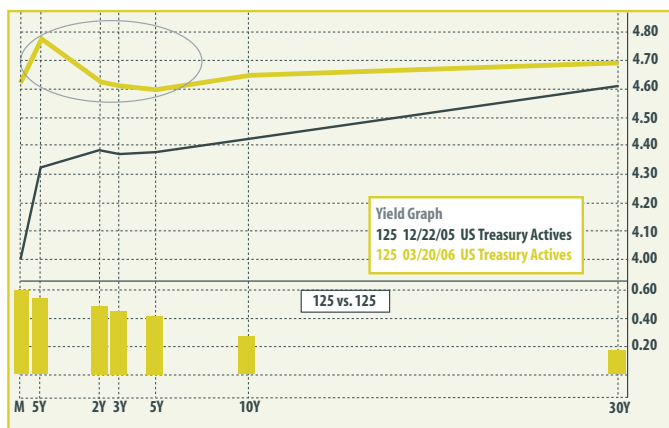
We want to end with a quick note of thanks for all of you who took time to fill out our client surveys. The surveys continue to be a valuable tool for us to figure out where we might improve. Since we started the annual survey, the numbers have continued to rise and although there are instances where we can do better, in 2005 we averaged between 8.22 and 9.5 (out of 10) in each of the categories surveyed. We were especially happy with our rating of 9.50 in responsiveness. Our communication has continued to improve as well. While we do not average a 10 yet (and that is our goal) your feelings about our continuing improvement are especially gratifying.

# Bond Market Overview

At the risk of sounding like a “broken record,” the theme of the bond market for the first quarter of 2006 continues to be the same, more Fed tightening of short term rates and a “flat” yield curve. In our year-end newsletter we wrote at length about the flat yield curve and the potential for an inversion of the yield curve (short-term rates being higher than long-term rates). We also talked about the competing opinions of economists on what an inversion of the curve could mean to the prospects for the economy. Some believe it to be the precursor to a slowing or recessionary period, while others merely attribute it to the strong demand for assets having longer maturities.

Well, we did in fact experience an inversion of the yield curve around the end of December 2005 and it remains inverted today. However, we are not any closer to ending the debate on what the inversion means for our economy in the months ahead. The graph below shows a “snapshot” of the Treasury yield curve as of our last writing and now.

**YIELD GRAPH**



Bloomberg, 2006

In addition to the inversion (circled area) of the Treasury yield curve, we can also see that the general level of interest rates has gone up since the end of last year. The increase has been relatively proportional for the intermediate part of the curve (2 – 10 years), while the very short end has increased more and the very long end has increased less. This reflects actual Federal Reserve increases to the Fed Funds rate (from 4.25% to 4.50% on January 31, 2006) and the continued expectation of further tightening of monetary policy by the Federal Reserve Bank in the coming months (March and May).

Longer rates have increased because there have either been increasing inflation expectations, and/or the economy has not slowed as expected over the last three months. It is difficult to say, based on the economic evidence that we’ve seen this past

quarter, whether the increase in longer rates is fundamentally driven or whether it is more of a technical correction to an “overbought” market.

There have been no major unexpected readings of current inflation recently. The Core Consumer Price and Producer Price Indices have both been relatively “in-line” with expectations and show modest changes month to month. Another favorite measurement of current inflation, the Core Personal Consumption Expenditure Index has also been relatively consistent with expectations. However, economic indicators that could potentially create upward pressure on prices and increase expected inflation have strayed a bit from expectations. Employment data has been better than expected. The unemployment rate has declined to 4.8% from the 5.0% we saw last quarter. Expectations were for that 5.0% to continue. Unit Labor costs were also a bit higher than expected in the 4th quarter of 2005, 3.3% (annualized) compared to the expected

3.0%. One final indicator that historically has kept a “lid” on inflation is Non-Farm productivity.

The more productive we are as an economy, the less chance there is that prices will increase, simply because of the competitive nature of economic forces at work. In the 4th quarter of 2005, Non-Farm productivity was a bit lower than expected, -0.5% rather than the -0.1% that was the economists’ consensus forecast.

However, when reviewing all of this data, we can’t make a strong case for inflation picking up. We believe that inflation continues to be under control and that the most recent increase in long-term rates is attributable to an economy that is not slowing down as expected, while

short-term rates continue to rise. There are still many uncertainties in the bond market regarding what this inverted yield curve may portend for our economy, we remain cautious about **overweighting** long duration bonds. Until we feel more confident that the tightening monetary cycle is coming to an end or that there are stronger signs of a slowing economy we will tread carefully.

## Longing for Long Bonds

Pardon the pun, but we’ve often been asked why our fixed income discipline does not focus on longer maturity bonds (greater than 10 years). The simple answer is that the risk/reward of long bonds over time is inferior to that of bonds of intermediate maturity (1 – 10 years). What is the basis for the above? How do we know this to be true?

We’ve often been asked why our fixed income discipline does not focus on longer maturity bonds (greater than 10 years). The simple answer is that the risk/reward of long bonds over time is inferior to that of bonds of intermediate maturity (1 – 10 years).

In our opinion, the conclusions derived by Ibbotson and Sinquefeld concerning the risk/reward relationship between intermediate-term and long-term bonds is still valid. We don't believe that the greater potential return from longer bonds is worth the additional uncertainty of those returns.

Thanks to a study done in 1973 by Professor Roger Ibbotson and Rex Sinquefeld where they partnered to research historical returns for common stocks, U.S. government and corporate bonds, U.S. Treasury bills, and inflation. Through their research, Ibbotson and Sinquefeld hoped to provide an update to the historical performance study done years earlier by Lawrence Fisher and James Lorie, as well as present convincing evidence that common stocks were still appropriate for long-term investors.

Among the findings of this research by Ibbotson and Sinquefeld was that, over time, the historical returns for long-term and intermediate-term treasury bonds on average were not that dissimilar. However, the variance of returns from year to year was much greater for long-term bonds than it was for intermediate-term bonds.<sup>1</sup> Hence, while the rewards (long term performance) were not significantly different, the risk (as measured by the variance of average returns) was significantly different.

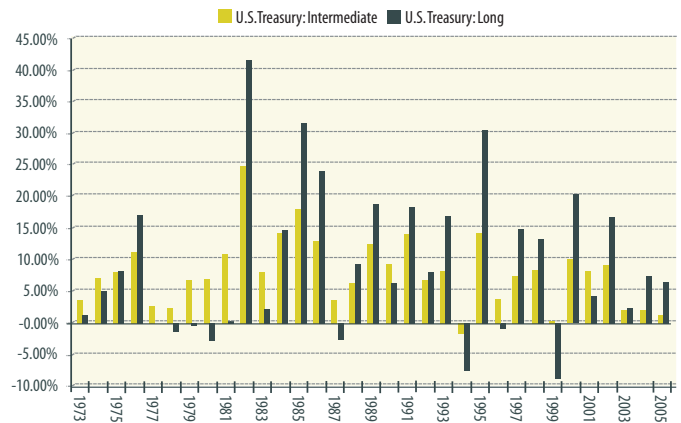
To satisfy our curiosity, and because we think it is of interest to you, we decided to do our own study going back to 1973 through 2005. We wanted to see if the relationship between long-term and intermediate-term bonds still applies. We based our study on the most widely followed bond index provider; Lehman Brothers.

Annualized Returns Lehman Bros. Index 1973 to 2005

	U.S. Treasury: Intermediate	U.S. Treasury: Long	Percentage Change
Average Annual Return	8.09%	9.60%	19%
Standard Deviation	5.50%	11.73%	113%

The above table shows that since 1973 the average annual return of investing in long-term U.S. Treasuries has actually been greater than intermediate-term U.S. Treasuries by about 1.5% per year. However, the variance of long-term bond returns is more than double that of the intermediate-term bonds. In simpler terms, over this period of time, an investor could expect to realize positive returns more often if invested in Intermediate bonds (8.09% ± 5.50%) rather than long-term bonds (9.60% ± 11.73%).

Annual Rates of Return 1973-2005 Lehman Bros.



We can see that over this time period the returns for Long-term U.S. Treasury bonds have been negative in 8 of the 33 years, while the returns for Intermediate-term U.S. Treasury bonds have only been negative once. Furthermore, the average annual returns for Intermediate-term bonds have been greater than those of Long-term bonds in 14 of the 33 years.

Distribution of Annual Returns Lehman Bros. Index 1973 through 2005

Index	Less than 0	Between 0 and 5%	Between 5% and 10%	Between 10% and 15%	Greater than 15%
US Treasury Intermediate	1	9	13	8	2
US Treasury Long	8	5	7	2	11

The above table shows the complete distribution of returns for the 33 year period we reviewed. Notice the wider range of returns for the Long-term bonds compared to the Intermediate-term bonds. The longer bonds had many more occurrences at the extremes than did the Intermediate-term bonds. Furthermore, when we analyzed the maturity structure of each index we found the results even more surprising. Over the period of time in our analysis the average maturity of the intermediate-term bonds was 3.68 years compared to 21.4 years for the long-term index.

What conclusions can we draw from our analysis? In our opinion, the conclusions derived by Ibbotson and Sinquefeld concerning the risk/reward relationship between intermediate-term and long-term bonds is still valid. We don't believe that the greater potential return from longer bonds is worth the additional uncertainty of those returns.

<sup>1</sup>Stocks, Bonds, Bills and Inflation  
Ibbotson and Sinquefeld updated their historical research and formally published "Stocks, Bonds, Bills and Inflation: Year-by-Year Historical Returns (1926 - 1974)" in the January 1976 issue of The Journal of Business of the University of Chicago.

If you are interested in learning more about our affiliate, Cook Mayer Taylor, and their small-cap portfolio management, please contact your portfolio manager or Craig Cairns, President of Howe & Rusling.