Investment Watch

4th Quarter, 2006

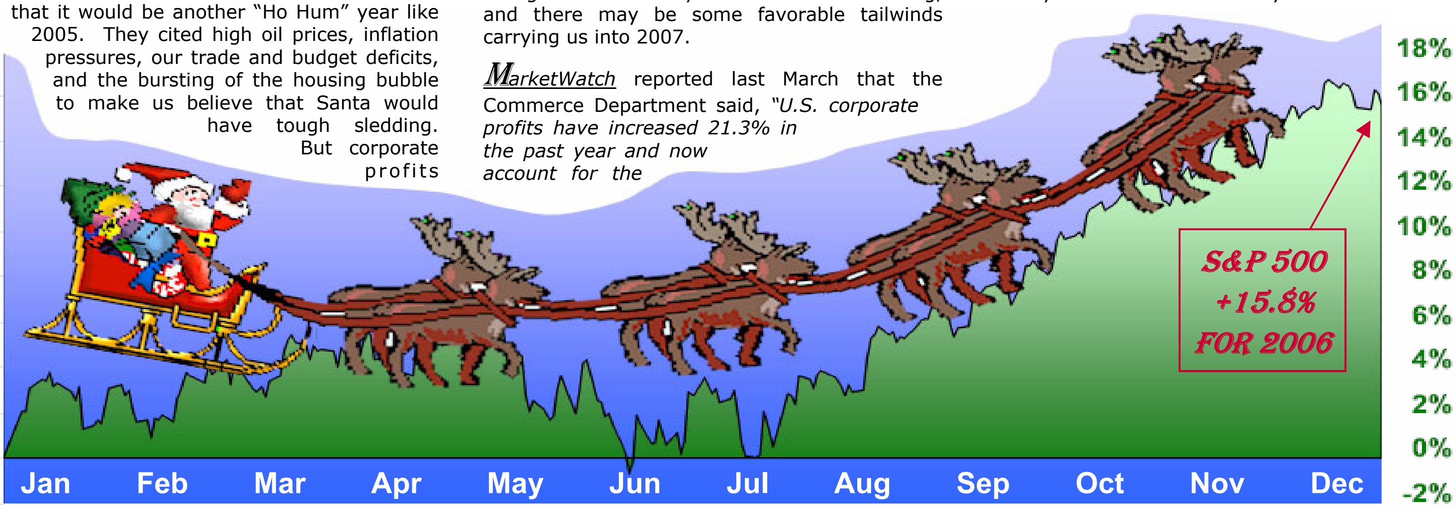
"HOLIDAYS IN JULY"

For stock investors, Santa came early this year in July and kept on giving through the New Year. Not much great economic news here at home and not much good news about our unsettled foreign affairs; but after Santa's sleigh bottomed out in July, he leaned back on the reins and his *"cursors they flew"* to double digit returns in almost every stock category.

This steady, unwavering ascent to new highs was unexpected, befuddling the pundits. Rarely do the markets proceed on such a direct upward course. After the second quarter downturn, many experts thought that it would be another "Ho Hum" year like 2005. They cited high oil prices, inflation pressures, our trade and budget deficits, and the bursting of the housing bubble to make us believe that Santa would have tough sledding. But corporate profits are. For example, if a stock is Priced at $100 and the reported earnings are $5, it has a **P/E** ratio of 20 ($100/$5). If earnings go up by 20% to $6, the price would have to go to $120 to maintain a P/E ratio of 20. **Profits drive prices.** Profits have soared, prices have increased and our savings have swelled. In the yearend *Barron's*, the P/E ratio of the S&P 500 declined from the end of last year to this year, even with the 15.8% boost in the prices. This shows the power of profits and why the Bulls stole Wall Street.

According to the Wall Street Journal, corporate profits for 2006 posted their 5th straight double-digit gain. The consensus estimates a 14.4% profit gain for 2006; however they also forecast profits to decline to around the historic average of 6%-7% for the New Year. Many believe that the slower, but solid, growth bodes well for long-term investors. So not only did Santa's cursors mount to the sky, they may have brought our economy in for that soft landing, and there may be some favorable tailwinds carrying us into 2007.

MarketWatch reported last March that the Commerce Department said, *"U.S. corporate profits have increased 21.3% in the past year and now account for the*



were the backdrop for a much rosier holiday outcome.

Santa didn't disappoint us. In fact, in three out of the last four years we had a **Santa Claus rally**. These yearend surges in the stock market put us in that holiday mood and put money in our 401(k)s. This year the Santa Claus rally was the consequence of unprecedented corporate profits. US companies have been generating more profit than ever before, amassing a record cash hoard.

With the recent upswing in the stock market, many think that stocks are now more expensive than at the start of the year. In fact, the cost of stocks as reported by the Standard and Poor's Corporation, measured by **P**rice/**E**arnings (**P/E**) ratio of the S&P 500, is as low now as it has been within the last 10 years. In fact, you'd have to go back to before 1990 to find lower **P/E's** by more than an just a small amount. More presents for less dollars!

The **P**rice/**E**arnings (**P/E**) ratio is the most common measure of how expensive stocks

largest share of national income in 40 years". This is not a US phenomenon. Santa has been spotted all over the world. European and Asian company profits are also soaring.

However many experts believe that the current level of corporate profits cannot be sustained and that wage and price pressures will wear them away. They also cite the decline in productivity gains, albeit from historically high levels. On the other hand, some believe that globalization will exert downward pressure on wages and inflation across the developed world and may help sustain these profit margins.

Years like this are rare, so let's look closer. As shown below, Dow Jones reports returns for various asset classes displayed using a Morningstar Size/Style box. It uses a grid to describe the size of stocks held in a fund — Large Capitalization, Mid-Cap and Small Cap and Style categories of Value, Blend and Growth.

US EQUITY 2006 RETURNS

	VALUE	BLEND	GROWTH
LARGE	18%	13%	8%
MID	13%	11%	11%
SMALL	17%	15%	13%

As the chart shows, the Small Cap stocks slightly outperformed their larger siblings. This has been the trend for the past five years. Similarly, Value stocks have again surpassed the Growth stocks by a considerable amount, especially in the Large Cap area. Pundits think that both Large Cap and Growth stocks may finally have their day in the sun in 2007. But, diversification reduces risk and as long-term investors we should maintain a diversified portfolio.

This year the stock pickers had a hard time beating the indexes. As you can see, the Large Cap Blend (core) funds trailed the S&P 500 by more than 2% for the year.

International stocks performed better than their US counterparts, partly due to the decline in the dollar. When the dollar goes down, foreign stocks do better due to the currency exchange rates. International stocks were up 26% for the year.

Despite the Fed's efforts to raise interest rates by increasing the Fed Funds Rate to 5¼%, long term interest rates remain stubbornly low. Therefore, bonds had fairly low returns of 3.4% for government bonds and 4.5% for intermediate-term, high-quality corporate bonds. Some coal in our stockings reduces risk and provides a solid foundation.

Holiday celebrations come but once a year. But when Santa arrives early in July and stays throughout the year, the joy can last all year.

The 401k store.com®

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