Year End 2006

Another year is rolling to a close, and following such a stagnant year in 2005 for the markets, this year's prosperity was certainly a welcome change. If you recall, 2005 began with a whimper, and the dullness of the markets lasted all year. It was so dull, in fact, that during 2005, bonds significantly outperformed stocks despite having yields at historically low levels. This year, however, was quite different.

Client portfolios posted solid gains in 2006, as the tailwind of a strong market helped to propel virtually all asset classes higher, with one notable exception: the U.S. dollar.

As you are most likely aware, my portfolio design has been what many would consider quite conservative, with a relatively large portion of money market and short-term government bond holdings. These holdings, among the worst performers in 2006 (gaining a mere 3% to 4%), did in fact hinder portfolio performance, but the exceptionally strong performance of your other holdings did so well that despite the more conservative nature of your portfolio, your overall performance still showed gains in-line with some of the best broad stock market averages.

To help you understand how we achieved such solid performance despite a significant weighting in some of the worst performers (bonds), let's recap briefly the market thesis from which I have been basing my investment advice. At the root of the thesis, is that we continue to live in a debt-ridden economy. With all the continued liquidity, there certainly seems to be a coordinated agenda to keep asset prices rising, as it is extremely important that assets continue to rise in order to support the additional credit created to fuel the debt induced consumption which is driving our economy.

As we have discussed many times in the past, the growing debt levels will at some point act as a significant headwind on the economy and in the markets. Although there is no way to know the timing of when this will happen, eventually, either the debts will be called in, we will decide to simply begin paying down the debt as a nation (and actually begin to *save*), or the debts will disappear due to some form(s) of bankruptcy. Any of these scenarios are a negative on our economy and financial markets, but again, the timing remains elusive.

Be that as it may, we certainly do not seem to be at the fulcrum where we are beginning to correct these macro-economic imbalances. But this continued delay due to ever-burgeoning debt levels comes at a cost; either a weaker currency or significantly higher interest rates. This is the reason that I stated one year ago, "So long as this remains, trying to achieve mid-single digit annual returns looks like all investors are likely to achieve, regardless of which asset class they may prefer. While I believe this is the upside in the equity markets, I continue to believe investments through precious metals, foreign currency investments, and money market and short-term bond funds look to offer the same potential as the stock market, but with far less risk."

I believe this statement from last year still holds as true today as it did then. You may have already surmised as much, since your portfolio allocations remain largely unchanged. But there are two points from this quote that I feel compelled to elaborate on, "mid-single digit annual returns" as the upside, and the concept of risk.

I clearly underestimated the upside in the markets this year. That is the bad news. The good news, however, is that your performance did not suffer because of it. In fact, your performance prospered as the main concept of the statement remained spot on: that this mix of assets still provides as much upside as stocks.

My thesis on the markets has remained focused for several years now on the liquidity being injected into the system and its relative effect on the value of our currency. I had surmised a few years ago that in all likelihood, there are three potential outcomes in the intermediate term. 1) The stock market could rise if the dollar falls, 2) The stock market would fall if the dollar rises, or 3) If the macro-economic imbalances are to begin to correct themselves, both the stock market and the dollar could both fall.

Noticeably absent from the possibilities is a rising stock market and a rising dollar (which has not happened in 7 years). And this is the primary basis for your portfolio design and my prediction that portfolios in precious metals, short-term bonds, and foreign currencies offered as much upside as stock portfolios, but with less risk. In the first and second scenario above, your portfolio design should perform just as well as the broad stock market averages (as has happened). Should scenario number 3 ever unfold (if and when), this portfolio design should dramatically outperform.

These portfolios are in fact seeing as much upside because, again, the dollar is still the key variable to asset price gains. Certainly, the risk portion of the comment is subjective. In the stock market, people do not typically perceive risk unless their portfolio declines. But regardless of continued upside in the equity markets, the risks involved to get them may well be increasing along the way, just as is the case of increasing your speed on an icy road. The fact that an accident has not yet occurred, by no means indicates that the dangers are not increasing along the way. So I look for an overall portfolio design that is much more stable than the broad markets (less volatility) during times of market uncertainty. Certainly, the large portion of short-term bonds and large dividend yield of the overall portfolio adds to this stability and reduces portfolio risk.

To come full circle, the reason for the strong performance this year despite holding a good portion of money market and short-term bond investments is that the trade weighted dollar index declined by 8.4% in 2006, which helped propel commodities and other "anti-dollar" investments far higher than even those returns seen by the broad stock market averages. Investments in foreign currencies rose by double digits. Energy investments rose in the high teens, and the precious metals had astoundingly high returns. You can quickly see how such solid out-performance in these investments was able to overcome the drag of rather mundane performance in your ultra-conservative short-term bond holdings.

To conclude, I am quite pleased with the performance in your portfolios. Those of you who have the ability to be slightly more aggressive were able to out-perform even the best performing market indexes. And for those who's circumstances dictate a bit more conservative approach, we performed nearly in-line with the best performing averages, and quite a bit better than the average market indexes.

For the reasons stated above, I remain confident that the current portfolio structure will continue to provide as much upside as the broad market averages, but with less risk. Performance will be the ultimate arbiter, but as we currently stand, I see no reason to believe that the stock market and the U.S. dollar will simultaneously be strong in the coming year. So long as those remain inversely correlated, I anticipate continued sound absolute and relative returns going forward.

Of course, the markets are dynamic, so any of this may in fact change at any time. Should such a change look to be in the offing, I will certainly let you know. In the meantime, it is a pleasure to report these prosperous returns to end the year, and I wish you an equally prosperous New Year.

Sincerely,

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