Robshaw & Julian Associates, Inc.

Helping Investors Reach Their Financial Goals Since 1979

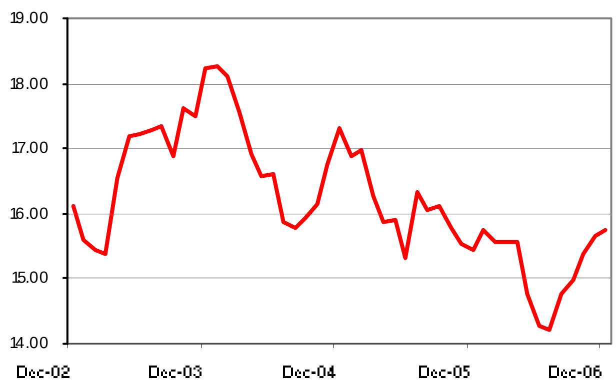
Investment Matters

For the quarter ended December 31, 2006

Whither Valuation?

The most common indicator of whether stocks are cheap or expensive is the ratio of earnings to prices or PE ratio. As the graph on this page illustrates, the PE ratio for the S&P 500 has declined over the past four years, even as the price of the index has risen. This could only happen if earnings were rising faster than stock prices, which is exactly what has been happening. This is also the opposite of what happened during the 1990's, when stock prices went up much faster than earnings.

How do we explain this trend? The best place to look is at long term interest rates. Stock valuation formulas depend not only on the earnings but on the interest rate used to discount those earnings over time. In the last four years, the 10 year government bond yield has risen from 4.0% to 4.7%, just about enough to account for the PE decline. While other factors such as earnings quality and sustainability may also play a role, the direction of interest rates provides the best explanation for the direction of PE ratios.



The PE Ratio of Stocks Has Been Falling

> ***"Stock valuation formulas depend not only on the earnings but on the interest rate used to discount those earnings..."***

This explains why, even though experts are predicting slower economic and profit growth in 2007, the stock market could have a good year. Moderate growth and low inflation, a "Goldilocks" economy, is likely to be accompanied by an easing in long term interest rates to lower levels. As earnings growth moderates, a decline in interest rates should spark a rise in PE ratios. Moderate earnings growth combined with a rising PE ratio is a recipe for good returns from stocks.

Looking at the graph, which shows a strong PE rise in late 2006, it's tempting to speculate that this process may already have begun.

> ***"Moderate earnings growth combined with a rising PE ratio is a recipe for good returns from stocks"***

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Milton Friedman: 1913-2006

Milton Friedman, often cited as the greatest economist of the 20th century, passed away in November at the age of 94. His clear insight into the role which the money supply plays in the economy won him the Nobel prize in 1976.

He used his fame to advance his ideas on the power of the free market. He won over many world leaders, sparking changes in government policy here and abroad which expanded freedom and boosted economic growth for the last 25 years.

But beyond his academic and political accomplishments, Mr. Friedman is best remembered as a champion of free-market principles. He not only wrote popular books such as, "Capitalism and Freedom" and "Free to Choose", he authored a column in Newsweek for 18 years and often gave interviews. Here is Milton Friedman in his own words:

"Underlying most arguments against the free market is a lack of belief in freedom itself."

"The only way that has ever been discovered to have a lot

Continued on page 2.

Milton Friedman: continued

of people cooperate together voluntarily is through the free market."

"The most important single central fact about a free market is that no exchange takes place unless both parties benefit."

"The problem of social organization is how to set up an arrangement under which greed will do the least harm; capitalism is that kind of system."

"There is no such thing as a free lunch."

"The Great Depression, like most other periods of severe unemployment, was produced by government mismanagement rather than by any inherent instability in the private economy."

"I am in favor of cutting taxes under any circumstances and for any excuse, for any reason, whenever it's possible."

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The 5% Rule

A serious problem investors face is deciding how much of their nest egg to withdraw each year during retirement. The first issue is how much longer they may live. About 40% of people aged 65 will live another 25 years. 20% will live 30 or more years.

The second key concern is inflation. At only 3% inflation, the purchasing power of a dollar drops in half over 25 years. Allowing for inflation is important but future estimates are problematic.

Future investment returns are also uncertain. In the past, experts suggested using historical average returns as a guide. As the recent experience of investors has shown however, projecting historical returns forward can lead to serious errors.

A recent study tried to determine a sustainable withdrawal rate based on analysis of returns from all actual 15, 20, 25 and 30 year periods from 1926-1995. Portfolio success was defined as having assets left at the end of the measurement period. A success rate was measured for each combination of time, asset mix and initial withdrawal percentage.

Some helpful guidelines have emerged from this work. First, for longer periods of time, portfolios with more stocks and fewer bonds had better success. With a withdrawal rate set at 5% of the initial portfolio value, 95% of the all-stock portfolios had money remaining after 30 years, vs. only 50% of the all-bond portfolios.

In tests which raised annual dollar withdrawals to compensate for inflation, the superior long term performance of stocks was even more evident. At a 5% initial withdrawal rate, 85% of the all-stock portfolios were successful for 30 years while only 17% of the all-bond portfolios held up for that long. Clearly, retirees who plan to live on their assets for longer than 15-20 years will need a substantial allocation to stocks.

These studies also provided helpful guidance on sustainable, inflation adjusted withdrawal rates. At a 3% initial rate, almost all portfolios lasted for 30 years. At 4%, only those with a healthy dose of stocks were successful every time. At 5%, 85% of all-stock portfolios lasted 30 years while only 17% of the all-bond portfolios passed the test.

And thus the 5% rule: If you expect your investment portfolio to provide an inflation adjusted annual source of income for up to 30 years, and if you are willing to hold mainly stocks, your first year withdrawal should not exceed 5% of the portfolio.

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The Bottom Line: 12/31/2006

Market Indicator	**Current Value**	**One Year Change**
Large company stocks *(S&P 500 Index)*	1418	+15.8%
Small company stocks *(S&P Small Cap Index)*	400	+15.1%
Short term interest rates *(3 Month T-Bill Yield)*	4.9%	Up from 4.0%
Long term interest rates *(10 Year T-Bond Yield)*	4.7%	Up from 4.4%
Inflation *(Consumer Price Index)*	201.7	+2.0%
Energy *(West Texas Intermediate Crude Oil)*	$61.05bbl.	0.0%
The economy *(Inflation adjusted GDP)*	$13.3 trillion	+2.9%

QUOTABLE

"In the history of financial markets arrogance has destroyed far more capital than stupidity."

Jason Trennert

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