**Robshaw & Julian Associates, Inc.**

*Helping Investors Reach Their Financial Goals Since 1979*

# Investment Matters

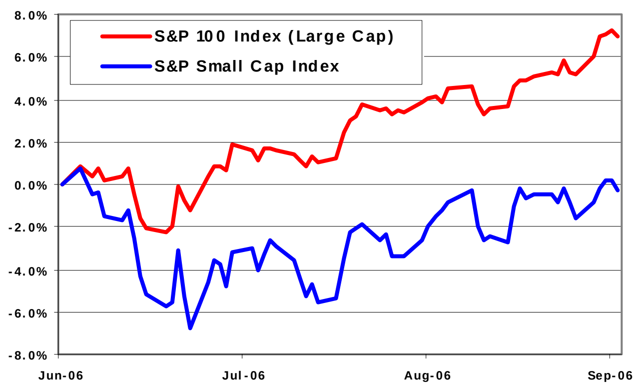
**For the quarter ended September 30, 2006**

## Markets Forecasting Slower Growth

If the investment markets are correct, growth of the economy will slow in late 2006 and early 2007. While the S&P 500 and the Dow Jones Industrial Index were up sharply in the third quarter, a closer look at market activity reveals indications of economic concern. Stock prices of major homebuilding companies are down 20-40% this year, a clear sign that this major driver of the economy is faltering. The prices of commodities such as oil, copper, lumber and steel, up strongly during the 2002-2005 expansion, are down substantially from their recent highs.

Bond prices were up sharply in the third quarter, partially reversing a decline which began in 2003. Bond prices often rise in anticipation of economic weakness.

The divergent behavior of large company and small company stock indices also leads to the same conclusion. Recently, large cap stocks have dramatically out-performed small. This is a big shift from the past four years, when small cap stocks were up strongly as the economy recovered from the 2001 recession.




RECENTLY, LARGE CAP STOCKS HAVE OUTPERFORMED SMALL

The stocks of small companies are more sensitive to economic changes than those of large companies. They tend to out-perform the market when the economy is strong and under-perform when the economy is slowing. Some of these differences can be explained by the fact that small companies do not have the extensive financial resources of the larger companies and that they are more dependent on the domestic economy. Additionally, small company stock indices are more heavily populated by economically sensitive Material and Industrial stocks; they also have far fewer Staple and Health Care stocks, which are more recession resistant.

> ***"the overall stock market is not predicting a recession, just a shift to slower growth"***

In contrast to these negative signs for the economy, the overall stock market is not predicting a recession, just a shift to slower, and perhaps more sustainable, growth. Economic recessions are almost always preceded by a substantial drop in the broad market and the broad market is still rising.

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## Rule of 20

There are many ways to determine the attractiveness of stocks, some sophisticated, some simple. One simple measure of stock market value which has worked well for decades is the Rule of 20.

The Rule of 20 is based on the fact that the sum of the price earnings ratio of the S&P 500 Index and the rate of inflation has averaged 20 over the last fifty years. When the market was depressed, the sum of the PE and the inflation rate has often dropped 3-5 points below 20. When the market was unsustainably high, the calculation produced a somewhat greater sum .

In 1982 the average PE of the S&P 500 was only 9.7 while the inflation rate was 6%. At under 16, the Rule of 20 indicated that stocks were cheap, a fact borne out by subsequent strong returns. In 1999 the average PE was 25.9 and inflation was only 2%. At over 27, the Rule of 20 indicated that stocks were expensive.

Like all rules of thumb the Rule of 20 is at best a rough measure of stock market valuation. Still, if the Rule of

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## No Recession Says Hyman

Ed Hyman, one of Wall Street's most respected economists, sees eight reasons why there is no recession on the horizon:

1) The model he has used to successfully forecast GDP over the past three economic cycles is still positive;
2) There is no wage-price spiral driving inflation;
3) Restrained growth of wages is keeping profits strong;
4) The yield curve is not deeply inverted;
5) Emerging countries are fueling strong global growth;
6) The world is flooded with liquidity;
7) Expansions usually last eight years and this one is only five years old;
8) The worse it gets the more bond yields will decline to help stabilize housing and support stocks.

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***Rule of 20: continued***

20 value rises into the mid-twenties it is best to exercise caution with your stock investments and if it slides to the mid-teens, the odds of long term success are much improved.

Currently: S&P 500 PE on next 12 months earnings = 14.4 (Business Week magazine - 10/2/2006 issue); Inflation = 3.8%; Sum = 18.2.

# Does Your Portfolio Need Bonds?

Most investment professionals advise investors to maintain a permanent allocation to bonds as part of their overall investment portfolio. This advice is based on the idea that assets with different return patterns can be combined into a portfolio which has the highest expected return for a given level of risk. Because bonds have return patterns which are not well correlated with stocks, the addition of bonds to a previously all-stock portfolio is believed to reduce risk more than it reduces return.

Recently, the economist Arthur Laffer and his associate Larry Speidell have challenged this widely accepted advice on portfolio construction. They conclude that bonds, *"are difficult to justify as a component of any rational portfolio with a horizon of much over five years"*.

Laffer and Speidel contend that investors have paid a large price for permanently holding bonds in their portfolios. Over longer periods of time bonds have dramatically underperformed stocks, falling behind in 87% of all ten year periods and 99% of all 25 year periods since 1896. By keeping a permanent allocation to bonds, long term investors have experienced significant shortfalls in wealth to provide for retirement or other investment objectives.

The key issue in the debate is how risk actually affects real investors. Risk is most commonly measured in terms of portfolio volatility, i.e. monthly or quarterly fluctuations in value. But real investors are typically looking ten or more years down the road before they need to cash in their investments. While they may be concerned about short term losses, they are also concerned about not meeting their long term objectives. This risk is currently ignored by commonly used asset allocation models.

As longer periods are used to measure risk and return, stocks increase their advantage over bonds. For a 10 year investment horizon stocks offer a far better return than bonds with only marginally more risk.

# The Bottom Line

| **Market Indicator** | **Current Value** | **One Year Change** |
|---|---|---|
| **Large company stocks** *(S&P 500 Index)* | 1336 | +10.8% |
| **Small company stocks** *(S&P Small Cap Index)* | 372 | +7.2 |
| **Short term interest rates** *(3 Month T-Bill Yield)* | 4.8% | Up from 3.5% |
| **Long term interest rates** *(10 Year T-Bond Yield)* | 4.6% | Up from 4.3% |
| **Inflation** *(Consumer Price Index)* | 203.7 | +3.8% |
| **Energy** *(West Texas Intermediate Crude Oil)* | $62.91/bbl. | -5.0% |
| **The economy** *(Inflation adjusted GDP)* | $13.2 trillion | +3.5% |

QUOTABLE

"Individuals who cannot master their emotions are ill-suited to profit from the investment process."

Benjamin Graham

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