Altamont Capital Management

First Quarter 2007 Performance

I'm a great believer in luck, and I find the harder I work the more I have of it.
Benjamin Franklin (1706–90)

After enjoying a seven-month run of smoothly climbing stock prices, investors hit a nasty road bump in February. Despite the choppiness, the U.S stock market ended the quarter approximately where it started with the S&P 500 up just 0.6%.

Once again the small (S&P 600) and the mid cap (S&P400) U.S. equity market outperformed their large cap brethren (S&P 500). Mid Caps ruled the roost, gaining 5.8% for the quarter. Small Caps turned in a more than a respectable 3.1%.

Value barely continued its run of outperforming growth in the large cap arena. The S&P 500 Growth ishares fell slightly while the Value ishares rose slightly during the quarter. The reverse was true in the small and mid cap stocks as growth edged out value.

The major indexes for most Asian markets were breakeven or down slightly for the quarter. The Shanghai exchange was the one exception. It led the February global sell-off and was down significantly. European stocks fared much better but returns were less than earned in the back half of last year. Overall, over-weighting in international stocks continued to payoff during the First Quarter as the international markets continued to outperform.

First Quarter 2007 Benchmark Index Returns

	First Quarter	Last Twelve Months
Large-Cap Benchmarks		
S&P 500 iShares	0.6%	11.7%
S&P 500 Growth iShares	-0.1%	7.9%
S&P 500 Value iShares	1.3%	15.4%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	5.8%	8.2%
S&P 400 Midcap Growth iShares	5.9%	5.3%
S&P 400 Midcap Value iShares	5.6%	10.8%
Small-Cap Benchmarks		
S&P 600 iShares	3.1%	5.1%
S&P 600 Growth iShares	4.3%	3.4%
S&P 600 Value iShares	2.1%	6.6%
Other Benchmarks		
MSCI EAFE Int'l iShares	4.1%	20.0%
MSCI EM Int'l iShares	2.0%	18.9%
Vanguard Total Bond Mkt Index	1.4%	6.6%
DJ-AIGC Commodities Index	4.4%	3.1%

The market choppiness in stocks was caused by a familiar group of concerns: a slowing American economy, rising problems with risky mortgages and signs that fast-growing emerging markets like China and India might be due for a correction.

The turmoil was triggered in late February by the Chinese government stating that it wanted to cool down its market's extraordinary growth. This caused a big drop in the Chinese (Shanghai) market, and a subsequent dip in stock prices worldwide.

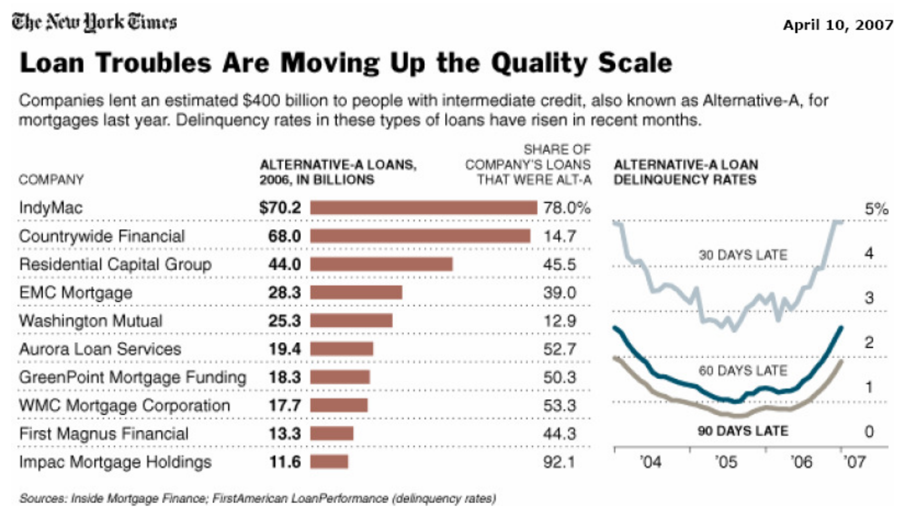
The 3.5% one-day loss experienced in the U.S. markets (in late February) is not unusual after the gains of the last seven months but it shook many investors which had become complacent. This left many investors wondering whether this was the beginning of the end of the four-year bull market that started in October 2002, or simply a pause.

What's Rattling the Market?

Last year, the market overcame a wrenching period of soul-searching in May and June (2006). Back then, the Federal Reserve was at the end of a two-year campaign to raise interest rates and the housing boom had started to fade. The concerns that dominated the minds of investors, however, did not linger, and the market had a solid second half.

Many market specialists assert that the current concerns will play out similarly. Weaknesses like those in the market for subprime mortgages issued to borrowers with weak credit will not threaten the broader financial markets, these experts say, because the world economy is growing, corporate profits are rising and consumers with good credit are not defaulting at high rates.

First let's talk about the subprime debacle. Most of us (especially those living in areas with very high housing costs) are aware that lenders have pushed the envelope in recent years and granted loans to enable people to buy homes they would otherwise be unable to afford. In so doing, many of these buyers have stretched themselves financially and have little margin for error. Low starter rates and temporary interest-only terms are winding down or expiring. The rates on these loans are resetting at a much higher level because interest rates are rising. As a result, defaults among subprime mortgages have climbed sharply. How widespread is the problem: well loans in this seg-ment accounted for 24% of loan originations in 2006 and late pay-ments in Alternative-A mortgages are escalating (the default rate in this sector is in the 13% to 14% range). The result, people are losing their homes and some subprime lenders have either experienced big financial losses or gone out of business.



Research analysts at PIMCO have suggested that this is a meaning-ful source of risk to the housing market, since these defaulting buyers have starter homes (less expensive homes) which are the first rung on the housing-market food chain. So on its face, rising delinquencies in a high-growth part of the market could be a serious concern.

Looking more closely, however, the picture is not as clear. The growth in subprime originations has moved in lockstep with a decrease in Federal Housing Authority loans (FHA borrowers are typically first-time home buyers who are unable to make a meaningful down payment).

In a recent report from Ned Davis Research was this explanation; "Essentially, the private market filled a void created by the federal government. The failure of federal rules to keep up with changes in the marketplace allowed the subprime lenders to expand their market share by 10 percentage points at the expense of government-backed loans. If it weren't for the easier lending practices this cycle, we would have expected little economic impact relative to what we had seen previously, since this effectively was a change in loan composition, not loan quality."

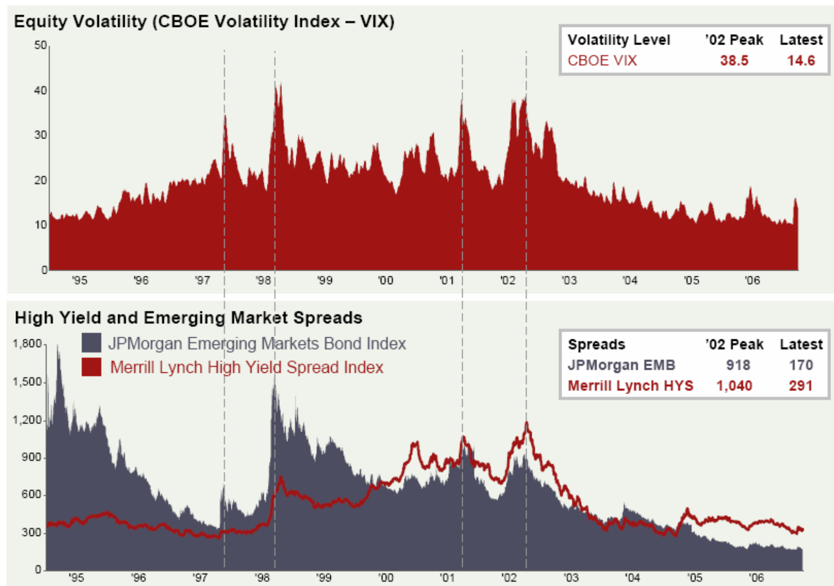
As of year-end 2006, more than 76% of all loans outstanding were still prime loans. This means that even if the combined subprime/FHA sector had a default rate of 20%—well above the prior peak in 2002—fewer than 5% of outstanding loans would be impacted. While this would be enough to cause pain, it would not be enough to result in a disaster for the economy.

Defaults and tighter lending standards will mean that growth in the subprime arena will stall, causing demand to sag further up the housing "food chain." PIMCO's analysts believe that we're still only in the middle of the housing downturn, and that this will ultimately cut roughly another 1% from GDP growth over the next few quarters (and that there is at least some risk that it could be worse). Clearly that's not good, but it is also not as bad an outcome as many others seem to expect given the extensive media play that this problem has received.

The Return of Volatility

With the recent choppiness in the markets, investors have become aware that stocks don't always just trend nicely straight up. Marc D. Stern, the chief investment officer at Bessemer Trust said in a recent interview, "We are in for some meaningful volatility for the next several years, and none of us should be surprised by that. There are lots of uncertainties to ponder."

Investors have gotten used to extremely low levels of volatility and they may find these normal price swings disconcerting. To put this in perspective, I've included the adjacent chart of the Chicago Board of Trade's VIX index. This index measures volatility based on investors' use of options on the S&P 500-stock index. It spiked in early March from historically low levels (see the far left portion of the top chart). As the graph shows, equity volatility is near the historical average but far from the high levels (peaks on the graph) experienced during the dot-com bust in the early 2000's. Bounces in the market are normal. A 3.5% one-day loss in the U.S. markets like the one experienced at the end of February is not unprecedented after seven straight months of gains totaling over 14%.



Source: JPMorgan, Merrill Lynch, CBOE, EcoWin/FactSet, JPMorgan Asset Management.

What is interesting is how little investors are being paid for taking greater risk especially in the bond market. The bottom graph illustrates this point. It shows the difference in return earned (spread) in a risky investment (in this case High Yield Bonds and Foreign Emerging Country Debt) compared to what is considered a risk less investment in ten year U.S. Treasuries. High Yield bonds are loans made to corporations that have compromised credit. These bonds are risky because they could default (not pay). So to compensate investors for this risk they pay a higher interest rate. The amount of additional interest compared to U.S. Treasuries varies over time. Currently these High Yield bonds are paying a historically low premium compared to the risk free Treasuries (free of credit risk). Investors are earning less of a premium despite the increasing volatility (another measure of risk) shown in the top chart. In other words, investors are not being paid enough of a premium for the risk they are taking. Investors have become complacent about risk. They have been so focused on chasing higher yields that they have forgotten that they could easily lose money in these riskier investments.

Investors beware. Risk is back and she can be a cruel mistress!

The Economic News

In these newsletters I always explain the current state of the economy, the Federal Reserve's policy stance and other news items that could impact the markets. It is difficult to present the general state of the economy in just a page so when I came across this scorecard below designed by JPMorgan, I was thrilled. I'll try to regularly include it in my future newsletters.

Many economists believe that we are close to full employment (5% or less unemployment is considered full employment by economists and the Fed). These gurus fear that full employment could lead to rising wages which could then cause inflation. The Federal Reserve is focused on the core rate of inflation (inflation less the volatile food and energy segments). Inflation is currently at the high end of the Fed's defined range of acceptable. So the Fed's board members want the core inflation rate to fall but don't want to raise interest rates again to achieve it. The Fed wants the market to adjust itself.

Market Scorecard

Market Insight Series

Economy

Investment Returns	Markets post modest returns in Q1 following a strong run in the latter half of 2006.
Overall Economy	Economic growth moderates due to a weakening of the housing market.
Employment	The economy continues to run at full employment, with the unemployment rate at 4.5%.
Earnings	Corporate profits post 19th quarter of double digit earnings growth (y-o-y). Profit margins at cyclical peak.
Interest Rates	Fed leaves funds rate at 5.25%. Yield curve remains flattish.
Inflation	The Fed continues to be concerned about the inflation outlook even as economic growth slows. Key concerns include tightness in the labor market and high capacity utilization levels.
Key News Items	Subprime mortgage delinquencies create concerns. Merger and buyout activity continues to be robust. Market volatility remains at low levels.
Fund Flows	Flows into International equities overshadow more modest activity in US equity, fixed income and allocation funds.

Source: Standard & Poor's, FRB, BLS, BEA, JPMorgan

When Bernanke became Federal Reserve Chairman he stated that he wanted to communicate the Fed's intentions more clearly to investors. The unintentional result has been the inversion of the yield curve (short term interest rates are higher than long term rates). In order to get long term interest rates up, the Fed has begun to abandon its policy of clear communication and transparency. It is instead refusing to send a clear message. The Fed recently changed its stance to neutral (instead of signaling its intention by stating a bias towards raising or lowering rates) but it is all posturing. The most recent Fed minutes from its last meeting are meandering and unclear. Consider, for instance, this excerpt from the minutes:

> …the prevailing level of inflation remained uncomfortably high, and the latest information cast some doubt on whether core inflation was on the expected downward path. Most participants continued to expect that core inflation would slow gradually, but the recent readings on inflation and productivity growth, along with higher energy prices, had increased the odds that inflation would fail to moderate as expected; that risk remained the Committee's predominant concern.

The Fed's mixed reactions regarding inflation are unsettling to many analysts and economists. It is all part of an elaborate game of chicken as the Fed desperately tries to balance the need to moderate inflation with keeping the economy growing. If the Fed has to raise short term rates to check inflation it might also destabilize the financial markets. If the Fed states a bias towards raising short term rates, it would probably cause the markets to grow too quickly. The Fed hopes to avoid these scenarios by convincing the market to raise long term rate which should help moderate full employment, wages and hence cool the core inflation rate. It will be interesting to see who blinks first, the markets or the Fed.

Source: BEA, FRB, BLS, FactSet, JPMorgan

Earnings Are the Key

The main story is the strength of corporate earnings. The adjacent graph shows, the growth rate of corporate profits over the last five years has been incredible. In fact, the growth rate has been double digit for the last seven quarters. Even more interesting is that these record profits are not fully reflected in stock prices.

The second graph below shows the performance of the S&P 500 from 1996 through First Quarter 2007. It shows the ride up during the dot-com bubble; the subsequent bust and the climb back up. Though close, the S&P 500 has still not exceeded its previous high even though the index is up 83% from its low. While the index is close to its previous high, stocks are significantly cheaper than before based on P/E ratios (for explanation of P/E ratio see box). In fact, stocks are 43% cheaper than from previous high.

Does this mean that stocks are cheap? No because reflected in current stock prices are future market expectations. Current stock valuations anticipate the slowing of earnings growth rate to low double digits or high single digits in the future.

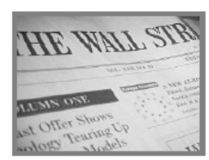
The P/E Ratio
P/E is the ratio of Price to Earnings. The price of a stock is a function of the underlying earnings and the P/E multiple captures that relationship. The ratio shows the embedded cost for every dollar of earnings the stock is generating. In other words, if the P/E ratio is 30 then you are paying $30 dollars for

Surprisingly, stocks are 30% "cheaper" following a 83% run in stock prices (98% including dividends).

Source: Standard & Poor's, First Call, Compustat, FactSet, JPMorgan Asset Management

In addition, the market is building in a margin of safety in case inflation doesn't moderate and the Federal Reserve has to raise interest rates again. It is factoring in all potential risks and discounting stock prices to reflect this increasing volatility. Usually big market declines are generally preceded by stretched valuations. It is comforting to know that even though the markets were more volatile this quarter, valuations seem reasonable.

However, valuations are stretched in some segments of the market like mid and small caps (Russell 2000 index). These smaller caps have outperformed its large cap brethren for years resulting in very high P/E ratio of 38.7 which implies a 63% earnings growth rate. These are unsustainable valuation levels. On the other hand, the Nasdaq has a negative implied earnings growth rate. The market expects the earnings of Nasdaq-high tech stocks to contract. Growth stocks have underperformed value stocks since the dot-com bust. Based on valuations, it is time to emphasize large cap stocks and growth stocks.



Source: JPMorgan, Ratios from the "Wall Street Journal's" Market Line Up page (March 31, 2007).

P/E data featured in The Wall Street Journal is provided by Birinyi Associates.

S&P 500

P/E ratio:	17.0	11% implied earnings growth
Est. P/E ratio:	15.3	
Dividend Yield:	1.83%	

NASDAQ

P/E ratio:	24.4	-1% implied earnings growth
Est. P/E ratio:	24.7	
Dividend Yield:	0.50%	

Russell 2000

P/E ratio:	38.7	63% implied earnings growth
Est. P/E ratio:	23.7	
Dividend Yield:	1.25%	

Summary
I couldn't fit it into this newsletter, so sometime this quarter I'll publish a piece on my Blog regarding the impact of private pools of capital--in all of its forms, private equity firms, alternative asset management companies, hedge funds, and investment banks. These pools of private equity have increased funding from many sources and through many structures. Their impact on the market is substantial and not transparent. My blog is http://financialpragmatist.blogspot.com. Our website has a link to my blog as well. Our website address is www.altamontwealth.com.

Sincerely,

Libby Mihalka CFA