

Altamont Capital Management

Second Quarter 2005 Performance

“Capitalism without bankruptcy is like Christianity without hell.”

Frank Borman (CEO of the now defunct Eastern Airlines, 1986)

So Far This Year – The World is Flat

Much like the first half of last year, overall returns were almost flat during this year's first half. We are still bouncing around in the same trading range. The First Quarter we went down and the Second Quarter we bounced back almost all of the way.

Although May and June's positive results helped chip away at the year's first four months of losses, they were not quite enough to pull the major stock market indices to breakeven for the year. For the first six months, the Large-cap S&P500 was down 0.8%, while the Small-cap S&P 600 was up 1.7%. Though tech stocks are down year-to-date (the tech-laden Nasdaq composite is down 5.5% for the year), they still posted solid gains during the Second Quarter, leading some major stock analysts to speculate that maybe tech stocks are starting their recovery after four years on the skids.

The market's recovery was sparked by abating inflation fears. The economy continues to show signs of moderate to healthy growth but there are reasons to worry. One thing that hasn't changed is the success of real estate investment trusts (REITs) and real estate markets in general. While many of us worry (including Alan Greenspan) about whether there is a bubble in the real estate markets and when it might pop, the price of homes, and REITs keep going up.

Bonds also enjoyed a surprising rally during the last two months, thanks to mild inflation news. The battle of short versus long term rates continues to wreak havoc on conventional wisdom. Despite steadily increasing short-term rates (thanks to the Federal Reserve), long term rates remain stubbornly low. This allowed mortgage rates to remain low and keep the housing bubble humming. In addition, this has resulted in longer-term bonds continuing to outpace their short-term peers. The general wisdom is to never fight the Fed as it is raising rates. So don't invest in long term bonds (because they usually fall in value as the Fed raises rates) and instead stay in shorter term bonds. But the market has been reacting counter to conventional wisdom. In fact long-term bonds gained 5.5% according to Morningstar, and short-term funds posted only slight gains of 1.4%. One weak spot was in high yield bonds, which were flat as downgrades of automakers' bonds roiled the market.

Second Quarter 2005 and Year-to-Date Benchmark Returns

	Second Quarter	Year-to-Date
Large-Cap Benchmarks		
S&P 500 iShares	1.4%	-0.8%
S&P 500 Growth iShares	0.1%	-1.8%
S&P 500 Value iShares	2.5%	0.1%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	4.3%	3.9%
S&P 400 Midcap Growth iShares	3.6%	3.5%
S&P 400 Midcap Value iShares	5.0%	4.2%
Small-Cap Benchmarks		
S&P 600 iShares	3.9%	1.7%
S&P 600 Growth iShares	3.7%	1.9%
S&P 600 Value iShares	4.1%	1.5%
Other Benchmarks		
MSCI EAFE Int'l iShares	-1.1%	-1.3%
Vanguard Total Bond Mkt Index	3.0%	2.5%
Dow Jones AIG Commodities Index	-5.0%	6.4%

Only one broad area of the market fared poorly during the Second Quarter: and that was foreign stocks. The principal problem was that the dollar rallied against foreign currencies, sending the MSCI EAFE foreign index down 1.3%. The Dow Jones AIG Commodity Index fell during the Second Quarter driven by volatile energy sector. Oil prices will remain choppy until supply and demand reach a new balance.

It's the Economy, Stupid!

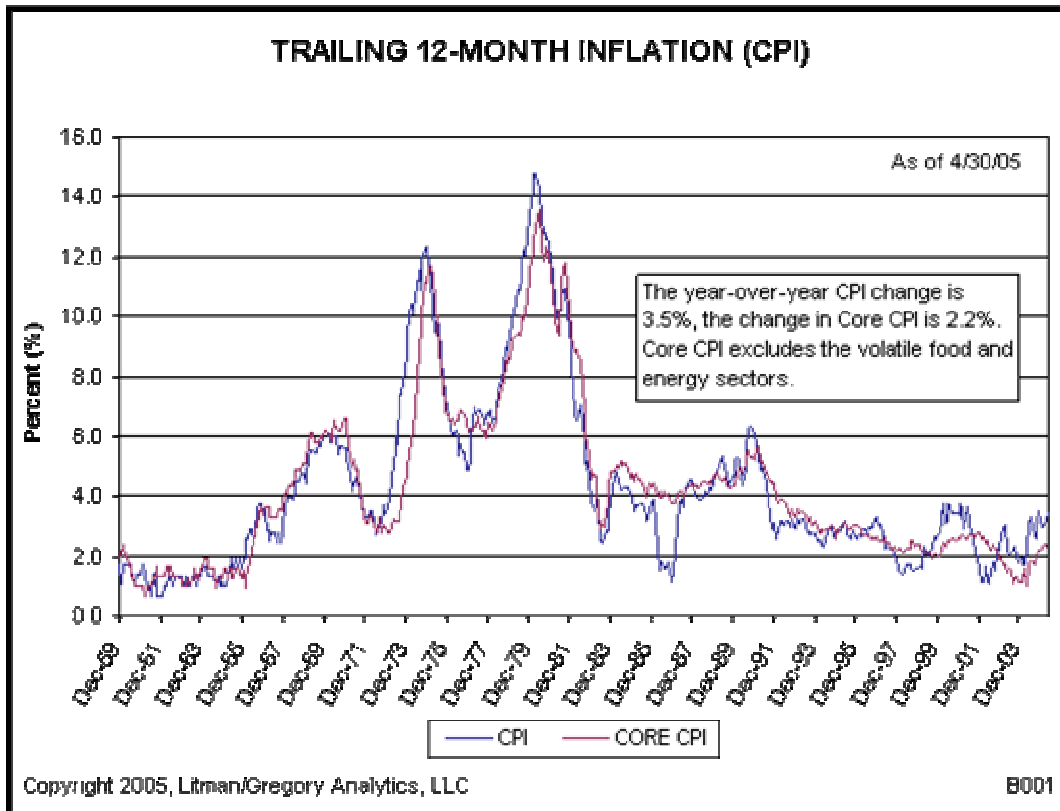
The economy is nearing its fifth year of expansion on a firm footing, yet a long list of worries still nags. It is these factors that keep the markets bouncing around. What factors should you keep your eyes on? A top concern is when will the Federal Reserve stop raising interest rates? On the last day of the Second Quarter, the Fed raised its closely watched federal funds rate – it is an ultra short term rate charged by banks to other banks on overnight loans – a quarter of a percent to 3.25%. This is the ninth straight increase by the Fed in a year-long campaign to head off further increases in the inflation rate. Over the past year, the Fed has gradually—but consistently—been raising rates, which are now 200 basis points (2.0%) higher than at the beginning of the cycle. Changes in Fed policy can take as much as 12 to 18 months to have an effect, so the impact of these increases may not yet be fully reflected in the economy. In spite of the recent increases, the current Fed Funds rate still is quite low by historical standards, so meaningful rate cuts are unlikely unless deflationary pressures mount. As such, the upside for investment-grade bonds is fairly limited.

Another factor that is concerning economists is the Federal Government's budget deficit. The budget surplus that was so widely praised in the late '90s has disappeared, and the federal government has been running a deficit since the spring of 2002. The current government has cut tax rates thereby reducing intakes, and increased spending thereby increasing outlays, resulting in a federal budget deficit of \$339 billion. This is approximately 2.8% of GDP, which is comfortably below previous highs. But this will require the government to issue more bonds to finance these deficits, and there could be upward pressure on rates from the increased supply. Also, if the dollar weakens, there is some risk that foreign investors—which are a significant source of demand for U.S. government-issued debt—could lose their taste for Treasuries, which would also be a negative for interest rates and the bond market.

Few economists expect inflation to run out of control, though worries about inflationary pressures persist. The concerns vary from high oil prices to froth in the housing markets to record trade deficits with other countries. A change in any of these concerns could swiftly change the outlook. In particular economists are citing the

housing market boom. This boom is providing a big boost to consumer spending. Consumers feel good because their net worth has increased thanks to the rising values of their homes. But because households have so much of their wealth tied up in their homes, a bust in the housing market could create a negative wealth effect, a decline in asset values causing consumers to stop spending.

Bill Gross, Chief Investment Officer at PIMCO, doesn't think interest rates will be the



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cause of the housing bubbles demise. He says, "If interest rates stay low (as he expects) there's no reason there has to be a disaster in housing. But if housing prices stop going up, which would be my forecast, that makes a substantial difference. Individuals have banked on that appreciation every year. You should come to a point where owners of houses realize we're in never-never land and stop buying on a speculative basis. Markets many times fall of their own weight. That's what happened with the Nasdaq in 2000."

The impact of the housing bubble on the economy has been staggering. Residential investment currently absorbs 5.8% of gross domestic product (GDP is total goods and services produced by our economy). This is the highest level since the late 1940s and early 1950s, when an entire generation of returning soldiers was setting up families and expanding into newly built suburbs. This time we are building second homes and enlarging current ones at a record pace. By comparison the tech-boom of the '90s was at worst a small bubble. Starting in 1991, business investment in information technology and communications infrastructure began a steady climb, going from 3.1% to a peak of 4.8% of GDP in 2000 before collapsing. Without much fanfare, residential housing basically followed the same path in the '90s. Starting at 3.4% of GDP in 1991, it rose to 4.6% in 2000, but it didn't stop unlike the tech-boom, instead spending on housing kept climbing fueled by low interest rates. Measured by the increase in its share of GDP, the housing boom is 40% larger than the tech-boom.

This housing driven growth is distorting the economy through its creation of low-tech commodity jobs. Construction is among the least info-tech intensive of all industries. What happens when the boom finally slows? The share of GDP going to housing construction will wane hurting construction workers, architects and homebuilders. The good news is that the end of the housing boom would allow a shift from housing and free up hundreds of millions of dollars for other more productive investments that will help America to stay competitive with other countries. This transition of capital from housing construction to more productive uses will take time and the short term impacts will not be pretty.

Also baked into the mix are the following variables:

- **Fiscal policy:** Increased spending and lower tax rates appear to have helped the economy, but there is some risk that the government may overshoot, leading to an acceleration in inflation. However, the sizeable U.S. budget deficit is likely to increase the supply of bonds as the government issues new debt to finance its revenue shortfall. The resulting higher interest rates put a damper on inflation. It is worth noting that in recent months, the federal budget deficit has begun to improve.
- **Global competition:** The global economy is very competitive. Price competition has increased as the internet has become more widely used and both consumers and corporations can seek the most attractive prices from around the world. As such, the ability to raise prices is more constrained than it was in the past.
- **Strength of the dollar:** The U.S. current-account deficit is more than 6% of GDP, which is very high relative to historical levels. The correction to this imbalance usually takes the form of a sizable currency decline, which makes foreign goods more expensive and allows domestic goods producers to raise prices. This carries with it a measure of inflation risk. It is quite possible that the current-account deficit will expand further before it begins to reverse, but the math suggests that further declines in the strength of the dollar will be required.
- **Labor markets:** Labor markets have been gradually improving along with the economy and most gauges are well off the lows reached during the past few years, but current employment growth and wage pressure have not been sufficiently powerful to ignite significant inflationary pressures. However, unemployment is considered a lagging economic indicator, so this shouldn't be weighted too heavily.
- **Consumers:** Gauges of consumer confidence can be volatile, but by most measures confidence levels are in line with historical averages. High levels of confidence may be associated with an increased risk of inflation, as consumers are more likely to increase their purchasing activity. Consumer spending has been growing at an impressive rate, which is important since consumer spending accounts for roughly two-

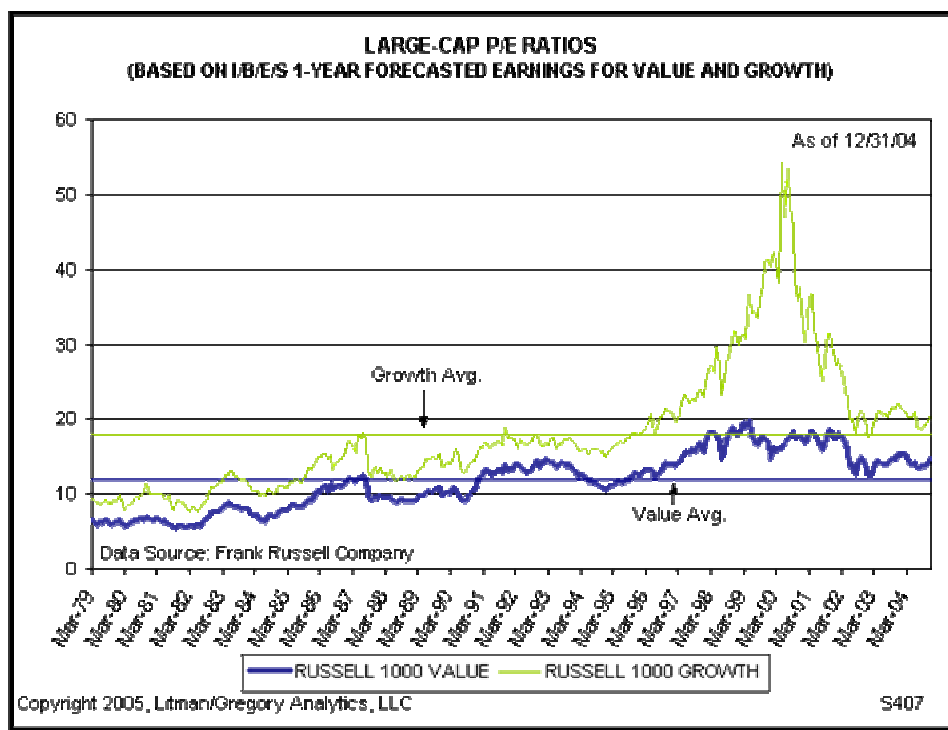
thirds of GDP. However, levels of consumer debt are quite high, which raises the question of how much longer this trend can continue.

- **Commodity prices:** There has been some choppiness in commodities over the past few quarters, but in general prices have been on the rise since early 2002. Most commodity indexes are at levels not seen since the early 1980s, but given the fact that commodity prices have generally increased more slowly than general inflation over that time period, this is not a concern. As commodity prices rise, however, raw materials become more expensive, which can increase the likelihood that corporations will pass along their higher costs in the form of higher prices. Oil prices are particularly important, and are near \$60 a barrel at this writing. This could be due to several factors, including an increase in demand due to China and other developing economies, concerns about longer-term supply constraints, continuing tensions in the Middle East, and other geopolitical issues. Oil prices can be very volatile, however, so it is difficult to assess how much of a lasting impact current prices will have on inflation.

My hope is that none of the big macro-risks come to fruition: a widespread crash in housing prices, a currency crisis, etc. I don't view these risks as being likely, but the possibility of these scenarios should not be ignored. It is always good to be prepared for the worst while you hope for the best.

So Where Does All This Lead Us?

For the past few years, many smart investment thinkers have been expecting interest rates to rise. While this has happened at the short end of the yield curve, as the Fed has repeatedly raised rates, it has not happened at the longer end of the yield curve. In other words, yields on cash are much better, while yields on long bonds are little changed. More recently, some smart bond people (such as PIMCO's Bill Gross) have adjusted their views, and now expect rates to remain low for at least the next several years. We believe the risk of rates going higher, at least temporarily, remains material over the next few years, and that there are good reasons from a portfolio strategy standpoint to consider higher



rates in setting return expectations. We explain these reasons in more detail below, but a brief summary goes like this: whether rates rise or stay low has little impact on bond returns over the next five or so years.

From an equities standpoint the issue is murkier, but I believe that equities are hovering around their fair market value. If the economy continues to do well, earnings remain strong, the dollar doesn't crash, and nothing blindsides investors, market returns could be quite attractive. However I think that earnings growth is going to be problematic. It has been good in absolute terms, but is likely to be lower going forward. I do not know which direction the economy will head from here—forecasting is an inexact science at best—but I think a slowdown in earnings growth is very probable. Because of slowing earnings I would expect returns over the next few years to fall in a mid- to upper-single-digit range. Given the expected level of low inflation, these returns in absolute

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terms (returns less inflation equals the absolute or real rate of return) are about in line with historical averages. However, returns could be considerably lower in a less-favorable environment (surprisingly high inflation, deflation, etc.), and of course they will fluctuate from year to year.

Further evidence supporting the conclusion that stocks are around fair value comes from the mixed comments we hear from equity fund managers. Most of the managers we talk to tell us that the easy money has been made and that finding truly undervalued stocks is no longer easy.

Our base-case scenario assumes that none of the big macro-risks come to fruition: a widespread crash in housing prices, a currency crisis, etc. We don't necessarily view those risks as being likely, but the possibility of these scenarios should not be ignored.

Where does this leave us? Well:

- The huge outperformance of value stocks over the past five years has erased the valuation edge they once had. I do not view value stocks as being overvalued relative to growth stocks, but they certainly are not a bargain anymore. Growth may even begin to outpace value over the next year.
- Small-caps have also experienced massive outperformance over the same time period, and valuations in that area are starting to get stretched, although they are not clearly overvalued.
- Bonds still appear to be overvalued, but they should still manage to keep pace with inflation, and are still an important volatility reducer for balanced portfolios.
- Foreign stocks were hurt by a big run-up in the dollar during the quarter. Currencies are volatile, so periods of out-of-sync performance should be expected.

At the end of the day, no one can know with certainty where things are headed. So knowing that I could be wrong, I've allocated your portfolio to provide some hedge against macro risks that everyone acknowledges are very real and could come to pass. These hedges include the Pimco Commodity Real Return Strategy fund and the Eaton Vance Secured Floating Rate Debt. Even with these hedges in place any of the macro events I've enumerated could cause considerable pain. These two additions to your portfolio also shouldn't hurt your return materially in the event that any of these negative scenarios don't come to pass.

Enjoy the rest of your summer!

Libby Mihalka