

# Altamont Capital Management

## Second Quarter 2007 Performance

The word “crisis” in Chinese is composed of two characters; the first is the symbol for danger; the second, for opportunity.

*Anonymous*

After an uninspired first quarter, stocks around the world surged in the second quarter. Despite some anguishing setbacks, the stock market charged ahead to a strong finish in the Second Quarter, overcoming significant challenges posed by climbing bond yields, escalating problems in the housing market and rising oil prices.

Growth stocks finally outperformed value in the Second Quarter regardless of their capitalization (small, medium or large). Value stocks have been trouncing growth since the dot-com bust in 2000. Furthermore, this is the first quarter in seven years where growth trounced value across all market cap segments. The surge was strong enough that growth indexes have now out-performed value indexes year-to-date.

*The New York Times*

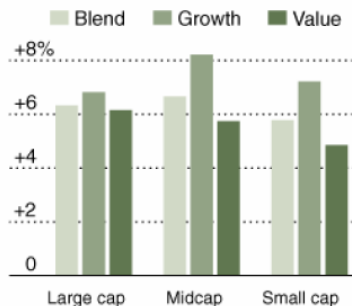
### Stocks vs. Bonds

Average returns, by mutual fund category, for the second quarter of 2007 and the past 12 months.



### Growth vs. Value

Growth stock funds had the biggest gains in the first quarter.



Source: Morningstar Inc.

Another new trend this quarter was that bigger was better, with larger

companies delivering the highest returns, followed by mid-caps and then small-caps. Though all parts of the market delivered strong returns this quarter, it was the large cap stocks that outperformed. Large cap stocks generated a 6.2% return while Mid-caps (S&P400) and Small caps (S&P600) generated 5.7% and 5.2% returns, respectively. Prior to this quarter, small and mid cap stocks have been defeating large caps for years.

Once again international markets performed strongly, with the developed country index (MSCI EAFE) up 6.5% and the emerging country index (MSCI EM) up an amazing 12.6%. International markets continue to outperform the U.S. markets and I expect that this trend will continue for the next few years.

The portfolio returns were mixed in the non-equity investments. The U.S. bond market fell slightly during the quarter, and returns are only slightly positive for the year. These negative returns are not surprising since interest rates rose this quarter causing bonds to fall in value. The yield on the 10-year Treasury note ended the second quarter at 5.03 percent, up from 4.65 percent in March. In addition, commodity futures were negative for the quarter although still positive for the year. Emerging-market short-term bonds (PIMCO Developing Local

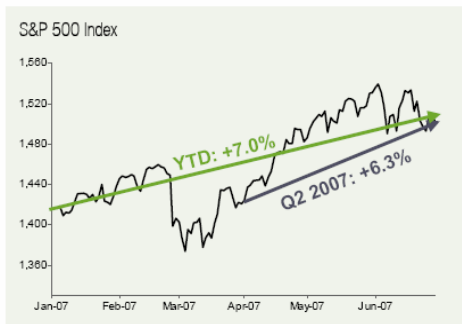
Markets) performed very well during the quarter delivering a 3.6% return. The U.S. Floating rate bond

### Second Quarter 2007 Benchmark Index Returns

	Second Quarter	Year To Date
<b>Large-Cap Benchmarks</b>		
S&P 500 iShares	6.2%	6.6%
S&P 500 Growth iShares	6.6%	6.4%
S&P 500 Value iShares	5.9%	7.4%
<b>Mid-Cap Benchmarks</b>		
S&P 400 Midcap iShares	5.7%	12.2%
S&P 400 Midcap Growth iShares	7.2%	13.8%
S&P 400 Midcap Value iShares	4.4%	9.5%
<b>Small-Cap Benchmarks</b>		
S&P 600 iShares	5.2%	8.3%
S&P 600 Growth iShares	6.2%	10.7%
S&P 600 Value iShares	4.2%	6.4%
<b>Other Benchmarks</b>		
MSCI EAFE Int'l iShares	6.5%	10.3%
MSCI EM Int'l iShares	12.6%	15.1%
Vanguard Total Bond Mkt Index	-0.6%	0.8%
DJ-AIGC Commodities Index	-0.3%	4.5%

**ACM Second Quarter 2007 Report**

market also performed well (Eaton Vance Institutional Floating Rate) generating a 3.6% return year-to-date compared to the break even return generated by the total U.S. bond market (0.8%).



	2Q 2007			Year-to-Date		
	Value	Blend	Growth	Value	Blend	Growth
Large	4.9	6.3	6.9	6.2	7.0	8.1
Mid	3.7	5.3	6.7	8.7	9.9	11.0
Small	2.3	4.4	6.7	3.8	6.4	9.3

**What's next?**

It's summer and I don't want to over load you with long economic lessons so here is my market outlook for the next six months in a nut shell.

The **U.S. economy** is slowing and will continue to slow to between 2% and 2.5% growth while growth remains relatively robust in the rest of the world. U.S. economic growth has clearly slowed, with first-quarter gross domestic product (GDP) growing at paltry 0.7%, the slowest rate in almost five years. That rate, however, should rebound somewhat in the second-half of 2007 despite ongoing concerns regarding the housing market, consumer spending and credit-related problems.

Investment Returns	👍	Equity markets surged in the second quarter, as the S&P 500 returned 6.3% on strong earnings and positive economic news.
Overall Economy	👍	Economic data turned notably more positive during the quarter. Gas prices and interest rates have yet to stop the powerful American consumer.
Employment	👍	The economy continues to run at full employment, with the unemployment rate at 4.5%.
Earnings	👍👍	Corporate profits slowed to single-digit growth but continued to surpass analyst expectations in 1Q.
Interest Rates	👍	The yield curve began to normalize as long-term rates climbed above 5% on strong economic news. Fed leaves funds rate at 5.25%.
Inflation	👍👍	The Fed continues to be concerned about the inflation despite relatively tame core inflation readings. Key concerns include tightness in the labor market and high capacity utilization levels.
Key News Items	👎	Subprime mortgage delinquencies create concerns. Hedge Fund woes worry some. Immigration Bill fails.
Fund Flows	👍👍	Flows into International equities continue to overshadow more modest activity in US equity. Fixed income flows gain momentum.

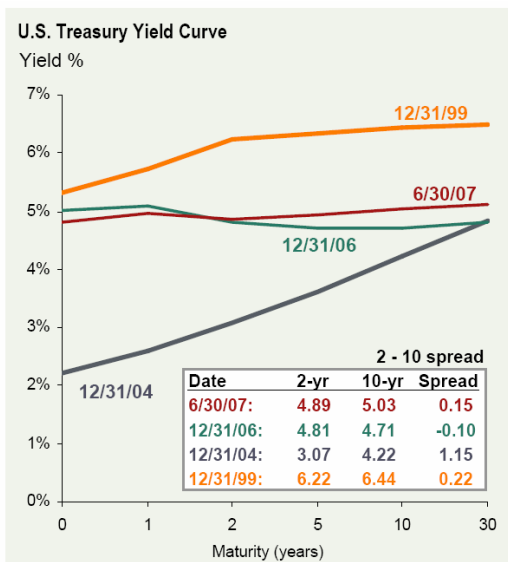
Source: Standard & Poor's, FRB, BLS, BEA, JPMorgan

**Earnings** growth in the United States is below trend for the first time since 2001. First-quarter earnings growth levels fell below the 10% mark for the first time in several years, but have continued to remain resilient. Looking ahead, earnings growth is expected to be sluggish, with earnings somewhere in the mid single digits at year end.

Equities are experiencing another good year by turning in strong **Investment Returns**. P/E (price/earnings) Ratios are expanding for the first time in six years. P/E ratios started to rise with the market rally last summer, and the outlook for stocks remains good. Low inflation, the possibility of the Fed lowering interest rates, and aggressive merger-and-acquisition activity make valuations appear attractive compared to alternatives. All these indicators suggest that the equity bull market is likely to continue, though in the short term we could hit some turbulence.

The average stock underperformed the broad market averages with large-cap and high-quality stocks outperforming small-cap and low-quality stocks. So the strong performance of the stock market has been generated by a select group of stocks. These trends have just begun to emerge and I expect them to continue in the second half of the year with high quality and large cap stocks leading the market.

The stock market's continued strong performance is partially due to the tenacious flow of liquidity from **merger-and-acquisition (M&A) activity**. The volume of mergers and acquisitions in the U.S. topped \$1 trillion in the first half of 2007, a record for the first six months of any year, according to Dealogic.

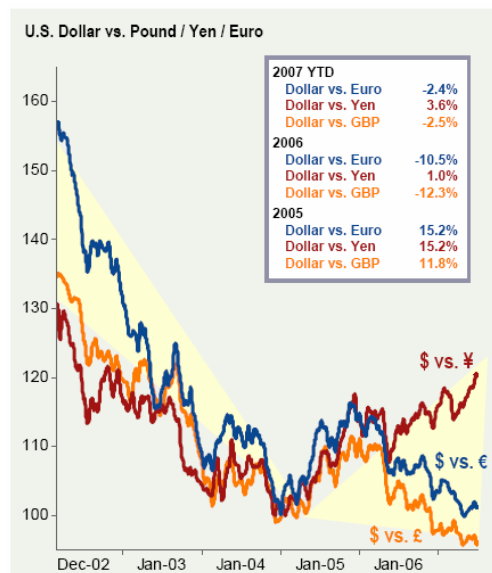


Source: EcoWin, FactSet, JPMorgan Asset Management  
Data as of 6/30/2007.



Deal activity was even stronger in Europe, where the combined value of mergers so far this year surpassed U.S. totals for the first time in four years. In addition, Standard and Poor's calculates that there is more than \$193 billion in private equity buyouts of S&P 500 companies currently in the works, representing 19 companies and 1.7% of the index's market capitalization. This tsunami of money mainly from private equity firms is significant, given the influence takeovers have had on stock prices. Money drying up from private equity, would negatively impact the stock market, but this is unlikely to happen in the next six months.

**The U.S. yield curve** finally turned modestly positive as short rates fell and long rates rose (see two graphs above). Since the first of the year, long-term rates have risen and the yield curve has become almost positively sloped. The direction of the Fed funds rate remains something of a mystery. In fact the Fed funds rate (which is the rate that banks loan each other money overnight) is significantly higher at 5.25% than any treasury bills (3 month to 30 year). The Fed is too tight and should cut rates. Unfortunately, the Fed probably won't cut rates before year end, and may actually raise them. The Federal Reserve board is very focused on the **low unemployment rate** and the **core inflation rate** and, due to conflicting economic data, could be making the wrong moves.

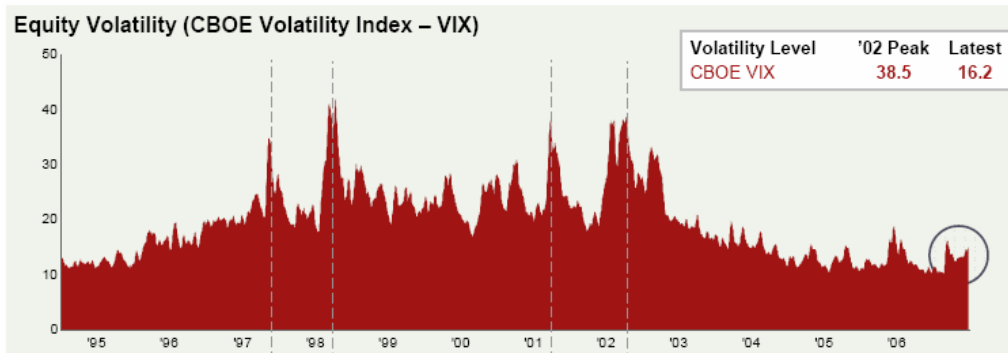


Source: EcoWin, JPMorgan  
Data is illustrated using a one-week moving average and is rebased at 100 on 12/31/04 to best illustrate the currency trends. Data as of 6/30/07.



In March, the **U.S. trade-weighted dollar** moved to its lowest level in a decade (see graph on previous page). While currency levels have bounced around, slower U.S. economic growth, along with climbing interest rates outside the U.S., means that the path of least resistance for the dollar remains down.

**Volatility** and return spreads increased from historically low levels. Given the current underpinnings of the equity market, the environment is ripe for quick shifts in sentiment, which could result in greater



market volatility. The graph clearly shows increasing volatility in February, followed by another blip in late May and early June 2007. The market will remain volatile as conflicting weekly economic data and new or disintegrating M&A deals will continue to whipsaw the market.

### **Growth or Value: Where Should You Invest Your Money**

Growth and value refer generally to whether a stock is in or out of favor. Value stocks are those that, for whatever reason, are being overlooked or even shunned by investors, and therefore have relatively low ratios of price to earnings or price to book value. By contrast, growth stocks tend to be the current Wall Street darlings and their popularity leads them to trade at relatively high valuation ratios. In fact, many professionals call growth glamour investing.

In cloistered halls, academicians have over the years generated study after study showing that the best way to invest in equities is to put all your money in value funds and nothing in growth funds. All of this research however, is backwards looking. What has happened before is not going to repeat exactly the same way. So making decisions solely on the past has proven to be a poor strategy. Of course, it is important to take the lessons of the past but use them to look forward, identifying the unique set of risks and opportunities that the economy and markets are currently facing. Based on my assessment of risks and opportunities I have always allocated a health portion of a portfolio to growth while still overweighting value. New studies have recently supported this strategy.

It is widely known that value has outperformed growth over the very long term. In fact, according to Ibbotson Associates, the race isn't even close: over the nearly four decades from the start of 1969 through the end of last year, value stocks outperformed growth stocks by an average of 2.5 percentage points a year. Even better, according to Ibbotson, the typical value stock over those 38 years was 15 percent less risky than the typical growth stock.

I do not believe that this historical data captures the essence of the risks and opportunities inherent in current investment market. Two published studies, quantifying the risk/return trade off of growth investing, support my hypothesis that growth stocks shouldn't be excluded from an investment portfolio. The first study was published in 2004 by John Y. Campbell, an economics professor at Harvard, and Tuomo Vuolteenaho, an economics professor at Harvard, and argued that long-term investors should still make an equal allocation to growth funds. The key to their argument is the need to differentiate between two types of risk. While a short-term investor is equally worried about each type, a longer-term investor is primarily interested in just one of them. The researchers found that, though growth stocks have more total risk than value stocks, they have less of the kind that is of most concern to long-term investors.

The first of the two kinds of risk is discount rate risk — which in some ways can be viewed as the risk that interest rates will rise. Growth stocks are particularly vulnerable to interest rate risk, because their current valuations depend so much on the discounted value of their future earnings (future earnings are discounted back in time to today because a dollar today is worth more than a dollar sometime in the future). The second kind of risk is that of economic trouble, or even catastrophe — what the researchers call cash-flow risk. They found that value stocks are more vulnerable than growth stocks to this type of risk.

The researchers argue that most investors with very long time horizons — a decade or more — will be less interested in discount rate risk because it tends to be largely self-correcting. A growth stock whose price comes down because of higher interest rates will recover most of that loss when those rates decline. By contrast, the researchers found that cash-flow risks tend to be much more enduring. Needless to say, a company that goes out of business will never recover.

Risk is like cholesterol in that both have a “bad” variety and a “good” variety. Doctors are not particularly alarmed by a high total cholesterol level if the bulk of it is the good variety. Similarly, the researchers argue, long-term investors shouldn’t be concerned about growth stocks’ apparently high levels of risk, because the bulk of it is the “good” variety, the discount rate kind.

The analogy isn’t perfect, of course. For the short-term investor, both kinds of risk are equally bad. That’s because stocks over short periods don’t have a chance to recover from any losses generated by higher interest rates. It’s only over longer periods that the investor becomes more concerned with cash-flow risk than discount-rate risk.

What does all of this mean for the choice of stock mutual funds in a retirement portfolio? An answer is provided by this second study that has been circulated for several months as an academic working paper by Luis M. Viceira, a finance professor at Harvard Business School, and Jakub W. Jurek, a Ph.D. candidate there.

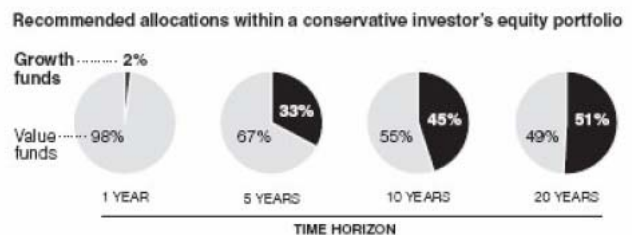
Professor Viceira and Mr. Jurek calculated which allocations to growth and value funds will produce the greatest future returns, relative to the amount of risk incurred. They concluded that an investor whose time horizon is relatively short — just a year or two — should place almost all of his equity allocation in value funds. But unless he is eager to take on risk, an investor with a very long time horizon — more than decade, for example — should invest as much as half of his equity allocation in growth funds.

The study by Professor Viceira and Mr. Jurek also illustrates the need to rethink the relationship between the short and long terms in the stock market. For years, many financial planners have made the implicit assumption that the long term can be viewed as a succession of short terms. The new study shows that this assumption is not always correct. The best approach, according to a powerful strand of recent research, is to divide a long-term portfolio just about equally between the two types.

I have traditionally given value a slight edge in asset allocation but never excluded growth. The reason being most investors cannot stomach a long term perspective. Surprisingly, most portfolio managers can’t either. I try not to succumb to the lure of the short term but I admit it *is* difficult. I instead try to allocate assets with a long term view and that is why you will always see a substantial allocation to growth in your equity portfolio.

#### **How Much Growth, and How Much Value?**

The longer the time horizon of a conservative investor’s equity portfolio, the greater the proportion that should be allocated to growth funds, a new study has found.



## **Fundamental Indexing**

I have also always been a big proponent of using the S&P 500 index as part of most investors' large cap domestic allocation. The S&P 500 has always had some problems inherent in its structure that has always bothered me but in the past there really weren't any good options. Now, however, there is a better mouse trap worthy of consideration.

Indexes were created so that investors could follow different sectors of the market were performing. They are the yardsticks by which portfolio managers measure their performance. Overtime investors began to invest in products designed to mimic the performance of these indexes from exchange traded funds to mutual funds. The **dirty secret about index investing** (or passive investing) is that the indexes were not designed for this purpose.

Most of the main indexes are cap weighted. For instance, the S&P 500 is composed of 500 large U.S. stocks. So if you buy an index product you do not own an equal amount of each 500 stocks. In fact, the top 20 stocks make up 30% of the value of the index. The bottom 100 stocks make up approximately 5% of the index's value. This is because the stocks are weighted by their capitalization which is the number of shares outstanding for any particular company times its share price. So the larger a company's capitalization the greater its weighting in the index. This is fine if you are using the index to track market performance but it falls short as an investment strategy. Here's the inherent problem the more a stock runs up in price relative to other stocks, the more you own of it. So you own more of the over valued stocks and less of the reasonably price stocks. Therefore, the index has a momentum bias, overweighting the growth stocks and underweighting the bargains (value).

In the past I've used an equally weighted index managed by Rydex to address this problem but this has proved a crude solution. It solved the cap weighting problem but inadvertently over weights the smaller companies (remember smaller stocks are riskier than larger). Now there is a better solution called **Fundamental Indexing**. This methodology arose out of market conditions in 2000 to early 2002, when the average U.S. stock was up but the indexes were down. Researchers began to look for a better way to index. Inspired by the long history of the Fortune 500, Research Affiliates tested a sales-weighted index—going back 30 years—and found more than 200 basis points (2% per year) of value was added when compared to cap-weighted indexes. Next, researchers looked at other factors such as sales and revenues, earnings and cash flow, dividends and book values. Much of this research has been done by Rob Arnott and his firm Research Affiliates, LLC.

Rob Arnott and his firm have created a Fundamental Index called FTSE RAFI U.S. 1000, in which they select and weight companies by basic pre-set measures of firm size and success, paying no attention to market capitalization, price or valuation multiples. Instead, the index uses a composite of four measures of a company's economic scale, based on a blend of the companies' sales, profits, book values and dividends.

Based on all the research I've read and analyzed, investing in a Fundamental index, as proposed by Rob Arnott, offsets the risks of traditional index products (which emphasize growth over value) and equally weighted index products (which emphasize small over large) while offering the potential for higher returns.

Schwab has joined forces with Rob Arnott to offer Fundamental Index Funds through the Schwab trading platform. The U.S. Large Company index product (ticker symbol SFLNX) is the option I recommend using in most taxable portfolios (trust and individual brokerage accounts). This is a straight-forward product and is very tax efficient. The only concerns are the tax consequences of trading clients out of their current index products and into this new investment. I will address this issue with each of you individually and make a recommendation.

## **Mispriced Junk Bonds Opportunity**

I've written extensively this year in my newsletter and blog about high yield or junk bonds. Investors are not being paid for taking greater risk they are taking. The graph illustrates this point and 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 riskless 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 back principal or interest). To compensate investors for this risk, these bonds pay a higher interest rate. The amount of additional interest compared to U.S. Treasuries varies over time as the risk of default changes in different economic environments. Currently these High Yield bonds are paying an historically low premium compared to the risk-free Treasuries (free of credit risk). Investors are not being paid enough of a premium for the increasing risk they are taking. Investors have become complacent about risk and have been so focused on chasing higher yields that they have forgotten that they could easily lose money in these riskier bond investments.

Like most bonds, junk issues suffer if interest rates keep rising. Junk-bond investors seek extra yield by buying debt of lower-rated companies, betting that these companies are sound enough to keep paying their bills and

debtholders. A slower economy, rising inflation, and higher interest rates all significantly hurt these lower rated companies, causing their debt (bonds) to fall in value. As companies begin to struggle

to meet their debt obligations, the bond market will begin to factor risk into the value of these bonds and the spreads will begin to increase.

The **ProFunds** Access Flex Bear High Yield Fund is designed to take advantage of just such a market by providing inverse exposure to the high-yield market. Unlike most funds that invest in high-yield, or junk, bonds issued by companies with less than perfect credit, this offering will primarily use derivative instruments—mostly credit-default swaps—to profit when the prices of junk bonds fall. Like an umbrella shop opening for business as dark clouds gather, this fund is designed to help investors profit if "junk" bonds get really drenched. If appropriate for your situation, I may recommend layering a very small percentage (less than 3%) of this fund into non taxable accounts only, such as an IRA, because the derivatives this fund uses are very tax inefficient.

Please be sure to review your quarterly rebalancing sheets and return them as soon as possible.

Also be sure to take a look at my blog for more in depth and up-to-date investment analysis, tax and financial planning information. My blog is <http://financialpragmatist.blogspot.com>. Our website has a link to my blog as well. Our website address is [www.altamontwealth.com](http://www.altamontwealth.com).

Thank you for your confidence and trust.

Libby Mihalka



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