Altamont Capital Management

Third Quarter 2005 Performance

"Doubt is not a pleasant condition, but certainty is absurd."

Voltaire

Stuck in the Same Trading Range

Third Quarter had its share of action with sky-high gasoline prices, one of the worst natural disasters in United States history, and plummeting consumer confidence. While these events may seem like a prescription for investor panic, that's not what happened in the Third Quarter.

Investors kept their cool and most equity mutual funds came out ahead of the game, especially if they had a stake in overseas markets. To be sure, the stock market swooned a bit in September. But the psychological damage from double-barreled hurricane blows in the Gulf region was relatively minor in September. Investors pulled back from consumer-oriented stocks, fretting that the critical holiday season will find shoppers in a glum mood.

Yet energy stocks continued to forge ahead, as did healthcare and technology issues. With huge sums of federal aid targeted to rebuilding the Gulf states, shares of engineering and construction, building materials, and machinery companies gained. Small- and mid-cap stocks, which many analysts had expected to falter after a lengthy stretch of out-performance, also held their ground.

Overall, equities have seen tepid returns year-to-date but did relatively well in the third quarter. The S&P 500 rose 3.6% and the small/mid-cap Russell 2000 gained 4.7%. Foreign stocks did very well, gaining 11.7%, as did commodity futures (up almost 17%) due in large part to soaring energy prices. Investment-grade bonds were slightly in the red, while foreign bonds did slightly worse due to appreciation in the U.S. dollar. 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 and during the Third Quarter we started to make some headway.

The Equity Rollercoaster

Equity strategists are cautiously optimistic about the fourth quarter, traditionally a strong one. Most agree that the three-year-old bull market is struggling to get its second wind. Locked in a narrow trading range for more than six months, it faces stiff headwinds - a steady rise in interest rates, an uptick in inflation, and lofty energy prices.

Most market analysts think that investors' worries are probably overdrawn. "At this midway stage of the economic cycle, stocks and cash continue to have the edge over most bonds," says James Swanson, chief investment strategist for MFS, a mutual fund company in Boston.

"We wouldn't be surprised to see a 5 percent pullback over the next month, but don't see any major drop in the indices coming," says Dickson. He expects the market's action in the next few weeks to be

Third Quarter 2005 and Year-to-Date Benchmark Returns

	Third Quarter	Year-to-Date
Large-Cap Benchmarks		
S&P 500 iShares	3.6%	2.7%
S&P 500 Growth iShares	3.7%	1.9%
S&P 500 Value iShares	3.4%	3.5%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	5.9%	10.1%
S&P 400 Midcap Growth iShares	4.3%	7.9%
S&P 400 Midcap Value iShares	5.4%	9.8%
Small-Cap Benchmarks		
S&P 600 iShares	5.3%	7.1%
S&P 600 Growth iShares	6.6%	8.6%
S&P 600 Value iShares	4.1%	5.7%
Other Benchmarks		
MSCI EAFE Int'l iShares	10.4%	9.0%
Vanguard Total Bond Mkt Index	-0.8%	1.7%
Dow Jones AIG Commodities Index	17.6%	25.2%

heavily influenced by Third Quarter earnings reports. Rising energy prices will produce some negative earnings surprises. Still, he says, reasonable price/earnings valuations and a lot of cash on the sidelines should attract value-conscious investors, mitigating any downswing.

There is plenty to worry about these days: hurricanes, housing prices, massive current-account and federal-budget deficits, strife in Iraq, rising inflation, and others. Though I spend a lot of time evaluating these risks and the impact they could have on the U.S. economy, I'm not convinced that this will translate into a recession or a down market in the long term. It's tempting to give in to these fears and assume a conservative investment posture, but this would ignore another—and perhaps more important—variable, which is valuations. Valuations matter because they provide insight into what the market expects to happen, and sometimes those expectations are overly optimistic or overly pessimistic. When these extremes happen they are frequently opportunities to reposition portfolios to potentially enhance our long-term returns, without increasing overall portfolio risk.

Evaluating the current equity markets using several different valuation methodologies, it appears that the S&P 500 is at the low end of what we consider to be a fair-value range. So the domestic market is not undervalued but at the low end of being reasonable valued. I t means stocks aren't on sale but they aren't overvalued. These valuation approaches assume an average level of risk relative to history. So if there are no major blow-ups or major cyclical downturns, the markets should generate an expected average annual return somewhere in the high single-digit range over the next five years.

The market always prices in risk to some degree, but it seems likely that the market is presently pricing in a somewhat greater-than-average level of risk. Though there is a higher than average level of risk right now, the current valuation buffer leads me to believe that investors are not ignoring these risks. In the short run, valuations seldom come into play as a backstop against losses; investors get scared and head for the exits, valuations be damned. However, the trade-off for that short-term pain is that it would create an opportunity for better-than-average long-term gains.

Why Bonds

Investments in the fixed-income world can be very tricky. For example, rising oil prices stoke fears of inflation, which is bad for bond prices, but at the same time there are concerns that high oil prices in conjunction with other factors (such as a slowing housing market) could slow economic growth, which is good for bond prices. While economic forecasting is difficult, and calling turning points is even tougher, these are not the factors I focus on when deciding how much fixed income should be in any portfolio.

In deciding how much to allocate to bonds it is important to think about their purpose. Is it to provide income? Is it to generate big returns to the portfolios when tactical opportunities present themselves? My view is that most of the time the primary function of bonds' is to help offset equity losses when the markets are in flux.

Though the main focus of my fixed income strategy is how to position the bond portfolio to effectively "play defense" when times are tough for stocks, I do try to assess the return prospects for different bond sectors and then try to take advantage of these returns while maintaining or reducing the risk. Right now this is exceptionally difficult. Real yields on investment-grade bonds are very low, which suggests they may be overvalued on a long-term basis. For instance, there are several scenarios where, over the short term, rising rates could result in cash outperforming bonds. However if we experience a significant economic slowdown, bonds would appreciate while equity markets would be underperforming.

So bonds are an important diversifier that helps manage risk. Even though the yield on bonds will probably stay relatively low they still are anticipated to generate returns in the 4% to 5% range. This outperforms or breaks even with cash returns over the long run in most scenarios, including a "steady-state" environment with few major economic conditions.

My thinking on alternative bond ideas keeps evolving. Earlier this year we began adding Eaton Vance Secured Floating Rate Bond fund in many of the portfolios to protect against rising interest rates. So far the strategy is working, adding return while reducing overall risk. Since the beginning of the year the fund has generated a 3.6% return versus the 1.8% return produced by the LB Aggregate index.

So where does this all lead me? Well read the next section for a discussion of my latest suggestions.

New Allocations to Investment Portfolios

A sustained period of dollar devaluation is very probable over the next five to ten years. This would negatively impact the value of US bonds and stocks. To mitigate currency risk I have spent hours considering various alternative investments before selecting the PIMCO Developing Local Markets (DLM). It invests in foreign bonds but with a twist.

Since early 2004, several important factors have changed in the foreign bond sector. The relative yield advantage of investing U.S. dollars in overseas bonds is no more. Also, the difference in real (inflation-adjusted) yields has narrowed, suggesting that foreign bonds no longer have a valuation advantage over U.S. bonds. Additionally, the dollar may not be as overvalued as it once was in relation to several developed regions, Europe in particular. However, because of the unprecedented magnitude of our current account deficit, the dollar should keep depreciating against the currencies of some of our larger trading partners over the long run. There also is a small risk of an outright dollar crash at some point if overseas investors unexpectedly decide to diversify or reduce their U.S. holdings, sparking a "rush for the exit."

A few months ago PIMCO launched the DLM fund, (the first public mutual fund of its kind) which invests primarily in ultra-short-term bonds in a wide range of emerging markets (versus those of developed countries). These emerging countries offer yields which are attractive in both nominal and real terms relative to the U.S. and developed markets; the PIMCO DLM fund's benchmark (a benchmark is the index that a fund compares its performance to), the JPMorgan ELMI+ Index, which currently yields roughly 5.5%. Also, the long-term economic fundamentals in many emerging markets have improved markedly (lower debt levels and higher foreign currency reserves, for example). In the next few years, this improvement, along with trade flows, will begin to cause the dollar to decline more materially against these emerging countries' currencies than against more developed markets' currencies. (These improved fundamentals also contribute to the attractiveness of the ELMI universe, although this in and of itself would not be a sufficient reason to invest there—it's just one of several positive factors.)

Because of the fund's very short duration—it is almost like a money market—there is no significant interest rate risk, although there is still the currency risk. The currency risk should not be ignored as a very real source of volatility, but the fund is extremely diversified with a wide range of emerging markets, and in the past this diversification has been surprisingly effective at mitigating downside risk. That doesn't mean there isn't risk—even in emerging markets yields are quite a bit lower than they were a few years ago and this means less cushion against capital losses, for example—but as noted the fundamentals are also markedly better. Finally, PIMCO's DLM fund in particular offers an advantage versus their developed market bond funds in that it has considerably more flexibility to make moves away from its benchmark. This flexibility is a must with emerging markets, where meaningful risks can come from a small number of countries. PIMCO's proven track record could add a meaningful amount of value; their Emerging Markets Bond Fund has a great record over the eight years since its inception. I think this fund is a good addition to most bond portfolios because it adds diversity by managing the risk of a significant decline in the U.S. dollar by spreading this risk across a broader basket of emerging-market currencies rather than just a few developed-market currencies such as the euro, pound, or yen. You will see this recommendation in your rebalancing worksheet.

Another change that I will be making over time will be shrinking your S&P 500 index ishares or Vanguard S&P 500 index mutual funds holdings and substituting Rydex's new Equally Weighted S&P 500 shares. The new

Rydex fund differs from existing market capitalization-weighted S&P 500 index funds in its approach. It represents the first time that an equally weighted S&P 500 index alternative is available at a reasonable fee. It is also in ETF (Exchange Trade Fund) format so it combines the benefits of mutual funds with the flexibility of stocks. It enables investors to purchase a diversified pool of securities in a single transaction, since it is traded like a stock.

There is only one S&P 500 index, and it is used by many different companies in the form of mutual funds and ETFs to capture the overall performance of the U.S. equity markets. It is composed of 500 large companies selected by the Standard and Poors Company. It has become the de facto index to monitor the U.S. equity market.

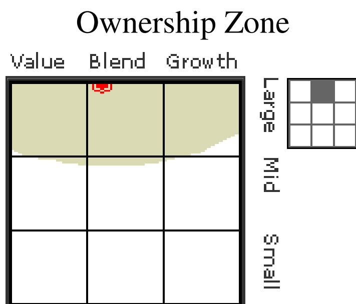
The S&P 500 is a capitalization-weighted index, as opposed to an equal-weighted. An equal-weighted index is composed of an equal amount of each stock. However, S&P 500 is capitalization-weighted and gives each stock a "weight" that is in proportion to the market value of the company. The weighted size of a company is determined by multiplying the number of shares outstanding by the share price. Microsoft constitutes nearly 3.5% of the S&P 500 index, while Nordstrom comprises .05%, meaning that Microsoft's impact on the performance of the index is 70 times Nordstrom's. There are over 150 stocks in the index with even less weight than Nordstrom. In fact, the top 20 stocks in the S&P 500 represent nearly one-third of its value, and the top 100 stocks, one-fifth of the total, represent three-quarters of the value. Four of the top 10 holdings - Microsoft, Intel, Cisco and IBM - make up over 8% of the value of the index, a substantial portion considering the total number of stocks in it. Since there are 500 stocks in the index, its overall movement will be influenced more heavily by price changes in the stocks with the heaviest weightings (and largest market capitalization).

The message is clear. Although the index appears at first glance to be a well-balanced basket of 500 stocks, in reality, because of the weightings, it is much more narrowly focused on the biggest companies. In addition it is a momentum vehicle. As the price of a stock increases so does its market weight (determined by multiplying the number of outstanding shares by the current stock price). So you are buying more of stocks that are growing in value and selling stocks that are falling. This style is counter to the old buy low sell high strategy which is called value investing. There are times when momentum investing outperforms value investing (like the dot com bubble) but over any historical 10 year period momentum investing has never outperformed value investing.

The style boxes below graphically show the compositional difference between the S&P 500 Index (Cap-Weighted) and the new version of the S&P 500 that is Equally-Weighted. Both are composed of the same 500 companies but in different proportions. They Rydex Equally Weighted S&P 500 has a larger proportion of the Mid Cap companies and less of the Gigantic Cap companies.

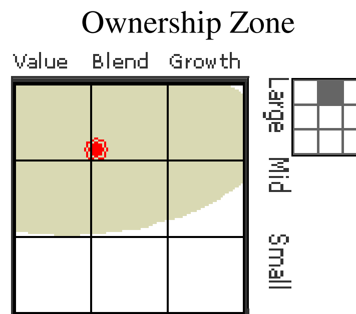
S&P 500 Index

Ownership Zone



Rydex Equally Weighted S&P500

Ownership Zone



Fund centroid represents weighted average of domestic stock holdings

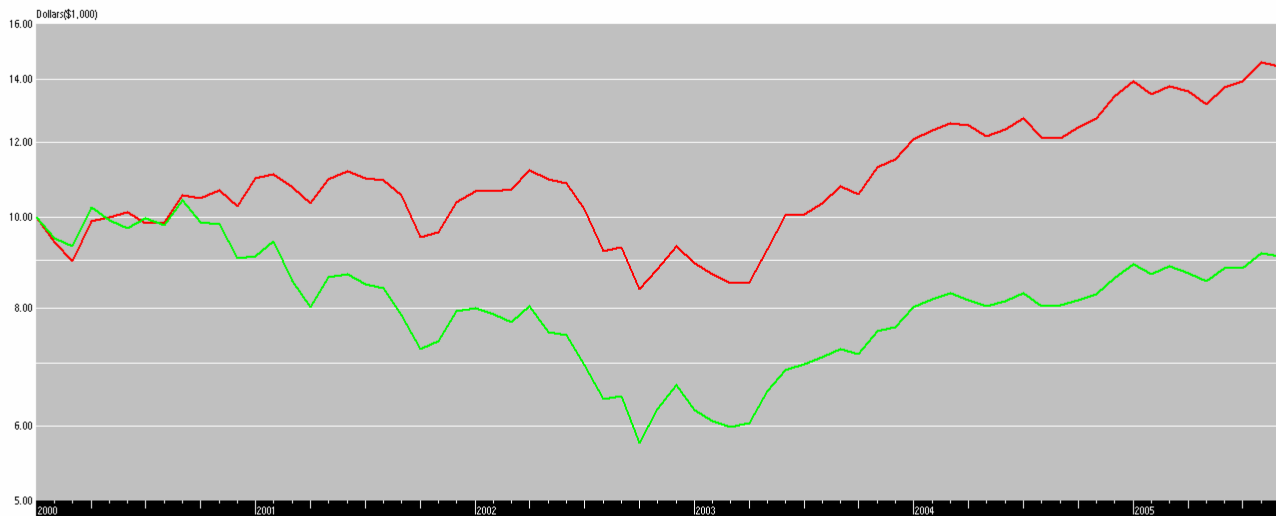
Shaded Zone represents 75% of fund’s domestic stock holdings

Although the Rydex shares are the first equal-weighted index ETF, the Morgan Stanley Value-Added Market Equity fund (VADBX) uses a similar but different methodology to achieve its equal-weighted S&P 500 strategy. Morgan Stanley fund, which was introduced in 1997, has a very high expense ratio at 1.60%. The fund's newer A shares are less expensive at 0.85%, but both share classes carry front-end loads in the neighborhood of 5%, according to Morningstar's fund database. That is expensive. The Rydex ETF has an expense ratio of only 0.40% and no-loads, making it affordable.

The purpose of the chart below is to show you the performance of the equally weighted S&P 500 index compared to the traditional capitalization weighted S&P 500 index. I have used the Morgan Stanley fund (VADBX) in the chart below as a proxy for the Rydex fund which was only started last year. The table below shows how Morgan Stanley fund performed against the S&P 500 from January 2000 through August 2005. The Morgan Stanley Equally Weighted S&P500 index mutual fund generated a 6.7% annual return during this period while the S&P 500 index (which is cap weighted) lost 1.7% on average each year. The new Rydex Equally Weighted S&P500 would have shown better performance than the Morgan Stanley fund because its fees are much lower.

Growth of $10,000: from 01-01-2000 to 08-31-2005

Fund/Index	Total Return %	Annualized Return %	Amount at End of Period $
Morgan Stan EqWtdS&P500 B	44.19	6.67	14,419
Standard & Poor's 500	-9.24	-1.70	9,076



Source: *Morningstar data*

Throughout most of the mid- and late-1990s (the tech and dotcom bubble), the equal-weighted approach lagged the S&P 500 because the momentum style outperformed. However, starting in 2000 after the tech bubble burst the value style outperformed so the edge went to equal weighting. There are times that the momentum style represented by the S&P500 out-performs but over the long term the value style represented by the new Rydex Equally Weighted S&P500 index has historically done better. The average annual total return for the S&P Equal Weight Index has exceeded return of the S&P 500 Index over the past one-, three-, five- and 10-year periods.

By lowering the concentration in larger companies, Rydex S&P Equal Weight ETF attempts to evenly capture the results of all constituents in the S&P 500 and emphasizes a value versus momentum style of investing, making it a valuable core holding for any investor's portfolio. In time you will see the Rydex Equally Weighted S&P500 Index become part of your portfolio. The timing depends on selling some of your current S&P 500 holdings which we will try to execute in the most tax efficient manner.

In Summary

I can't fully protect your portfolio against all risk without significant opportunity cost from excessive conservatism. But I'm confident that my approach of balancing risk and return is sensible considering the broad range of possible economic scenarios. In carefully assessing this range of possible economic scenarios, it is impossible to hedge perfectly against all risk. The worst case scenarios could still cause substantial losses but the problem is that the only way to completely hedge this risk is to have very low allocations to volatile investments such as equities. But even bonds are not a perfect solution (we can imagine bonds losing 5% or more in a dollar crash or stagflation scenario, and they could even lose money if the economy did unexpectedly well). That leaves few options other than cash, which under any circumstances does not offer attractive long-term returns. So trying to protect against all possible risks would result in a permanent, ultra-conservative asset allocation. That level of excessive pessimism can be just as detrimental to long-term returns as market disruptions: missing big up-moves can seriously reduce long-term average returns. I have included investments like bonds, commodity futures, and foreign bonds to help in the event that some of these risks come to pass, but in turn investors must always be willing to accept a small chance that risk thresholds could be violated by a few improbable but very severe scenarios. As always I try to make sure you are in the right type of portfolio for your level of risk tolerance.

I thank you for your confidence and trust.
Best Regards,

Libby Mihalka, CFA, MBA
Altamont Capital Management

"According to our brokerage statement, they're going to dump a truckload of something called 'pork bellies' on our front lawn this morning."