

The Portfolio Reporter

A Newsletter Provided by Dunn Capital Management, LLC

January, 2006

Alfred, Lord Tennyson, *The Day-dream*

But any man that walks the mead,
In bud or blade, or bloom, may find,
According as his humours lead,
A meaning suited to his mind.

How true. Furthermore, each reader and writer can and may have his or her own interpretation of a poem based on what he or she personally wants to believe. And I will allow you to do the same, but with some preamble from me to introduce part of this month's discussion, to which the above lines also apply. Each and every one of us can choose data and information to suit the investment outcome each wants. This is why some of the analyses being provided by some market analysts are laughable to me.

This month we will cover two topics: one, what are the important factors to monitor in the year ahead; two, the review of analyst forecasts for the market for 2006. We have a lot to cover this month, so we are breaking from tradition and extending our self-imposed one-page restriction.

Using information to fit a conclusion doesn't just "lack scientific rigor"; it is of no help to anybody. True analysis is finding those factors that impact the end result. Otherwise, information is just coincidental. For example, back during the Middle Ages, when the Black Plague struck, ministries blamed the rats. So the ministries went out and killed as many rats as they could find. However, it was not the rats that were the problem; it was the ticks and mites living on the rats that were carrying the disease. Killing the rats made the parasites move to another host, humans, to survive. Therefore, killing the rats only made the situation worse.

The moral of the story is that we must find those factors that really have an impact and not just tie our analysis to coincidental information.

Exchange Traded Fund Market Performance - As of Dec. 30, 2005

	1 Month % change	12 Month % change
S&P 500	-0.4	3.0
S&P 500 Growth	-0.5	2.5
S&P 500 Value	-0.3	3.5
S&P 400 Mid-Cap Growth	0.8	12.6
S&P 400 Mid-Cap Value	-0.1	9.6
S&P 600 Small-Cap Growth	-0.9	8.4
S&P 600 Small-Cap Value	-1.5	4.8

Over the past 14 years, I have tracked the factors that impact and **lead** the stock market and economy in a downturn. When I come across an indicator that has economic justification for having an impact, I test to see if it has historical significance. Historical significance means an indicator that turns down or slows in growth and has foreshadowed a downturn in the economy or the market in the past. Two factors that have met this test are new home sales and the inverted yield curve.

New home sales recently declined by 11%, the greatest amount since 1994. This is a concern because a decline in home sales has historically foreshadowed a decline in the overall economy. For example there have been seven declines of 15% over a six-month period that have preceded a decline in the economy and four other declines of 15% that gave a false indication of a slowdown in the economy. But the present decline needs to be larger and continuous over several months to make this information more conclusive.

The inverted yield curve is more difficult to explain. Let's define what the yield curve represents. The curve compares what interest rates are in the short-term (such as 3 months, 1 year, 2 years) to long-term (10-year) interest

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rates. Short-term rates are generally lower than long-term rates. If we plot the rates on a graph with the horizontal plane representing the term (months or years for the interest rate) and the interest rate on the vertical plane, then drawing a line between the rates, we see that the line rises as we move left to right. You have just drawn your first yield curve. So you can now pull out the daily newspaper and get you favorite short- and long-term rates and graph the yield curve. Or, for you more impatient folk, go to <http://www.stockcharts.com/charts/YieldCurve.html> and you can see a daily graph of the yield curve.

The explanation for why the curve rises from left to right is that investors expect a higher return for tying up money for a longer period of time. I think most of you understand this, since you have requested information from me about bonds paying higher rates and/or tying up money for a longer period of time.

The inverted curve results when investors believe an economic slowdown or recession is imminent. When bond investors sense this slowdown, they purchase long-term bonds for security. This increased demand for long-term bonds drives interest rates lower on the long end of the curve. The result of this move toward security is a flattening of the line drawn between the short- and long-term rates, or even worse, the long-term rate dropping lower than the short-term rate. This is known as the inverted yield curve. Since 1954, there have been seven inverted yield curves, and five of those have predicted a recession. The yield curve has also missed three periods when there was a recession and the yield curve was not inverted. The yield curve also became inverted twice without a recession occurring.

Still we need to see further evidence, in terms of both magnitude and time, to confirm this danger. Until that time we will not seek protection for the portfolio by hedging (buying inverse funds) or buying precious metals and bonds to protect the value of the portfolio.

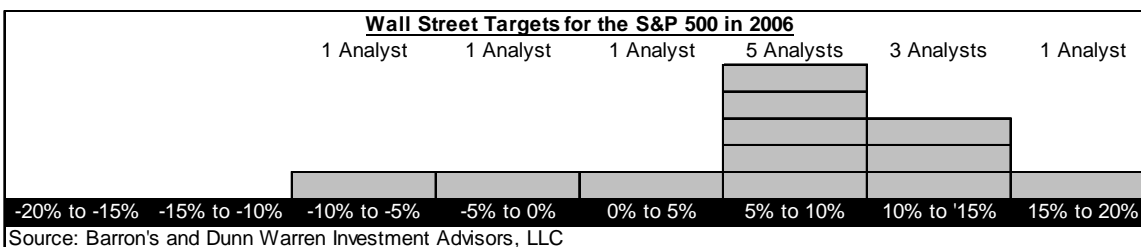
This time of year, we hear many projections from analysts for the stock market and the economy in the year ahead. Barron's, the weekly investment newspaper published by Dow Jones, reports the projections of Wall Street Analysts. They have, this year, questioned 12 analysts who, on average, expect a 9.0% return for the S&P 500 in 2006 from its close on December 31, 2005.

This year one analyst expects the market range to be up 0.0% to 5.0%, five analysts expect the S&P 500 to increase 5.0% to 10.0%, and three analysts believe it will increase 10.0% to 15.0%. Two analysts believe it will decline.

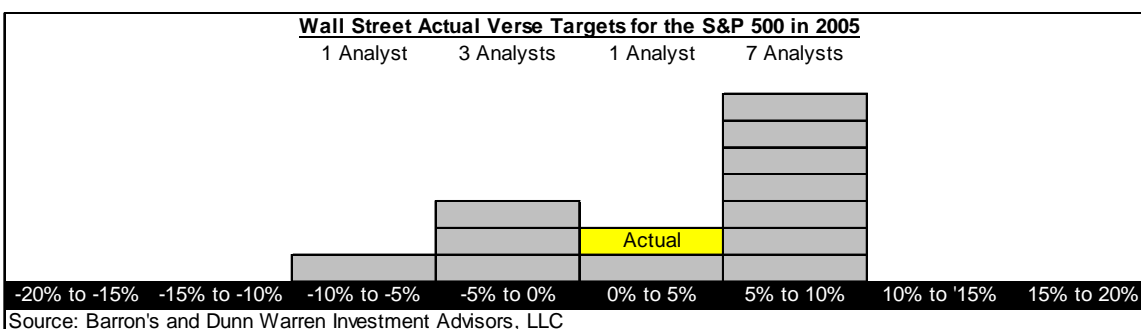
We would be very surprised to see the market up over 10%, given its high valuation now, but

The Portfolio Reporter

we are not going to guess. See the table below.



In keeping with our acknowledgement of historical perspective, we tracked the accuracy of analysts over the past four years by collecting the past estimates presented in Barron's. The analysts' targets going back to 2001 were just as likely to be wrong as right. 2005 forecasts were clustered from 5.0% to 10.0%. There was only one analyst who expected the S&P 500 to increase 0.0 to 5.0%. The actual return was 4.9%. The table below indicates the divergence of analysts' targets from the actual results in 2005.



As Barron's indicated in their issue dated December 31, 2005:

This year's big finish is, no doubt, part of the reason for the strategists' generally upbeat consensus. The spirited fourth-quarter rally that began in mid-October has lifted the major indexes by anywhere from 7.0% to 12.0% and has drawn loud applause after a frustrating three quarters. And while more upside could always be tacked on in the 14 trading days before 2005 expires, at this point it appears that equity returns for the year will trail the consensus call from strategists a year ago, when a 6.0% gain was the collective expectation.

What we can gather from this small sample size is that trying to estimate where the market will be is useless. Nor should we try to make investments based on analyst expectations of where the market will be.

While the year ahead will certainly be difficult, we look forward to making the ride as smooth as possible. We will not find "A meaning suited to his mind" but will look only for that evidence that is supported by historical and scientific rigor.