

# The Portfolio Reporter

A Newsletter Provided by Dunn Capital Management, LLC

September, 2005

At this time we see very little reward potential due to the indicated slowdown in the economy. We see risk increasing, since valuations are high and investors' tolerance for risk is diminishing. Add to this the rise in oil prices and interest rates, and the economy has reached a point that presents just a small potential for stocks to increase in value. For this reason we would reposition a portfolio to have less aggressive investments for less impact from a potential downturn in the market.

*At last the large egg broke, and a young one crept forth crying... It is very large and not at all like the others. I wonder if it really is a turkey... It would be very sad, were I to relate all the misery and privations which the poor little duckling endured during the hard winter; but when it had passed, he found himself lying one morning in a moor, amongst the rushes... He had been persecuted and despised for his ugliness, and now he heard them say he was the most beautiful of all the birds.* Hans Christian Andersen (1844)

In March I discussed the "conundrum" that Alan Greenspan, the Federal Reserve (FED) Chairman, exclaimed with regard to the occurrence of the falling yield curve, where the 10-year bond rate was declining during the same time that the FED was raising interest rates. This is often cited as a prelude to a recession or at the very least a slowdown in the economy.

However, just as the farm animals in Hans Christian Anderson's fable needed time to realize the beauty that emerged from the ugly duckling, we needed time to understand why the 10-year bond was falling, indicating an economic slowdown. In March we cited four possible reasons for the falling rates, but we did not take a chance with the portfolios, choosing to take "a more cautious stance and keep equity exposure low."

In an article published in July by Paul McCully, the FED Strategist and PIMCO portfolio manager, he explains why there was no conundrum. Mr. McCully sites the ISM (Institute for Supply Management) Index as an indication of why the rates on the 10-year bonds were falling. ISM is a survey of purchasing

Exchange Traded Fund Market Performance - As of August 31, 2005		
	1 Month % change	12 Month % change
S&P 500	-0.9	10.2
S&P 500 Growth	-1.1	8.0
S&P 500 Value	-0.7	12.3
S&P 400 Mid-Cap Growth	-1.1	22.8
S&P 400 Mid-Cap Value	-1.2	23.8
S&P 600 Small-Cap Growth	-1.0	27.9
S&P 600 Small-Cap Value	-1.9	22.3

managers throughout the manufacturing sector. "The ISM index is the single best statistical indicator of the direction and pace of manufacturing activity in America, which is the single best cyclical indicator of the direction and pace of Fed policy... The fact of the matter is that there is no conundrum in what long rates have done since the Fed started tightening, if you look at what both the ISM Index and long rates did in the year before the Fed started tightening!"

While the United States is no longer dominated by manufacturing companies, the business cycle still is. This is because the business cycle is driven off the inventory cycle, which represents the interplay between customers' orders and producers' - manufacturers' ability to meet those orders. Consequently, from the winter through early summer, the ISM index has been falling, indicating a slowdown in manufacturing.

The ISM is just one of several variables we view to monitor the overall strength of the economy and to gage the REWARD potential on our Risk-Reward Matrix. At this time we see much greater risk than reward and would urge extreme caution.

*All numerical data has been provided by Barclays Global Investors, unless indicated otherwise.*

*Please feel free to pass the "Portfolio Reporter" to interested friends and family members.*

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