

## A Tale Of Two Markets

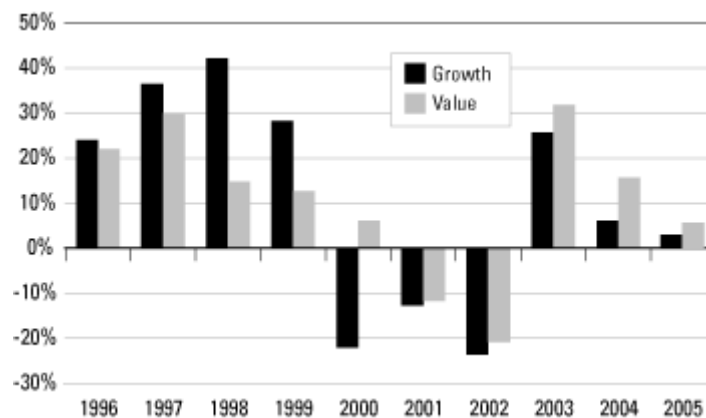
With apologies to Dickens, “A Tale of Two Markets” could well describe the action or inaction that reveals the stock market is not a single uniform market, but a marketplace with many inner-components. In traditional terms there are two primary classes of stocks: Growth and Value. To give a quick description of the two:

“Growth” is stocks of companies that grow 15% or more per annum and are prone to having their earnings growth accelerate or decelerate based on the health of the economy. Examples are Technology, Manufacturing, Financial Services, Retail, Healthcare, Transportation and Telecommunication companies.

“Value” is stocks of companies that grow fairly reliably but at less than a 15% growth rate and is less dependent upon changes in the economy. Examples of these are: Food, Household goods, Liquor, Drugs, Oil, Minerals and Healthcare insurance.

Biotechnology is the odd performer, although it’s generally grows at a “Growth” rate it tends to perform better when the economy slows since healthcare is largely insensitive to minor economic fluctuations.

The 1990’s, the golden era for Growth stocks as shares of Growth sharply exceeded those of Value. However, since both tend to perform neck and neck over the long term, frequently one class will move head and shoulders past its competitor, just as Growth beat the pants off Value in the 90’s, Value has done the same to Growth since 2000. See chart below:



Which category is best for the long-term investor? There’s no right answer, both will reward the investor well given a long-term perspective. What happens in the long run is that one class will move to an extreme valuation and then under perform for an extended period of time. I believe we’ve reached that point of extreme with Value now. A while back I suspected there was an unusual anomaly at work and found a study done by the research firm Credit Suisse First Boston stipulated: ***“on a price-to-cash flow basis growth stocks are cheaper than value stocks for the first time since at least 1977.”***

What does all this mean? Sometime soon but impossible to predict with precision, Value will start to lag and Growth stocks will accelerate upward. The tipping point in 2000 from Growth to Value coincided with the Federal Reserve altering its policy from accommodative to restrictive. The Fed is frequently the inflection point: 2007 will be a crossroads year; at some point in 2007 the Fed will initiate a series of rate cuts, this should ignite growth dramatically.

As I've repeatedly said in this forum for years: From 1960 to 1998 stocks grow at an 18% per annum rate when the Fed is cutting interest rates. I believe it's a long shot to presume that Value will grow at 18% per annum in 2007 due to its past out performance, I believe the odds are much better that old line traditional Growth stock will ignite and move to a premium over Value by 2010. In other words, the table is set for Growth to outperform just like it did when the Fed was accommodative in 1995. ***If the Standard and Poors 500 Index grows at a 13% rate in 2007, it's likely that Growth could return a premium return in excess of 20% in 2007. Such is the ebb and flo of markets, the yin and yang, its now time for Growth to make that leapfrog and the event that will be the catalyst will be the Fed cutting rates.***

Bottom Line: Stocks remain the asset with the best potential relative to bonds. Recently, Bill Miller made the following observation: Private equity is "buying the cheap asset, which is stock, and selling the expensive asset, which is debt." This is the smart money, and that is how they are playing it. Individual investors should take note.

#### **Do you think you're alone in under performing in 2006?**

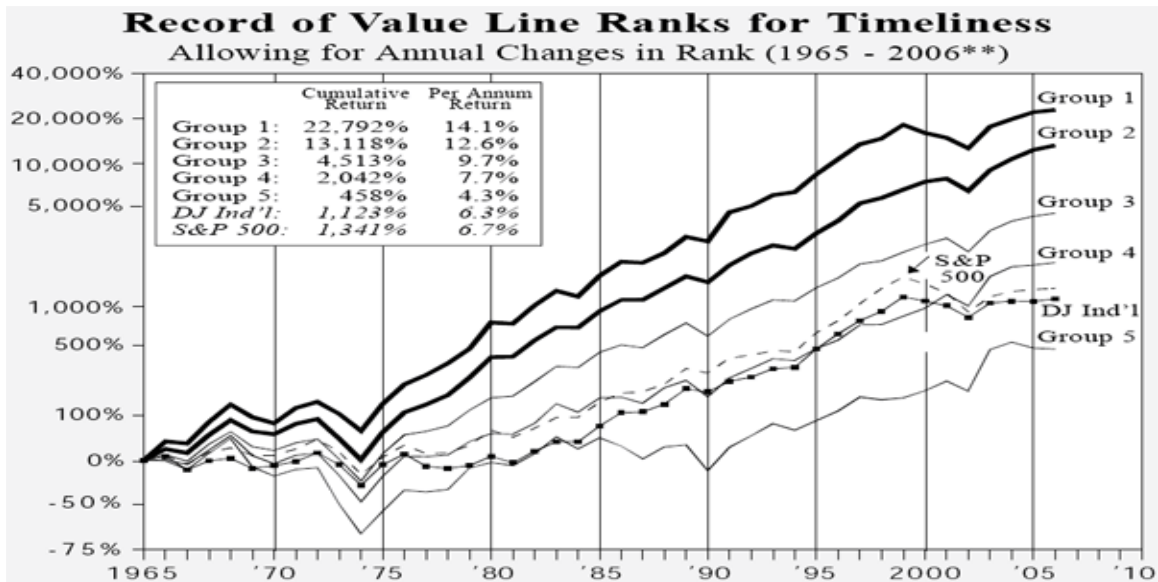
*Legendary Bill Miller who outperformed the SP500 for 15 straight years returned just 4% in his Legg Mason Value Trust.*

*Hays Advisory, a research firm I value and trust saw its 6 year record of beating the S&P 500 end as well with a return of just 4%.*

*Lipper's Multi-cap Growth funds were up only 6.4% on average.*

*Lipper's Large-Cap Growth funds were up a limp 3.7%*

To answer the earlier question: "Which style is best for the long term investor?" Although there is no right answer to that, to be more precise there are stock selection systems that do beat the pants off of the markets for extended periods of time. In my opinion, the best, the most critically and favorably reviewed has been the "Value Line Timeliness System". Data goes back to 1965, see the chart below:



As the chart shows, Group 1 stocks have grown at a 14.1% per annum rate for 41 years versus 6.7 for the SP500.

By the way, the Value Line Timeliness #1 are predominately Growth stocks.

#### And what did Group 1 do in 2006?

A very modest, +4.5% before expenses. See chart below which graphs Group 1 performance.



GSPC is the SP500 Index Composite. PIV is the Value Line #1 Timeliness index (a proxy for RMHI accounts since we employ the Value Line system). Since we use the Value Line Timeliness system extensively, you would presume our accounts mirrored the PIV and you would be correct. Our portfolios peaked in the early part of 2006, but lagged in the second half.

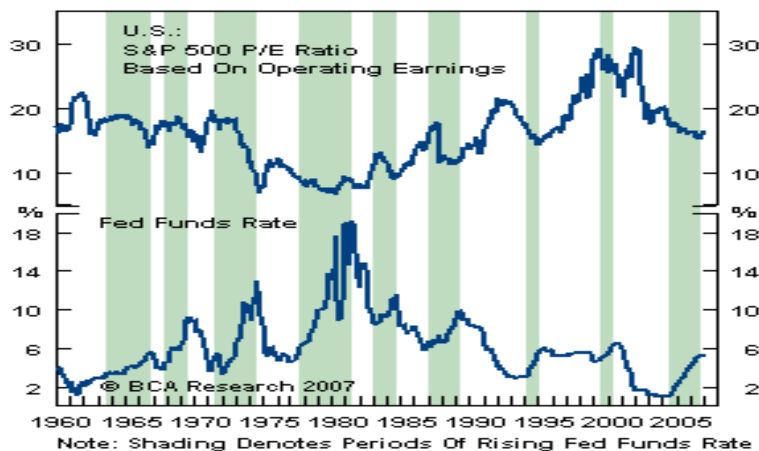
#### Could you have done much better in 2006?

Yes, but remember the components of Value you'd have to have owned every major oil company along with Phillip Morris aka Altria, Pfizer, factory farms along with most companies involved in animal testing. One tidbit of information that should be understood is that most of the "negative" or "sin stocks" are stocks that do better when the economy is slowing down, like 2006.

### Looking Forward to 2007

Here are some key themes for the New Year:

- The third year (2007) of the Presidential term is typically the most profitable for stocks, raising by an average of 17% per annum, with only 5 losing years since 1901, the last being FDR's second term.
- The Fed will soon be lowering interest rates. Since 1960, stocks have risen by an average of 18% per annum when the Fed is easing interest rates. Although it's an open argument exactly when the Fed will commence lowering rates, they're clearly done raising them. In addition, the one crazy uncle on the Fed Board of Governor's (the head of the Richmond Fed) who insisted on actually raising rates as of the last meeting will no longer be a voting member.
- The 20 year average for the PE of the Standard and Poors 500 index is 24.4 but despite the run up in share prices since 2003, the PE of the market is just 16.2 at present. This would mean the SP500 could rise by 50% for the index to go back to its historical norm. This rise would have to occur without any growth in the U.S. economy, which appears to be a low probability in future years, any growth would increase the return of stocks as they revert to their historical relationships.



Look at the chart above. The bottom line is the measure of the Federal Funds interest rates, do you notice that in the white areas (when the Fed is lowering rates) the line above (the PE ratio of the SP 500) tends to rise? The exception is the crazy period post 2000. This means that investors tend to pay a higher premium for stocks when the Fed is lowering interest rates. This graph confirms that stocks tend to rally by 18% per annum when the Fed is lowering rates.

The 20-year average P/E for the S&P 500 is 24.4 but right now its 16.2. What does this mean? Stocks are still very cheap versus interest rates and any other benchmark. This increases the probability of both outstanding returns in the future and that any market declines will be shallow. *Bad Bear Markets happen when stocks are rich and the Fed is raising interest rates, not lowering them.*

**Bad: (stocks return under 7%) 10% probability** – The Fed ends up triggering a recession due to the imploding housing market. This in-turn affects the consumer with a rash of defaults and foreclosures, the by-product of abusive lending in the first half of the decade. Chances of this are growing very slim.

**Good: (stocks return 7% – 14%) 50% probability** – The Fed decides to wait till near the end of 2007 before embarking on an easing policy, the economy weakens but doesn't break. Earnings growth is still good, running at 7% or better. PE expansion is very modest but Microsoft encounters more delays with Vista and there is a lack of a killer platform for technology. Oil prices don't break and end up near \$70 per barrel, investor dollars still biased towards Value. Not a bad year, but Vanilla nonetheless.

**Better: (stocks return exceeds 15%) 40% probability** – The Fed does start easing in 2007 as the goal of curtailing inflation expectations is a success and the economy continues to grow at a healthy rate with earnings growth exceeding 8%. PE expansion becomes viable and just a modest rise in the PE to 17.5 combined with 8% or more earnings growth forces growth stocks to exceed 20%. The dwindling supply of shares caused by private money buybacks causes money to be focused on a shrinking number of quality stocks, forcing valuations higher. Compromise is reached in Iraq for the initial stages of a withdrawal of US forces.

All the best to you in 2007  
Brad Pappas  
January 8, 2007

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