



# Stormy 2005 Expected to Give Way to Steadier Seas in 2006

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*Economic sector allocation largely determined 2005 performance*

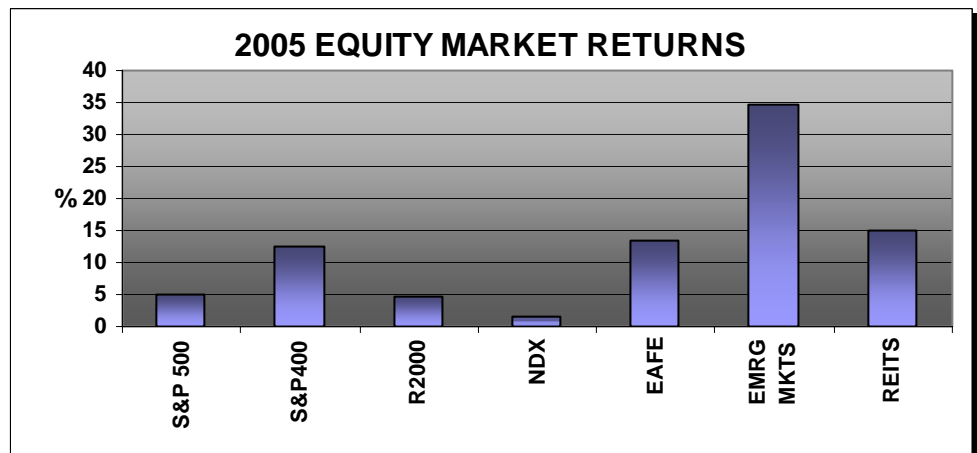
## A Review of 2005 Capital Markets

The year that started with unreal footage of the damage of the Indian Ocean tsunami, continued with the most active hurricane season in over 25 years, creating major energy market imbalances throughout 2005. By all rights, 2005 could be dubbed the year of the natural disaster and associated energy market turbulence.

From a political standpoint, the year proved fairly uneventful with no major change in the US involvement in Iraq and a stalemate in the US Congress over Social Security Reform. Typical of second terms, the focus has already shifted to the mid-term elections and potential Presidential candidates for 2008.

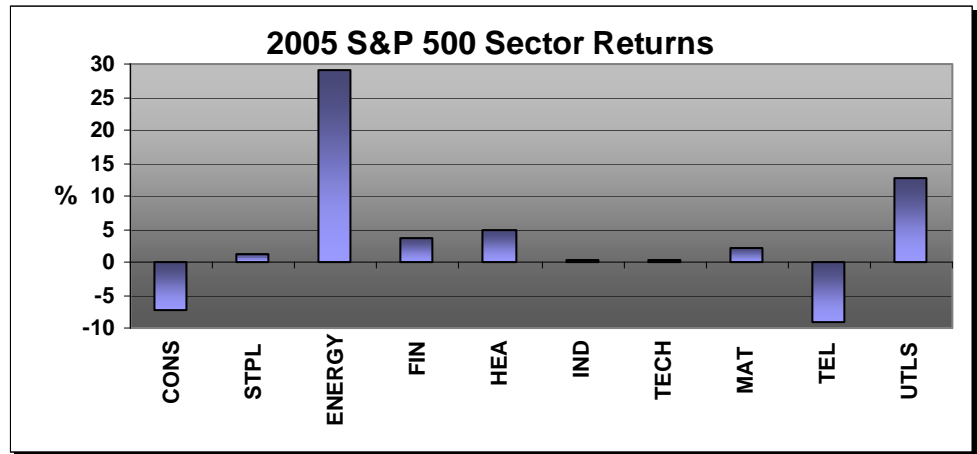
On a more positive note, the US economy performed well-beyond expectations even after accounting for the problems caused by Hurricane Katrina and the tremendous rise in energy costs. Comparing notes on how much it cost to fill up one's car became a neighborhood pastime, but the overall economy stayed the course despite this.

By contrast, the U.S capital markets proved fairly lackluster with global market volatility at near all-time lows and a dearth of major market shattering events. Emerging equity markets were on fire during the year while US equities trailed most international stock indices, even after adjusting for the double-digit appreciation of the US dollar. Large capitalization stocks in the US slightly outperformed their small cap counterparts, but mid-cap stocks took the prize, with returns exceeding 12% for the year. REIT stocks again performed very well in 2005, but cracks emerged during the fourth quarter as the fundamentals of the real estate market showed signs of a slowdown.



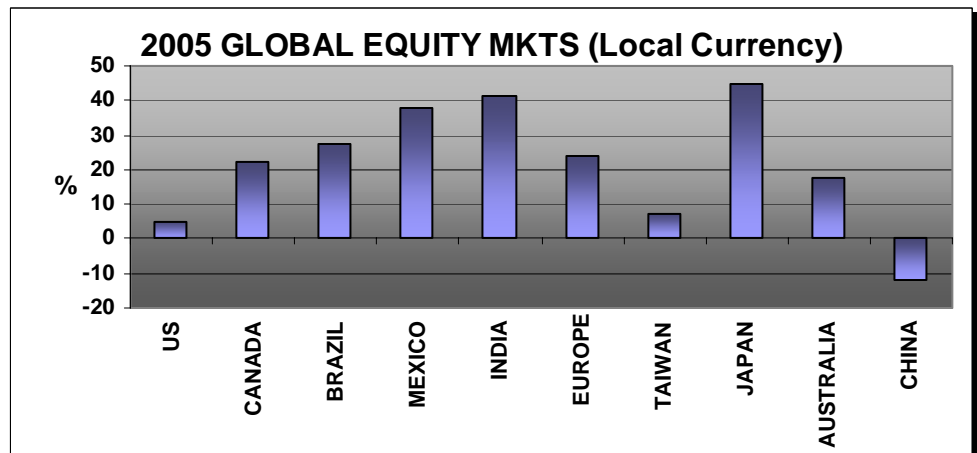
The US equity market also showed signs of unbalanced performance during the year. The best performing industry in 2005 was coal, with all energy-related industries delivering exceptional performance. Internet stocks also garnered their fair share of press, with Google doubling in price during the year. Two sectors, Consumer Discretionary and Telecom Services, exhibited losses for the year. Automobile-related stocks took a real beating during the year as industry fundamentals deteriorated significantly. Legacy fixed-line telecom operators also bore the brunt of adverse competitive conditions and performed miserably during 2005.

Major return differences were observed in 2005 among economic sectors.



### International Equities Exceeded Expectations

While our expectations in the beginning of 2005 was for international equity markets to outperform US stocks, due to lower international valuations and the expected depreciation of the US dollar, the stunning performance of non-US markets vastly exceeded these expectations. Japanese equities, for example, were up more than 40% for the year. In local currency terms, international stocks scored a knockdown. Even after accounting for the double-digit appreciation of the US dollar relative to the Yen and Euro, US stocks still experienced a severe beating relative to their non-US counterparts. A sample of major equity market returns is shown below. Only Chinese stocks experienced losses for the year. This pattern was a repeat of 2004.



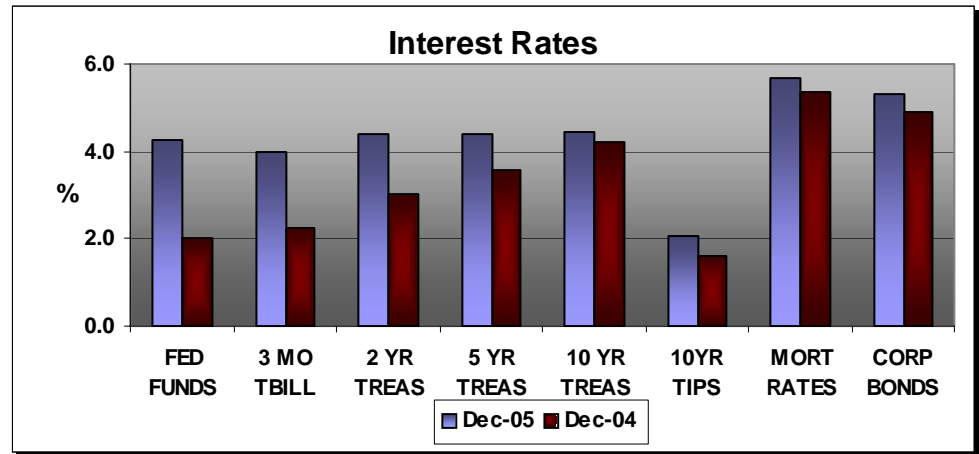
The U.S equity market again significantly under-performed international equity markets.

### The US Bond Market Story That Never Came to Be

At the beginning of 2005 most market strategists expected the real action in the U.S to be centered on the bond market. The consensus was for a gradual rise in both short- and long-term rates. The Federal Reserve did indeed keep raising short-term rates, but on the long-end of the yield curve there was very little action, despite the spurt in inflation and above-trend GDP growth. The flattening of the yield curve in the US received a lot of press, especially late in the year, when the interest rates on 2 to 10 year US Notes became virtually indistinguishable from each other.

Interest rate effects continued to baffle investors in 2005 with no clear picture yet emerging.

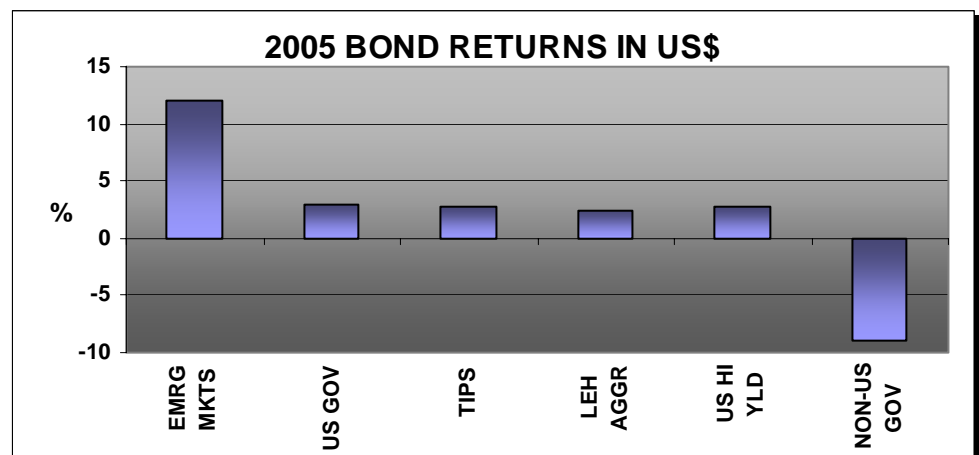
*While interest rates did go up on long-dated bonds, the small magnitude of the increases perplexed many market observers.*



In general, while interest rates on long-dated Treasuries, Corporates and Mortgages did increase in 2005, most market participants remained perplexed as to the small magnitude of such increases. Typically in a year of strong economic growth and major commodity price rises, long-term interest rates start reflecting upward inflationary expectations. This departure from historical patterns was the basis of Alan Greenspan's conundrum.

Given the slight increase in long-term rates in the US, returns to domestic fixed income strategies proved limited. While interest rates in most developed international bond markets (except Japan) actually dropped in 2005, the returns in US dollars were negative due to currency effects. However, just as in 2004, emerging market debt delivered the best performance – up over 12% for the year.

*U.S bond returns were muted with emerging market debt again delivering the best performance during the year.*



As of the end of the year, US interest rates remained significantly higher than those in the major European economies and Japan. While economic growth and inflation remained higher in the U.S., thus justifying higher short and long-term rates, the interest rate differential provided a boost to the US dollar relative to the Euro and Yen. In 2005 the US dollar appreciated over 12% versus the Euro and 14% relative to the Japanese Yen.

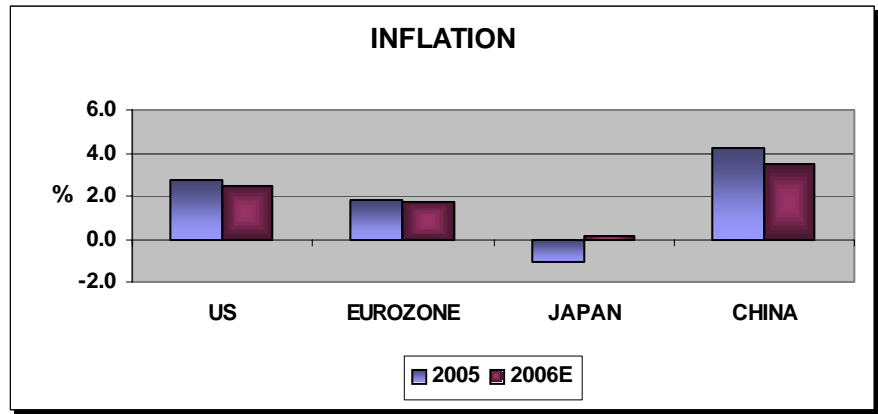
### INFLATION AROUND THE GLOBE REMAINED IN CHECK

The worldwide economic landscape in 2005 was shaped by the tremendous rise in energy-related costs. Inflation rates in the U.S picked up noticeably during the first part of the year but subsided in late 2005 as the deleterious effects of Katrina worked themselves out of the system. Lower inflation rates were observed in Europe as economic growth in the area suffered from over-capacity, while in Japan deflationary conditions persisted during the year. Of the major regions driving global growth, China exhibited the highest inflation rate at slightly over 4% for the year. Clearly, the global economy still shows signs of significant slack in terms of productive capacity, thus constraining upward pricing pressures.

*The absence of large inflationary pressures around the globe signals there is still plenty of excess capacity on the sidelines.*

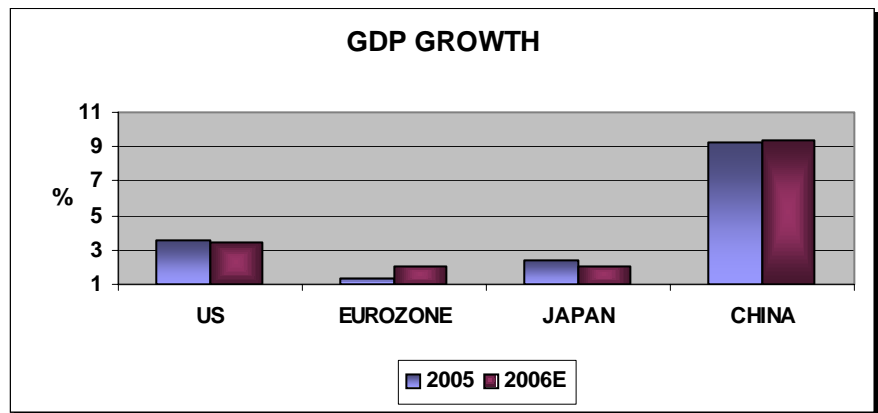
*In 2005, GDP growth in Europe lagged, the US drove in the center lane, and China continued pushing the pedal to the floor in the GDP growth fast lane.*

*Commodity prices continued their upswing but increased volatility is part of the price paid.*



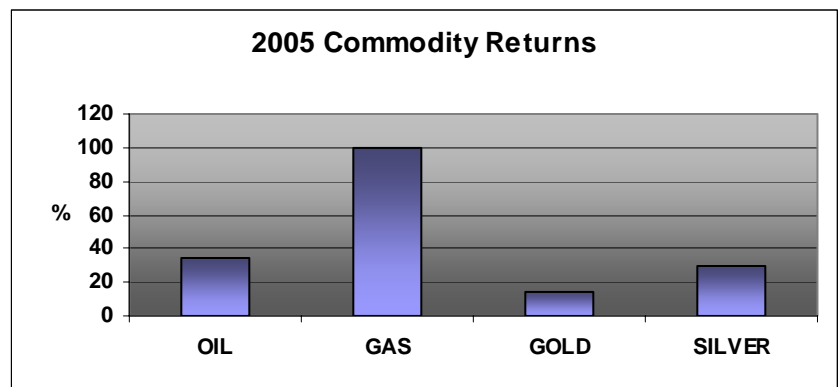
### GDP GROWTH RATES RISE BUT UNEVENLY ACROSS THE GLOBE

The US economy again displayed above-average economic growth during the year vastly out-growing the Euro block and Japan. The continued resuscitation of the Japanese economy proved to be a welcome development in 2005. GDP growth in China, meanwhile, continues unabated and is expected to top 9% again in 2006. Expectations for 2006 for the U.S, European and Japanese economies are for solid growth, but slightly below the rates of the past year.



### ENERGY PRICES COMMAND CENTER STAGE IN 2005

As was the case during 2004, the biggest current uncertainty deals with commodity prices. While it appears that commodity prices are in the midst of a secular up-trend, the volatility of commodity prices has increased significantly as the number and type of participants in these markets has also significantly increased. And, while the popular press focused on the vicissitudes of the oil market, natural gas prices doubled during the year. Similarly, spectacular price jumps we observed in the metals market while agricultural commodities exhibited more subdued price rises. Gold prices surpassed the psychological barrier of \$500 per ounce.



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## 2006 Asset Class Predictions

*The storms of 2005 are not expected to be repeated, but steadier seas in 2006 will still require navigating periodic choppy waters.*

*Enhanced returns and reduced risk will come from taking advantage of short-to-medium term pricing inefficiencies and changing investor sentiment.*

*Expect the S&P 500 to return slightly below 10% in 2006.*

*Mid-cap stocks will outperform large caps, which will outperform small caps.*

The upcoming year is not expected to yield any great surprises in terms of the magnitude of asset class returns. We believe that the global capital markets will remain in a tight, yet choppy, trading range environment of high single-digit returns for stocks, and the bond markets will under-perform inflation rates.

We believe that opportunities will continue to exist to add value to portfolios and reduce overall portfolio risk as asset class returns ebb and flow with changing fundamentals and investor sentiment, creating short-to medium term pricing inefficiencies in the financial markets. While overall capital market volatility is currently at historical lows we still observe a wide range of return patterns across asset classes and over shorter periods of time. Moreover, our expectation is that the complacency displayed by investors in the last few years will be transformed into a more active approach to investing, leading to more normal levels of asset class volatility. Taking advantage of the resulting pricing inefficiencies will require ongoing monitoring of asset fundamentals and changing investor sentiment within the context of a well-defined investment philosophy and approach.

### **Exploiting the Individual Components of Total Return**

Our approach to developing asset class return expectations is based on evaluating each of the components of total return. For stocks, the total return is a function of three drivers: an income component given by the dividend yield, a growth component given by the expected increase in economic earnings, and finally, a multiple component that assesses the changing price the market is willing to pay for a stream of economic earnings. The total return to bonds is similarly a function of a couple of drivers: an income component given by the coupon of the bond, and a valuation component given by the change in interest rates and default premium for non-governmental bonds.

When evaluating the components of total return for stocks, the dividend yield is fairly predictable and evolves slowly over time. The earnings growth component is somewhat more volatile than the dividend yield, but in the context of overall economic growth still fairly predictable. The third component, the change in the price the market attaches to the economic earnings stream (i.e. asset valuation) is very dynamic and significantly subject to investor psychology. Similarly, for bonds the coupon income is known with certainty, but one must anticipate the change in interest rates and default premium in order to assess the expected return of fixed income securities.

### **Equity Market Predictions:**

For 2006 we expect stocks to perform in-line with historical averages. For domestic large cap stocks (proxied by the S&P 500) we anticipate a 1.8% dividend yield, an 8% growth rate in earnings, and no change in the valuation multiple. As of the end of 2005, the P/E multiple on the S&P 500 stood at 16X. We believe that given the low prevailing interest rates and reasonably stable economic environment, a P/E multiple of 16X is reasonable for the upcoming year. Given all these assumptions, the S&P 500 is expected to return slightly below 10% for 2006.

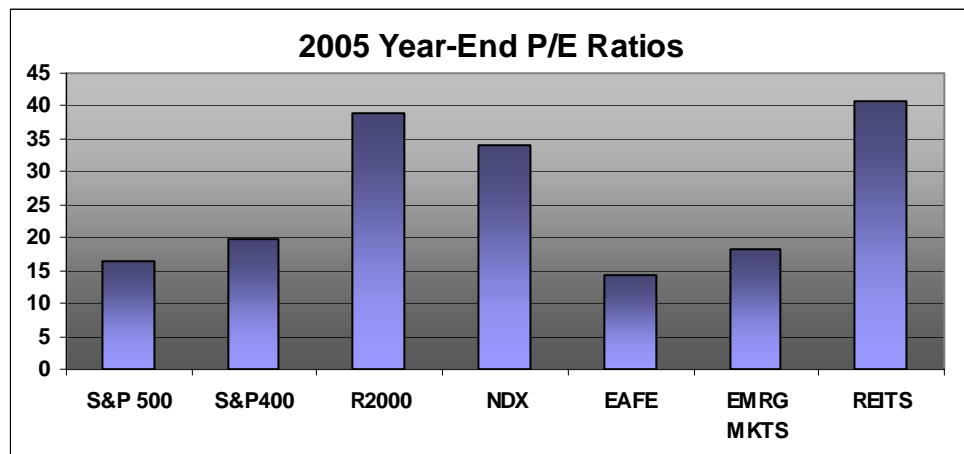
Within the domestic equity markets, we believe that the superior earnings growth rate of domestic mid-cap stocks (13% in 2006) will give this group a slight performance edge over their large-cap counterparts. Conversely, while small cap stocks exhibit superior growth rates, their valuation multiple seems over-extended to us and likely to compress in 2006. Therefore, our expectation for U.S. stocks is for mid-caps to perform best, followed by large-caps, with small-caps pulling up the rear.

The P/E ratios of various equity asset classes illustrate our concern for the small cap sector as well as REITs. The higher dividend yields of REITs are clearly attractive for income-hungry investors, but the fundamental deterioration of the sector makes the reward-to-risk of the sector unattractive.

*Health Care has the best reward-to risk profile among U.S. sectors. Consumer Discretionary has the worst.*

*Emerging markets continue to be favored in 2006, but with the need to respond quickly to changing investor sentiment.*

*Look for bonds to continue their lackluster run, with expected returns not high enough to offset inflation.*



In terms of domestic equity sectors, we believe that Health Care represent the best reward-to-risk profile. We like the contrarian nature of Health Care, its very predictable earnings growth rates, and low valuation levels. Our least favorite sector is Consumer Discretionary. We don't like the interest-rate sensitivity of this sector and believe that it suffers from tremendous over-capacity, leading to persistent price discounting. In addition, the softening of the US housing market and its associated negative effect on consumer spending are expected to lead to a flow of negative earnings revisions for the Consumer Discretionary sector. The higher interest rates expected to prevail in the US will also likely lead to multiple compression in the sector.

#### **Emerging Markets Will Continue to Outperform Other International Equities**

In terms of international equities, we favor emerging markets over developed markets given the lesser-developed markets' higher rates of growth and lower valuations. However, quick changes in investor sentiment and the associated asset flows, make emerging markets particularly vulnerable to pricing inefficiencies and create the need to actively trade these markets. For 2006 we don't anticipate international developed equity markets to outperform domestic equities in U.S dollars (we are neutral on the USD), but still recommend their inclusion in clients' portfolios in light of their diversification benefits.

#### **Bond Market Predictions:**

At year-end 2005, the interest rate on the 10-year US Treasury stood at 4.4 %. Assuming interest rates rise by 0.60% over the course 2006 to 5%, the expected return on the 10-year note would be of less than 1%. Corporate bonds are expected to only slightly outperform Treasuries. (The higher coupons paid for corporate bonds will be offset by the widening spread that reflects the increased likelihood of company default as the U.S economy slows down.) Similarly, emerging market bonds are expected to slightly outperform U.S Treasuries given their higher yield to maturity.

It is our expectation that the Federal Reserve will raise the Federal Funds target to 4.75% in 2006; as such we think that cash-equivalent instruments represent good value and offer superior returns compared to longer-dated bonds. We also expect subdued inflation in 2006 (around 3%) leading to positive real rates in the neighborhood of 1.5 %.

#### **Economic Growth Predictions:**

The U.S economy will grow at close to historical levels (3.3% real GDP for 2006) after growing at a 4% clip during the last year. The tremendous increase in energy costs and restrictive monetary policy during the past year will have a delayed negative effect on economic growth, but we still feel that there are more positives than negatives driving the US economy.

*Asset class allocation is the key determinant to portfolio success, but careful stock selection efforts in 2006 will help enhance the overall return potential.*

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## Summary of Our High-Level Predictions for 2006:

- Stocks will outperform bonds in the U.S by a wide margin. Stocks will perform in-line with historical averages, while bonds are expected to deliver below-average rates of return.
- Mid-cap stocks in the US are expected to outperform large- as well as small-caps.
- Developed international equities are not expected to outperform US stocks, but their diversification benefits will merit inclusion in investors' portfolios.
- Cash will outperform bonds in the U.S as the yield curve becomes steeper and credit spreads widen to reflect a slower rate of economic growth in the US.
- Corporate bonds will slightly outperform Treasuries,
- Emerging market equities and bonds will top their asset class peers, but with significant short-term volatility.
- The US dollar will be range bound.
- Interest rate and stock market volatility will rise significantly.
- Inflation rates in the US are expected to remain subdued around 3% as energy price increases are largely behind us.
- Economic growth in the U.S will remain strong, but below year-earlier levels.

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## Stock Ideas for 2006

While the previous section outlined our high-level asset class predictions for the upcoming year, we also believe that given the tight range of expected asset class returns in 2006, stock selection efforts will be well rewarded.

Our proprietary *Life Cycle Classification Methodology* forms the basis of our stock level ideas. Our proprietary methodology evaluates over 4400 stocks on a quarterly basis and assigns each stock into one of four membership categories:

- ***Rising Stars***
- ***Wall Street Darlings***
- ***Fading Stars***
- ***Outcasts***

This classification system is based on the company's growth and profitability characteristics. Our research supports the evolution of all companies as they go through a repeatable life cycle. We believe that external factors, such as competitive pressures and general economic activity, as well as internal forces, such as resource allocation and managerial competence, tend to coalesce into predictable patterns of growth and profitability.

The figure below illustrates the conceptual underpinnings of our *Life Cycle Classification Methodology*. Typically the evolution of company's fundamentals involves a clockwork rotation from *Rising Star* to *Wall Street Darling* as growth and profitability improves, followed by a subsequent deterioration (most frequently in profitability) leading to a *Fading Star* classification, and culminating in an *Outcast* status, as both profitability and growth significantly deteriorate and the company hits rock bottom in terms of analyst and investor respect.

LongPoint Financial's proprietary "Life Cycle Methodology" model identifies where a particular company stands in terms of its fundamental growth and profitability potential. Such a classification scheme allows us to identify the best investment opportunities in the universe of about 4,000 securities.



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## Bottom-Up Approach LongPoint Financial's Life Cycle Classification System



Historical back-tests of the *Life Cycle Classification* approach demonstrate that the best performing stocks over the intermediate term are classified as *Rising Stars* followed by *Wall Street Darlings*. Stocks classified as *Fading Stars* have a high probability of underperforming and stocks deemed to be *Outcasts* have the worst performance characteristics of any of the segments. In general, companies tend to progress in a clockwise manner in terms of business fundamentals as well as stock price performance.

Our stock level ideas for 2006 represent a variety of industries and risk characteristics. We employ our Life Cycle Classification Methodology as the starting point, but refine our ideas using additional fundamental information and valuation criteria. Our goal is to provide ten stock level ideas that either: 1.) Don't typically fall onto Wall Street's radar picture, or 2.) Represent an under-appreciated reward-to-risk opportunity given the fundamentals of the investment.

Five US domiciled stocks and five international stocks are provided.

### LongPoint Financial's Stock Ideas for 2006:

- Adidas-Salomon (ADDYY) – main beneficiary of 2006 World Cup
- Avid Technology (AVID) – shift to digital media
- Encore Medical (ENMC) – fast growing orthopedic sector
- Mahanagar Telephone Nigam (MTE) – phone services to the Indian masses
- Macquarie Infrastructure (MIC) – infrastructure play with solid dividend
- Sepracor (SEPR) – new sleep drug on the market, likely takeover target
- Shamir Optical (SHMR) – progressive lenses for an aging population
- Triquent Semiconductor (TQNT) – leading-edge wireless technology
- Verint Systems (VRNT) – analytic-software for the intelligence market
- UBS AG (UBS) – expanding global capital market presence

## LongPoint Financial Planning, LLC

LongPoint Financial Planning is a fee-only registered investment advisory firm, specializing in comprehensive financial planning and investment management services. Our two partners, Eric and Katie Weigel, bring a wealth of institutional and retail experience to the table, affording you, the investor, access to the best available financial advice. For more information, please visit our website, [www.LongPointFinancial.com](http://www.LongPointFinancial.com).

