

October 2006

An investment in the S&P 500 provided a total return of 5.66% during the third quarter of 2006.

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We continue to be overweighted in fixed income, large cap equities, and international equities.

The Case for Diversification

Up, down, and all around. Similar to being on a shoddy carnival ride, an investor who closely monitored the markets in the third quarter of 2006 quickly became dizzy. One minute the market was up, the next minute it was down. What is an investor to do in such an unpredictable market? The only logical solution: create a portfolio that is diversified among various asset classes and sectors.

Third Quarter Review

The third quarter of 2006 started on a rough note, but gradually turned around to provide stellar returns across the board. Major equity indexes produced excellent returns for the quarter, led by the 5.66% return of the S&P 500. Fixed income securities also fared well during the quarter. The Lehman Aggregate Index, a broad measure of the U.S. bond market, returned 3.81%¹. One of the most notable events in the third quarter was the Federal Reserve's decision to keep the Fed Fund's rate at 5.25%, stopping a string of seventeen consecutive rate increases. As represented from the quarter's performance, the market welcomed the decision.

Conflicting Data

The third quarter returns are signaling two different economic scenarios. The rise in stock prices is indicating that good times lie ahead for the economy, while the bond market's run is implying a slowdown, or a possible recession. The million-dollar question is who is correct, the bond gurus or the equity traders.

Over the next 6-12 months we expect the economy to continue to slow. Recent data confirms this notion. Corporate profit growth is shrinking, manufacturing activity and factory orders are declining, the Big Three are cutting auto production, global interest rates are rising, and the housing sector continues to show signs of weakness. Recent housing data from August showed new home sales down 17% on a year over year basis. The most alarming figure is the 1.3% year over year decline in the median price of existing homes, the first decline in over 10 years². This trend is likely to continue, and will ultimately erode the spending power of the relentless U.S. consumer.

Our Clients' Portfolios

Although the Dow is reaching all time highs as we write this newsletter, we maintain a cautious stance on the markets, maybe even more so. Certain equity investments are poised to do well in the current environment, and your portfolio is allocated to these positions. Like all investors, although not all admit it, we cannot time the market. For this reason, we continue to hold a diversified portfolio of stocks and bonds. It is clear that we were early on the move to reduce equity exposure, however, our client portfolios are still generating solid returns. Our tactical move to decrease mid/small cap equity exposure and increase large cap has paid huge dividends recently (no pun intended). We continue to be overweighted in fixed income, large cap equities, and international equities. Our current stance will persist until our research indicates the need for a change.

Patience is a virtue. This is especially true when it comes to investing. Those who do their research, block out all the investment noise, and stick to their plan will end up ahead in the long run. If we focus on the everyday movements of the market, we will quickly become dizzy and fall off the ride. Hang on tight! We have your best interest at heart.

¹ Source: Morningstar, Inc.

² Source: Bloomberg

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