

January 2007

The S&P 500 returned 15.79% in 2006.

The Federal Reserve kept the Fed's Funds Rate at 5.25%; an increase might sharply curtail economic growth.

Reducing volatility in portfolios plays a significant role in increasing long-run returns.

A Strong End to 2006

The final quarter of 2006 will be remembered with relish by many investors. The financial markets picked up significant steam as the year drew to a close, with the Dow Jones Industrial Average exceeding 12,500 for the first time. The year finished on a stronger note than many investors had predicted. Concerns about the housing and automotive sectors were waved aside as American consumers continued their tireless spending spree.

Fourth Quarter Review

The emerging market category provided the highest returns for the period, with precious metals following close behind. During the quarter, value stocks continued to outperform their growth counterparts, maintaining a run that spanned the entire year. The S&P 500 Index rose 6.70% during the quarter, pushing the return for the broad U.S. market index up to 15.79% (including dividends) for 2006. The domestic bond market again significantly trailed equities in the fourth quarter. The Lehman Brothers Aggregate Bond Index returned 1.24%.

Uncertain Environment, Despite Some Good News

December retail sales data indicate that holiday shoppers were upbeat about the state of the economy. Consumer spending makes up more than two-thirds of America's gross domestic product, and the higher than expected retail figures are seen by many as a positive sign for the economy. Consumer optimism has also been increasing, which may be a result of the reprieve in gas prices, which have pulled back significantly over the past several months.

While the major domestic equity indexes continue to rise toward record levels, there remains a strong sense that the economy is slowing. At their most recent meeting in December, Federal Reserve policy makers remained cautious about prospects for the housing market. For the time being, it is unknown to what extent the cooling of the housing market will affect the broader economy.

Another discussion point at the Fed meeting was whether the current Federal Funds rate of 5.25% is at a level that will maintain economic stability. As previous StraightTalk's have stated, this number plays an important role in balancing economic growth and keeping inflation at bay. The Federal Reserve may be forced to increase interest rates should considerable economic growth continue. This may cause a slowdown in the economy.

Our Clients' Portfolios

Some of our concerns about the state of the economy have abated somewhat since the last issue of StraightTalk. Increasing inflation, soaring energy costs, and a slowing housing market are still areas of concern, but at least for the moment all three seem to be under control. There is clear evidence that the economy is slowing, but economic indicators are pointing towards respectable growth over the next several months.

Our clients' portfolios are diversified across numerous asset classes and sectors at the start of 2007. Diversification helps to mitigate the ups and downs in a portfolio's value, which is a critical factor in maximizing long-term returns. Although we believe diversification is the most prudent investment strategy for the average investor, we are attempting to add value through strategic allocations. We continue to be overweight in large-cap and international equities, as we feel they offer the most attractive valuations and the opportunity for market-beating returns. We are confident our clients' portfolios are well positioned, but as always, we are monitoring the investment environment for signs indicating a needed change to our investment strategy.

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