



INVESTMENT UPDATE

October 2005

Economic Conditions & Market Outlook

While predictions regarding the potential negative impact of hurricanes Katrina and Rita dominated much of September's news, the financial markets themselves remained remarkably unaffected. Was this the result of the markets recognizing that the longer term impact of natural disaster recovery efforts and increased spending often economically offsets the short term drain on gross domestic product caused by property damage, job loss, and infrastructure/transportation disruption? Or is this yet another example of Federal Reserve Chairman Alan Greenspan's oft-repeated recent warnings that many investors, and the financial markets in general, are becoming much too cavalier in their willingness to accept additional risk and that this tendency will not have a positive ending? We think a little bit of each is at work here.

First, the overall economy and investment markets continue to have several positive factors working in their favor. These include; strong corporate earnings, plenty of corporate cash for reinvestment, benign inflation to date, relatively reasonable stock valuations and low long-term borrowing rates. The rash of recent corporate merger activity after a period of relative dormancy is indicative that the current economic recovery still has legs. Likewise, despite the massive destruction of Katrina and to a lesser extent Rita, the promised \$200 billion in Federal spending to aid the stricken region will eventually more than offset the current economic losses.

However, there are factors above and beyond the positives that warrant serious consideration. To ignore these is the 'whistling in the wind' cautioned against by the Fed Chairman. One notable trend is that consumer prices surged by 1.2% during the month of September - fueled (no pun intended) by a record 12% increase in energy costs. While consumer prices were going up, consumer spending and consumer confidence was heading down; with the widely followed University of Michigan Consumer Confidence Index hitting a 13 year low in mid-October. It is noteworthy that these price increases resulted in the third straight monthly reduction in net weekly earnings for 80% of the U.S. workforce. This was before factoring in the impact of the dramatically higher heating costs projected for the upcoming winter season.

Some observers have espoused that there's really a silver lining in September's consumer price index (CPI) numbers, in that the so-called 'core' CPI rate posted a modest monthly increase of 0.1% versus the 1.2% rise in overall CPI. The 'core' rate is a measure of inflation that disregards the impact of increased costs for energy and food. Exactly why anyone would want to ignore such critical areas of personal spending if the goal was accurately measuring consumer price changes is beyond us. Call our office if you want an explanation of the Department of Labor Statistics' convoluted rationale for this measure. Suffice to say, our view is this rationale is akin to saying your favorite football team had a great record if you'd only ignore all their losses.

In our opinion, any solace that the 'core' inflation rate came in slightly lower than expected is also sorely misplaced. Why? The impact of any financial change, including increased energy costs, is typically delayed for several months, if not quarters, before being evidenced in broader economic measures. These higher energy costs will certainly have a less-than-positive impact on consumer prices in all economic sectors once the expense increases traverse the system to the end user. Exactly how much of an impact there will be is impossible to predict. But when the cost of crude now looks attractive at \$60 per barrel when twelve months ago all pricing norms assumed a mid \$30 per barrel range...something has got to give and will eventually find its way to whatever inflation measure is used, 'core' or otherwise.

Additionally, the consumer segment of the economy has been spending aggressively for quite some time. With the collective home-equity piggy bank already tapped, interest rates on the rise, personal debt at record levels, and little savings from which to draw, it's hard to imagine a scenario where overall price increases don't continue to dampen consumer enthusiasm and spending a bit.

Be aware that the blue-collar segment of the workforce is not the only demographic impacted by these negative sentiment changes. The quarterly CEO Confidence Survey released on October 15th by The Conference Board noted that the overall confidence of business leaders surveyed fell to its lowest point in the past four years, with executive respondents retreating in both their short-term and long-term growth expectations for the economy.

Finally, the third quarter corporate earnings results currently being released should remain positive and relatively unscathed due to the time lag noted previously. However, despite the truly amazing resiliency of the U.S. economy, any assumption that third quarter earnings fully reflect the impact of higher energy costs, transportation delays, and increased materials/production expense would be folly. Again, it is too early to ascertain to what extent, and for what time, these changes may impact our overall economy, but clearly the dramatic rise in energy costs that started well before Katrina and Rita, coupled with major destruction/disruption of two of the U.S.'s top five shipping ports, is not a good thing.

Despite the economic disruption caused by the Gulf Coast hurricanes and concern over skyrocketing energy costs, the Federal Reserve defied some predictions and continued its progressive tightening of U.S. money supply in late September. Since May 2004, the Fed funds rate has been incrementally increased eleven times to date and now stands at 3.75%. Unless the economy truly falters, it is assumed the Fed will increase rates three more times at 25 basis points per clip to reach its 4.50% target rate by midyear 2006. While there are still some observers lamenting the inevitable end of cheap money, we see the ongoing disciplined move away from stimulatory rates to more historic norms as a positive, particularly in light of increasing inflationary pressures.

Other noteworthy factors that can have a longer-range impact on the economy obviously include international geopolitical concerns, the war in Iraq, and ever-burgeoning federal spending. The latter is particularly bothersome. While living with a U.S. budget deficit appears to have become an accepted economic fact of life, the concept of restraint in government spending appears to be as outdated as the quest for a balanced budget. Case in point, where exactly will the \$200 billion in promised federal dollars for rebuilding New Orleans be coming from and for what purposes will it be used? Stephen Moore, senior economics writer with *The Wall Street Journal*, put this number in perspective when he noted that every one of the estimated 500,000 families displaced by Katrina could receive a personal check for \$400,000. Even in the land of plenty, \$200 billion is a lot of change. No less for the government than individuals, a 'buy now-pay later' approach to finances ultimately results in unpleasant consequences when taken to extremes. The one bright spot, if one can call it such, is that these consequences will not affect the economy or the markets until a bit further down the road.

In summary, does this mean we are pessimistic about the economy as a whole? No. Neither are we optimistic that the economy and accompanying financial markets will waltz through these significant near-term economic issues with nary a scratch. With the number of notable variables currently in play, our present view could best be described as cautiously realistic...with a stance that doesn't try to guess what 'might' happen but instead is effectively positioned to respond to what actually 'does' happen.

As always, it is important to note that neither economic nor market factors can be accurately predicted nor directly controlled. We are firm believers that successful, long-term asset management is not the result of crystal-ball prognostication but, instead, results from the diligent focus on portfolio fundamentals and the nimble response to inevitably changing markets.

Our Tactical Investment Stance

Roof Advisory Group's disciplined strategic investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's personal investment objectives and risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- For the majority of clientele, we have recently reduced equity exposure to ***midpoint in the equity allocation range*** as defined by individual investment policy. This one step reduction in equity range occurred after the firm had maintained a ‘one step below maximum’ equity exposure throughout 2004 and 2005 after incrementally increasing equity exposure from a minimum equity allocation beginning in April 2003. This reduction may be somewhat temporary based on economic/market changes between now and year end 2005.
- ***New equity positions are added when attractive*** buying opportunities are presented. The firm’s individual equity focus favors companies with solid management, consistent earnings, low P/E ratios (18 or below), dividend yield (2%+), and annual appreciation potential (10%+). Stocks outside these parameters are also used when unique pricing or appreciation opportunities exist. ***Several specific equity positions have recently been eliminated*** because they no longer met the parameters prompting their original purchase or they had reached a desirable target price.
- ***Diversification remains a priority*** in our management approach. Overall equity exposure is regularly evaluated for diversification based on management style, business grouping, and industry sector while fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region. While the firm does not make deliberate industry sector bets, variations relative to S&P 500 benchmark levels can result from our equity selection process. At present, ***Energy, Utilities, & Telecom*** sectors are often concentrated at ***slightly above index weightings***; while ***Industrial Materials*** (particularly chemicals) & ***Financials*** have recently been ***pared closer to index levels*** with ***Business Services & Consumer Goods*** being carried at ***market weighting***. While still below market concentration, ***very select additions*** have been made in ***Information Economy*** sectors. ***Healthcare*** and ***Consumer Service*** sectors remain ***below benchmark level***.
- Our general ***bias towards large cap stocks*** has served client’s well and remains intact. Mid/small cap equity exposure is typically at mid-point or below defined policy range. ***Specific foreign equity exposure remains incidental*** to domestic equities, with a few exceptions. This is complimentary with our belief that holding ***large companies that effectively tap global markets*** provides much of the ***upside of international investing without most of the inherent risks***. As outlined previously, individual stocks of companies with strong bottom-line fundamentals, attractive valuations, and consistent dividend yields are used in appropriately sized equity portfolios. These positions are often blended with managed funds that are complementary to that portfolio’s overall objectives and diversification.
- Individual bonds are used for larger fixed income portfolios to control quality, maturity, and yield. High-quality, ***investment grade bonds*** (BBB and better) of short to intermediate term maturity (5-15 years) are emphasized in our overall fixed income management. Overall bond portfolio quality is not sacrificed to chase yield. Naturally, a client’s tax bracket/account type determines whether taxable or tax-free bonds are more advantageous. We currently maintain a ***shortened average maturity of 5-7 years*** on our typical fixed income portfolio in anticipation of ongoing interest rate increases. We also currently retain a ***higher concentration*** in the ***very short-term end of the fixed income market*** because yield pickups have been most notable at that end of the curve and no significant yield premium is presently available in the intermediate/longer term range. This ***flattened yield curve*** will most likely remain the norm until somewhat closer to the end of the Fed’s anticipated rate moves, i.e. mid-2006.
- New accounts and large cash infusions are typically phased into their targeted investment policy levels. The ***deployment of cash for equity purchases*** during phase-in was ***slowed a bit*** in ***early September 2005***. ***Deployment of cash for bond purchases remains slower than the norm***, with overall repositioning of cash for bonds being very deliberate in the rising interest environment. This will accelerate as bond yields improve.

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