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INVESTMENT COUNSEL

INVESTMENT OUTLOOK

Third Quarter 2005 Review

By Whitney Brown

- Stocks make progress.
- New highs for oil.
- More Fed rate hikes.
- Economy stays strong.

The old adage "the stock market climbs a wall of worry" rang true in the third quarter. In the face of deeply disturbing events on many different fronts, the market managed to putter its way along to modest gains. July brought the terrorist bombings of the London subway, a new high for the price of crude oil, and a sharp rally for stocks. August brought another Federal Reserve interest rate increase, more new highs for crude oil, and then, Katrina. Stocks didn't rally, but they didn't go to pieces either. September saw the aftermath of an American disaster on par with the San Francisco Earthquake and the Chicago Fire (neither of which the entire nation watched unfold on around the clock cable television), not to mention $3-a-gallon gasoline and another Federal Reserve rate hike. Stocks rallied for a week and a half right into the end of the month and the quarter.

Market Returns & Rates		3rd Quarter	Year 2005
S & P 500		3.1%	1.4%
Dow Jones Industrial Average		2.9%	-2.0%
NASDAQ Composite		4.6%	-1.1%
Morgan Stanley EAFE		9.6%	6.6%
Lehman Bros. Intermediate T-Bond Index		-0.4%	1.1%
	9/30/05	12/31/04	9/30/04
10 Year Treasury Bond Yield	4.33%	4.26%	4.12%
90 Day Treasury Bill Yield	3.54%	2.22%	1.67%

A glance at the table above shows us that, despite a fairly good quarter, all three of the major U.S. market averages are within a percentage point or two of having gone nowhere for the year so far. But, the averages seldom tell the whole story. Investors holding energy, natural resources, utilities, and international stocks have been having a good year. Those concentrated in consumer related and financial stocks likely haven't fared as well.

The Federal Reserve continues to try to damp down the housing market and ward off inflation with persistent quarter-point increases in the fed funds rate. Their campaign has brought great relief to short-term savers and growing pain to short-term borrowers. Look no further than the table above to see that the yield on 90-day Treasury Bill has more than doubled over the past year. See also that the yield on the 10-year Treasury note has barely budged during the same period!

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Also in This Issue

Recovery for Japan

by Watt Dixon

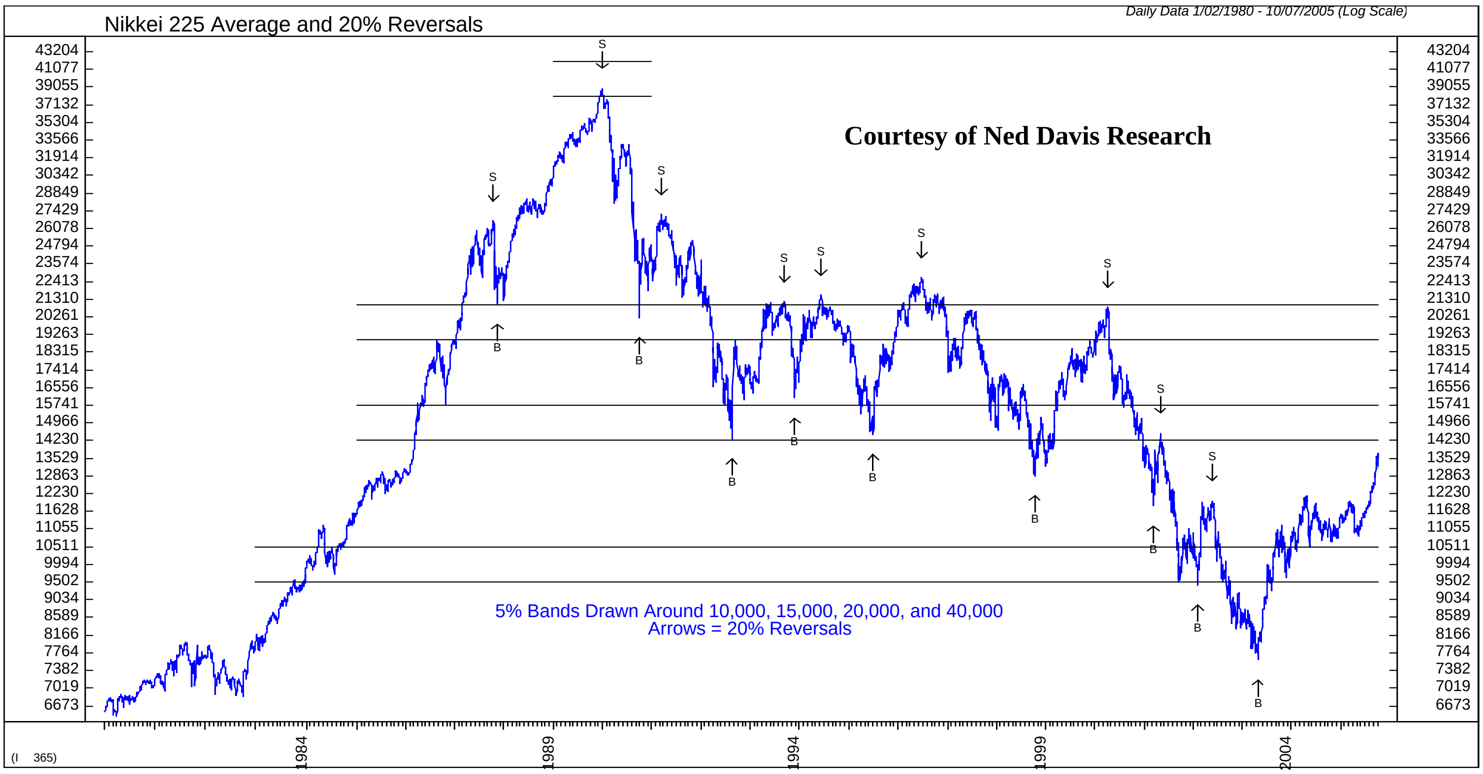
Following a classic stock market mania, Japanese stocks lost about 80% of their value from 1989 through 2003. Weak corporate earnings, a burst real estate bubble, tons of bad debt, and rising unemployment were some of the contributing factors. However, the Nikkei 225 Index, which tracks Japan's strongest companies, has had a powerful rally, with a major surge this summer. The overall economic health of Japan has been improving as well.

Prime Minister Koizumi has just come off a landslide victory. He is promising to continue with his economic reform policies to continue strengthening the Japanese economy. Koizumi, and his Liberal Democratic Party, plan to privatize the Japanese postal system, long suspected of monetary kick backs and other possibly shady business dealings. Koizumi is also pushing for smaller government, deregulation, and less government spending.

Throughout much of the 1990's, the Japanese economy and stock market experienced brief rallies that eventually fizzled out. Often after a huge boom and bust cycle, like Japan experienced, there will be a long period of correction with many short but unsustainable rallies followed by further decline. The chart below illustrates the boom in Japan's stock market in the 1980's followed by the long correction process through the 1990's and the first half of this decade. While it may be too early to tell if this current rally is the beginning of an increased time of prosperity for Japan, there are signs that the worst may be over for the world's second biggest economy.

Specifically, economic growth forecasts were recently upgraded to 3.3% from a previous estimate of 1.1%. The major banks' bad loans are behind them. Also, land prices are rising in Japan for the first time in fifteen years. Unemployment has dropped to 4.1% in June, its lowest level since 1998. Consumer spending is up, and companies are increasing capital spending.

Japan's recovery is tied to economic activity in the U.S. and China, which are Japan's two largest export markets. A slowdown in economic activity in the U.S. or China could slow the Japanese recovery process significantly. Also, Japan imports virtually all of its oil. Continuing rising oil prices could adversely affect recovery as well. Once again, it still may be too soon to determine whether Japan is in the beginning of a durable economic growth period, or if this recent upturn in stock prices coupled with some strong economic figures, is yet another "sucker" rally.



Diversification for Safety and Opportunity
by Walter Dixon

"Don't put all your eggs in one basket." Sound investment advice! Holding a variety of stocks and bonds, rather than just a few issues, is a fundamental principle of most investment portfolio managers. Risk of loss from unanticipated company-specific problems can be mitigated by owning a portfolio of many stocks. If the companies operate in a number of different industries, so much the better.

How many stocks should one hold to provide adequate diversification? Studies have shown that as few as twelve different companies may be sufficient, assuming they represent a wide enough variety of industries and stock characteristics. Of course, holding more than twelve issues further spreads the risk; but the additional transaction and holding costs of doing so may dampen the benefit.

During the past fifteen years or so, more attention has been paid to diversifying equities according to capitalization (share price times number of shares outstanding), and general nature of the underlying company (growth companies vs. those operating in more developed environments, usually termed value companies). Also, with the rise of more open national governments and economic globalization, non-U.S. investments have received much more consideration for portfolio investment.

Bonds, inherently more stable in price than equities, also should be diversified among different issuers, an exception being U. S. Government-guaranteed debt, which is considered risk-free. Holding issues having maturity dates from one to ten years is a good hedge against the long-term risk of capital loss when interest rates rise. As the general level of interest rates rises or falls, bond prices will vary inversely (rates rise, prices fall; and vice-versa); and the more distant the maturity date of the bond, the greater the degree of price fluctuation. Another diversification consideration is investment quality of the issuer (higher the quality, lower the interest rate).

Investment returns are typically measured over different periods, usually from three years (a typical cycle) to around fifteen years (the long-term). Among major security asset classes, common stocks have been the big winner during the past ten to fifteen years, earning nearly 12% per year, including dividends. However, there have been shorter periods when equities have lagged returns from other kinds of assets, such as bonds, commodities, and simple cash reserves. For this reason most investment portfolios benefit from holding a variety of asset classes, again a diversification technique that provides some investor protection from the unexpected.

Analysis over the very long-term, such as the entire 20th century, indicates that a portfolio invested about two-thirds in equities and one-third in bonds has provided the optimal balance of risk and return. This two-thirds/one-third mix can be considered a theoretical starting point for determining individual portfolio investment policy. Of course, in real life the actual policy will vary depending upon specific factors pertinent to the situation at hand.

Five-year returns for mutual funds through the third quarter 2005 have just been reported in The Wall Street Journal, and the results indicate how important portfolio diversification is to investment returns. For instance, for the five-year period through September 30, 2005, the annualized returns for the average U. S. stock fund and the average taxable-bond fund were:

Average U. S. Stock Fund	0.0%
Average Taxable-Bond Fund	5.5%
Stock/Bond Blend Funds	2.9%

While the average U.S. common stock fund had zero return for the five-year period, results varied significantly within the groups based upon capitalization (large, medium, and small) and style (growth or value):

Large cap funds	-2.9%
Medium cap funds	4.6%
Small cap funds	8.6%
Multi- cap growth funds	-7.8%
Multi- cap value funds	5.8%

Combinations of the two groups provide an even wider range of returns. From best to worse, small cap value funds *earned* 14.6% per year for the five-year period, while large cap growth funds *lost* on average 7.8% per year.

Of course, these results are history; and looking ahead, extrapolating these returns very far into the future might be injurious to one's financial health. The point is, however, that during the past five years there was ample opportunity to do either well or poorly, depending upon your portfolio diversification, both between bonds and stocks, as well as within the stock portfolio.

Diversification remains a primary tool in portfolio management, both in controlling risk, as well as in gaining exposure to promising opportunities.

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Third Quarter 2005 Review (continued)

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Despite the abundance of gloomy reasons why stocks should drop and longer-term interest rates should go up, they just haven't. On the other side of the ledger there are some major positives. The U.S. economy is remarkably resilient and adaptable. GDP growth has exceeded 3% annually for over two years. Corporate profits continue to be very strong. Low longer-term interest rates allow relatively cheap access to capital for businesses and enhance the affordability of mortgage loans for homeowners. In addition, low bond yields make stocks the more attractive investment based on dividend yield and potential appreciation.

Looking ahead to the end of this year and beyond, we remain generally positive on the markets and the economy. In the near term, an inflation scare may be at hand. Concerns about massive federal deficit spending to pay for rebuilding the Gulf Coast along with persistent high energy costs seem to be alarming the markets. The thought of inflation seems to come with the notion of inevitability, but, outside of energy costs, inflation remains contained.

It would be normal at this stage of an economic expansion cycle to see some temporary slowing. As we all try to adjust to high energy costs, higher short-term borrowing costs and the great questions surrounding the ultimate impact of Katrina on the economy and the national mood, it would be unusual not to see a soft patch.

For stocks, we are entering the time of year when positive seasonal effects come into play. A sharp pullback may well set the stage for a significant rally later in the quarter. A narrowing of the market in terms of how broadly stocks participate is the natural progression of a maturing bull cycle; however, well positioned portfolios should benefit from renewed strength in leading areas such as energy, materials, commodity related issues and foreign stocks. We expect that 2005 will finish as a positive year for stocks and keep the perfect record alive for years ending in 5 (see Second Quarter 2005 Review).