

INVESTMENT OUTLOOK

Second Quarter 2007 Review and Outlook

by Whitney Brown

- Stocks surge in second quarter.
- Yields turn sharply higher.
- Global economy strong.
- Environment for stocks still positive.



The stock market rose steadily throughout April and May with barely a pause, stumbled in early June, then spent the remainder of the quarter consolidating its gains. After a flat first quarter, the strong returns in the second quarter put the major market

indexes well into positive territory for the half-year, as shown in the table at right. The familiar leading sectors of energy, materials and industrials fared well for the quarter while financials and utilities suffered from a sharp rise in interest rates.

Intermediate and longer-term interest rates, or bond yields, took a sharp turn higher starting in early May with a four-week run from 4.67% to 5.20% on the ten-year U.S. Treasury note. With the latest spike up, yields have broken a major long-term downtrend dating back to 1988. The significance of a long-term trend break should not be downplayed, but yields remain low on a historical basis. The ten-year Treasury yield actually closed out the quarter lower than it was a year ago. The chart on page 2 illustrates the steady downtrend in yields dating back to the 1980's as well as the recent break above the well established trendline from 1988.

It is likely that yields will establish a higher trading range than that of the past 2-3 years. However, reversals of very long-term trends in interest rates take years to develop. There is not much doubt that the bias is to the upside, but the benefits of economic globalization and the proliferation of technological

<u>Market Measures</u>	<u>2nd Qtr</u>	<u>YTD</u>	
S & P 500	5.8%	6.0%	
Dow Jones Industrial Average	8.5%	7.6%	
NASDAQ Composite	7.5%	7.8%	
Russell 2000	4.1%	5.9%	
Morgan Stanley EAFE	5.9%	10.3%	
Lehman Bros. Aggregate Bond Index	-0.5%	1.0%	
	<u>6/30/07</u>	<u>12/31/06</u>	<u>6/30/06</u>
10-Year Treasury Bond Yield	5.03%	4.71%	5.14%
Three-month Treasury Bill Yield	4.79%	5.02%	5.00%

innovation are essentially disinflationary and should serve as a powerful moderating force on rates.

In the past, rising bond yields usually meant trouble for stocks. With higher yields bonds become a relatively more attractive and far less risky investment than stocks. Much of the negative implication of higher yields really has more to do with inflationary expectations. The market sets yields or interest rates based on the real cost of money in the absence of inflation plus a mark up for inflationary expectations. In this particular case, inflation remains fairly well contained both at home and abroad.

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The rise in yields this time around has been due largely to rising real yields which is a positive indicator of global capital spending and economic growth. Economic growth has been generally much more robust outside the U.S. With the weak dollar and slower growth at home, U.S. rates have needed to come up some to remain competitive.

As we have noted before, the current cyclical bull market has been running for over four years, lengthy by any historical comparison. However, another

characteristic of this particular cycle has been the modest gain so far. At this point, stocks are still reasonably valued by measures such as price-to-earnings ratios. Earnings growth has peaked but still remains strong. Inflation, always on the minds of central bankers around the globe, remains under control. In addition, the ongoing wave of private equity buyouts, leveraged buyouts, mergers and acquisitions has served to limit the supply of stock on the market. Altogether, the environment for the stock market remains more positive than negative.

Recent developments such

as distressed sub-prime hedge funds and the spike in yields have served to remind investors that risk is still very much part of the investing equation. Other hazards certainly exist, and the market has an uncanny ability to do just what everyone thinks it won't. Still, the market has not given indications of the extremes in valuation and sentiment usually found near market tops. Taking into account the usual setbacks and even the likelihood of a significant correction, we think the market can continue to work higher in the months ahead.



Hedge Funds in the News

by Watt Dixon



Rarely does one watch the evening news these days without hearing a story regarding hedge funds. While the first hedge fund was started over fifty years ago, the hedge fund industry has literally exploded in the past ten years. Although hedge funds share some common characteristics with traditional mutual funds, major differences exist. Despite recent legislative attempts, hedge funds are not currently required to register with the SEC and are not required to issue periodic reports under the requirements of the Securities Exchange Act of 1934. Limiting the number of investors and requiring that investors be "accredited" has enabled hedge funds to avoid as much regulation as mutual funds.

Most hedge funds require a one million dollar minimum investment. Hedge funds charge a management fee between 1% and 2% annually. In addition to this

fee, hedge funds also take a performance fee of 20% of all profits. With the likelihood that a large portion of the fund manager's fee is derived from performance, the hedge fund manager might be pressured to take greater risks in the hope of generating larger fees for the fund.

Liquidity is also a concern. Many hedge funds have a "blackout" period where investors are prohibited from drawing on their funds. Because hedge funds are not required to register with the SEC, their reporting and valuation methods can be very confusing to their investors. A number of hedge funds invest in highly illiquid securities that hard to value.

Also, many hedge fund managers invest in the same securities that are available to individuals. This makes the timing of the hedge fund manager's investment decisions critical. During the bull market from 1994- 2000 the S&P 500 index outperformed every major hedge fund strategy by 6% in annualized returns. These performance numbers support the thought that hedge funds are less appropriate during

bull markets.

There are three broad categories of hedge funds with respect to investment strategy. Arbitrage strategy, also known as relative value strategy, attempts to take advantage of price or spread inefficiencies. This often involves the use of derivative types of investments. A macro hedge fund is hoping to profit from shifts in global interest rates or a specific country's economic policy. Lastly, an equity hedge fund will take both long and short equity positions. Often these equity hedge funds will buy distressed securities in hopes of a turn around. Regardless of the type of hedge fund, all are expected to make money during bull or bear markets.

Some hedge funds have produced large returns for their investors, but an equal number have suffered catastrophic losses. For some large institutional investors, a small percentage invested in hedge funds may be appropriate, but for most individuals, the fee structure, lack of disclosure, and risks posed by most hedge funds make them unsuitable investments.

Charitable Rollover IRA Gifts

by Ted Feinour



The Pension Protection Act of 2006 which Congress passed last August allows IRA owners to exclude from income IRA distributions used to make charitable gifts. This specifically permits an IRA owner who is 70½ or older to exclude up to \$100,000 from annual gross income for qualified charitable distributions made directly to the charity. The donor is not allowed to take a charitable deduction for the contribution, but the chance to make a tax-free withdrawal from the IRA presents a rare opportunity for someone with charitable intentions.

This has helped both donors and charitable recipients since it has allowed larger gifts to be made currently rather than made in future gift contracts or by will or trust. *This provision is only temporary and is set to terminate at the end of 2007.*

Several of our clients took advantage of this

provision last year, and a number are planning to also utilize it this year. Many charitable organizations have been making donors aware of it, too. The qualified charitable distributions do count toward the IRA owner's required minimum distribution.

Charitable organizations are hoping that Congress will extend the expiration date past December 31, 2007 and possibly make it permanent. The Public Good IRA Rollover Act of 2007 was introduced in Congress in March and would broaden the IRA charitable rollover to include gifts made to donor-advised funds, supporting organizations and private foundations. It would also cover gifts greater than \$100,000 and planned gifts by donors older than age 59. Indication for its adoption has been limited.

Please contact us if you are interested in making a charitable distribution from your IRA. We will be glad to help you make the necessary arrangements before the end of the year.

DIXON, HUBARD, FEINOUR & BROWN, INC. *investment counsel*

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Watt Dixon Receives CMT Designation

Dixon, Hubard, Feinour & Brown, Inc. is pleased to announce that Walter M. "Watt" Dixon, III has been awarded the Chartered Market Technician (CMT) professional designation. Over the past several years he has completed an extensive program of independent study involving a succession of three courses and proctored exams. Requirements also include industry experience, sponsorship by other charter holders and adherence to a code of ethics.

Successful candidates are required to demonstrate proficiency in a broad range of topics related to technical analysis. Technical analysis is a form of security analysis that involves interpreting an underlying security's past trading history and trends in order to anticipate future price movements. Technical analysis often complements fundamental analysis which focuses on valuation of a market or security based on financial measures such as assets, profits and business trends.

The CMT is awarded by the Market Technicians Association (MTA), a non-profit organization

incorporated in 1973. The objectives of the CMT Program are:

- To guide the candidate in mastering a professional body of knowledge and in developing analytical skills;
- To promote and encourage the highest standards of education;
- To grant the right to use the professional designation of Chartered Market Technician (CMT) to those members who successfully complete the Program and agree to abide by the MTA Code of Ethics.

At Dixon, Hubard, Feinour and Brown, Inc. we have included technical analysis as part of our investment management process since the firm's inception. We are pleased that Watt has chosen to pursue this prestigious designation and anticipate many benefits from his membership in the MTA. Congratulations, Watt!