

MARKET NEWS

Keeping our Clients Informed

Third Quarter 2005

THE ALDER
FINANCIAL
GROUP, INC.
INVESTMENT MANAGERS

October 12, 2005

Three Down – One to Go

Since we're 7 weeks into the season, we'll start this newsletter off with a football analogy. At the end of 3 quarters, stocks are virtually scoreless for the year. Year-to-date through September 30, the Dow Industrial average was down 2% while the S&P 500 was up only 1.4%. Early into the fourth quarter (roughly 2 weeks), the market is decidedly lower, with the Dow Industrials off 5.2% and the S&P down 2.8%. This marks the worst fourth quarter start for stocks in several years.

Can the team rally to pull out a victory by the end of the year (or at least beat money market rates)? The jury is still out but it's not looking good. If stocks are to finish the year with decent gains, they'll have to beat out a pretty good defense headed by fifth year senior Alan Greenspan and red-shirt freshman Historic Energy Prices.

The Fed continues to be on a relentless campaign to raise interest rates. After hurricanes Katrina and Rita the market was hopeful that the Fed would at least pause, or better yet cut short, their pursuit of higher rates. Those wishes have gone unfulfilled. At their latest meeting (September 20th), the Fed once again raised rates 1/4 point to 3.75%. This was the eleventh time in the past 15 months that the nation's central bank has boosted that key lending rate. In addition, their comments have made it clear that they intend to raise rates further over the coming months. The general consensus is that the Fed's near-term target is 4.50%. This implies three more quarter point hikes over the next four to six months.

The Fed, under the leadership of Alan Greenspan, is clearly preoccupied with fears of inflation. By definition, inflation is the result of too many dollars chasing too few goods. This situation leads to higher prices for goods and services in the economy. Prior to the oil and gas shortages, the economy was on a path to healthy growth and we were beginning to see some signs of inflation. Although, the

level of price increases was tame relative to the economic expansion.

Since then, persistently higher energy costs and two natural disasters have put substantial downward pressure on the economy. The full impact of these events is still very hard to gauge. It may take as much as a year before we really know what the effect on growth has been.

One thing is clear; higher energy prices are going to be here for a while. After the hurricanes, domestic crude oil production fell to levels not seen since World War II. Refining capacity in this country is down by 20% and pipeline disruptions are causing natural gas shortages heading into winter. These vital commodities are leading to higher prices. But is this really inflationary?

We tend to disagree with the Fed at this time. Our belief is that the Fed is fighting an imaginary foe. Higher energy prices have historically not been inflationary but have instead lead to economic slowdowns. Mr. Greenspan even acknowledged this recently in a speech when he said that rising fuel costs will undoubtedly be a drag on economic expansion from now on. Why then does the Fed feel the need to slow the economy further?

In light of this it is easy to see why stocks are struggling this year. This continues to be an incredibly difficult time for investors. While there have been a few bright spots within equities, the major market indices are down year-to-date. Bonds investors, too, have had a difficult time. The threat of higher inflation has kept most investors away from longer term maturities while the Fed rate hikes have hurt shorter term maturities. The result has been an increasingly flat yeild curve. Although the Fed has raised short-term rates from 1.00% to 3.75% over the past year and a half, long-term rates have barely moved. Currently, there is only a 20 basis point difference in yield between the 2 and 10 year treasury bond.

	THIRD QUARTER			NINE MONTHS		
	06/30/05	09/30/05	% Change	12/31/04	09/30/05	% Change
Dow Jones Industrial Average	10,274.97	10,569.02	2.9	10,783.01	10,569.02	-2.0
Dow Jones Transportatin Average	3,487.76	3,740.34	7.2	3,798.05	3,740.34	-1.5
Dow Jones Utility Average	386.59	432.37	11.8	334.95	432.37	29.1
Standard & Poor's 500 Index	1,191.33	1,228.82	3.1	1,211.92	1,228.82	1.4
NASDAQ Composite	2,056.96	2,151.69	4.6	2,175.44	2,151.69	-1.1
NASDAQ 100	1,493.52	1,601.69	7.2	1,621.12	1,601.69	-1.2
New York Stock Exchange Composite	7,217.78	7,632.61	5.7	7,250.06	7,632.61	5.3
American Stock Exchange Composite	1,544.41	1,736.04	12.4	1,434.34	1,736.04	21.0
Russell 2000	639.66	667.80	4.4	651.57	667.80	2.5

If inflation does pick up, the prices on longer term bonds will decline. Since investors are not being compensated by higher yields for taking this risk, we are forced to sit in the lower returning one to two year maturities.

Cash Flow Planning in Today's Market

The lack of any meaningful inflation over the past five years has meant that fixed income investors have had to struggle to maintain their portfolio cash flow. Unlike stock values, there is no natural trend for fixed income yields to rise over time. In fact, there are often extended periods of time when cash flow levels actually drop. This problem becomes even more significant when you take into account the need to maintain your buying power over a retirement lifetime.

So what can you do to insulate yourself from lower bond yields? One solution is to incorporate stock dividends into your long-term cash flow plan. Stock dividends differ from traditional interest-paying securities in that the payout rate is not tied to interest rate movements. Instead, dividend payout rates are based solely on the company's earnings, which are seldom related to interest rates.

Over the life of a 10 year bond, the difference in cash flow performance can be substantial. Let's look at a typical example of how this would play out over the life of a bond. Assume you invested \$15,000 in a 10 year bond that yielded 6.5%. You would receive \$975 per year for the next 10 years. At the end of that time you would get your \$15,000 back and have received a total of \$9,750 in interest payments. Now assume you invested that \$15,000 in a stock that yielded 3.5% (a yield found in many large bank stocks). Using the actual dividend history of Bank of America for the last

10 years, we'll assume that this dividend grows by an average of 14% (50¢ per share the first year, 58¢ the next, then 66¢, etc.). The first year you would receive \$525, well below the \$975 amount that the bond would provide. But by year 5 that amount would grow to \$887 and in year 6 it would surpass the bond with \$1,011 of annual income. In the final year the stock's income would be \$1,707, nearly double the bond's income.

Based on the initial price per share that you would have paid for the stock, the final year's dividend would equate to an 11.4% yield. Once again, well above the bond's fixed return of 6.5%. An interesting point to make here is that you never see a healthy company's stock actually yielding 10 or 11 percent. This is because the stock price will have gone up during that 10 year period. So in addition to the cash flow performance, it would be reasonable to expect your \$15,000 investment to grow as well. In our example, if the yield in the final year was 5.5%, your \$15,000 would have grown to \$31,041. Granted this example uses a higher than usual growth rate of 14%, but it illustrates the importance dividends can play in cash flow generation in a comprehensive portfolio.

This is not to say, however, that bonds are not important. There are risks associated with stock investing that do not exist with bonds. While dividend payout rates are not tied to interest rates, they are a function of corporate health and thus need to be followed more closely. You cannot take a "buy it and forget it" attitude with stocks like you can with bonds – ask any GM investor today. In addition, the underlying price volatility makes stocks much less liquid than bonds. The final maturity on a bond makes planning for large future expenditures much easier.