Ponderosa Investment Group LLC
INVESTMENT LETTER

Second Quarter 2006 · v1

SUMMARY:

Several factors—low interest rates being one of the biggest—have contributed to an increase in risk-taking in the financial markets. This has happened at a time when markets have seen few disturbances, so it is understandable that the market gyrations we've seen recently have created a lot of concern, even though these gyrations are not out of line by historical standards.

The Fed's reaction to rising inflation seems to be the biggest concern. Aside from the direct damage of inflation, there is risk that the Fed will overshoot in trying to choke off inflation and that higher rates will push us into a recession.

There are several anti-inflationary forces at work, including the string of rate increases, so we aren't overly concerned that we'll see further big rises in inflation that would necessitate a lot of additional tightening.

The stock market is pricing in a lot of risk, and accordingly U.S. stocks are attractively valued—but not quite enough for us to take a tactical overweight. If we see additional declines, we are prepared to overweight stocks.

The Investment Letter is mailed quarterly to my clients and friends. The intent of this publication is to share some of my more interesting views and research.

Quarterly Investment Commentary

The markets bounced around quite a bit during the second quarter, with the S&P 500 reaching a year-to-date high in early May before sliding sharply, then recovering at the end of June to finish the quarter down 1.4%. The small-cap Russell 2000 Index dropped 5%, while foreign stocks managed a slight gain for the quarter. Value stocks continued their dominance over growth stocks in the second quarter. Domestic investment-grade bonds and emerging market short-term bonds (local currency) were flat, but commodity futures fared better, gaining roughly 6% over the three-month period.

The past several weeks have certainly been a wake-up call to many investors. For a few years now, investors seem to have taken comfort in a number of things: the fundamentals looked good in most parts of the world; we'd gone more than three years without a market correction; and there was lots of money looking for a home. This money came from many sources, including hedge funds. These vehicles have grown in popularity and influence, and in many cases their managers have been looking anywhere and everywhere for places to eke out some extra return. These funds often use leverage (meaning they invest borrowed money) and with the incredibly low interest rates we saw in 2003 and 2004 they could borrow very cheaply, then put that money to work anywhere it stood to gain more than the cost of borrowing. Corporate and high-yield bonds, as well as emerging markets securities, were likely big beneficiaries, and it's very possible that commodity futures, and maybe even REITs and small-cap stocks were a part of this strategy as well.

We can't say for certain how much of these asset classes' behavior was due to hedge funds' involvement, but we do know two things: 1) Most hedge fund managers' fees create a very strong incentive for risk-taking, and 2) according to an article in *The Economist* magazine, hedge funds controlled more than $1 trillion in assets as of year-end 2004, and can account for more than half the daily volume on the New York Stock Exchange (and can have an equally large presence in every other financial market). My point

here is not so much to dissect hedge funds' impact on the markets, but rather to point out that a collection of factors have led to an increase in risk-taking in the financial markets, and it has been a few years since something came along and rattled everyone's nerves. So it is understandable that the market gyrations we've seen in the last month and a half may have caught people's attention, even though these gyrations are not out of line by historical standards.

But what suddenly caused things to change? Investors' biggest concern seems to be inflation. And in particular, it is concern over what will eventually happen if inflation persists and the Federal Reserve Board keeps raising rates.

Why Should We Worry About Inflation?

Aside from the direct damage of inflation, there is risk that the Fed will overshoot in trying to choke off inflation and that higher rates will push us into a recession. The hope among investors has been that the Fed will stop soon and that the economy will slow just enough to bring inflation back within the Fed's targeted range while leaving the economy healthy enough for decent earnings growth. As economic growth has continued to surprise on the upside—and the Fed has continued to raise rates—the risk of an overshoot (and the ensuing recession) has increasingly been on people's minds.

The big question we must ask ourselves is: What are the odds that continued inflation will lead the Fed to tighten to the point that the economy ultimately tips back into recession? Cutting to the chase, I believe that the longer-term inflation picture is not too troubling. Given the sizeable rate increases that have already occurred, and signs that the economy is slowing somewhat, my guess is that further rate increases will be limited and a near-term recession isn't too likely. The risk is still there, but even if it materialized, we have the benefit of going into this environment with stocks already at attractive valuations, so a cyclical bear market shouldn't be too bad, and this would actually set stocks up for nice returns going forward.

I Think the Odds Favor a Benign Inflation Environment

There is a potentially large laundry list of counter-inflationary forces at work right now, and among the biggest of them is globalization. Not long ago, the outsourcing of jobs was the big headline, and while the media has chosen to focus on other things now, we still live in a very competitive world where 1) cheap labor is readily available in most industries, and 2) it's hard to raise prices when the competition is so stiff. If jobs go overseas, domestic consumers' aggregate wages may temporarily decline; and even if producer prices (e.g., oil) experience inflation, any company with overseas competition is going to have a hard time raising prices to offset its higher costs. Their profit margins may get squeezed, but unrestrained price pass-throughs to consumers would be difficult.

Along with globalization, technology has had a big impact on productivity. Globalization and technology work together, and their combined impact have played—and will continue to play—a big role in keeping inflation in check through increased productivity. The so-called "productivity miracle" is a big part of the reason why profit margins are high, even in the face of rising commodity prices and a lack of pricing power. This is a secular force that is likely to dominate a temporary cyclical rise in inflation.

Another force working against inflation—albeit a cyclical one—is a slowdown in the housing market. Without the tailwind of rising home prices or declining interest rates, homeowners are less likely to refinance or

take out home equity, leading to lower spending. The construction and financial services industries have grown tremendously in recent years in response to the booming housing market, and a slowdown could lead to layoffs; higher unemployment is usually considered recessionary, rather than inflationary. Also, with fewer families rushing to buy homes, there's less spending on all the goods that come along with a home purchase (furniture, appliances, etc.).

Weighing all the evidence, I think it is unlikely that a broad, dramatic, and sustained rise in inflation is likely in the foreseeable future. Anything can happen in the short-term, but there are at least as many reasons to be concerned about a recession as there are reasons to be concerned about inflation.

Valuations Revisited

So if inflation is causing the market's problems, but I don't think those concerns are justified, does that mean stocks are undervalued and represent a fat pitch? The short answer is: Not quite. I look at valuations many different ways, but when we go through the math today, I don't feel like stocks are cheap enough to compensate the portfolios for taking on the risk of an overweighting to equities. Before taking on the added risk, I want to feel highly confident that the market is being irrationally pessimistic, resulting in significantly above-average return potential over the next three to five years. From where we stand today (the S&P 500 is at 1267 as of this writing), I'd need to see a decline in the 5% to 10% range before feeling confident that an irrational level of pessimism was reflected in stock prices.

Having said that, I do believe that valuations are quite attractive and already discount much of the risk. If a negative scenario fails to materialize, or is less than investors expect, the market will likely have a nice run-up as investors price in the new information, leading to five-year average returns that are quite good.

A Brief Recap of Other Asset Classes

My views on the other major asset classes have not changed much, in spite of the big moves some of them have experienced lately. Investment-grade bonds have performed poorly for several quarters running, which should come as no surprise given the Fed's persistent interest-rate hikes. Inflation has been on the rise as well, meaning that real interest rates are still somewhat low. The real question is what inflation will do going forward, and in spite of all the negative media attention, the bond markets are only implying long-term inflation of 2.7%. In this context, investment-grade bonds are probably close to a fair-value range, and continue to play a very important role in protecting portfolios against losses during tough equity markets, especially in a recessionary or deflationary scenario. I continue to believe that emerging-markets short-term local-currency bonds will outperform domestic bonds over a multi-year time frame, in part due to their attractive yields, but more so because of the potential for currency appreciation; the current-account deficit remains a significant risk, and a decline in the dollar over time seems likely.

In the equities arena, I continue to view large-caps as being attractively valued versus small-caps, even after the big drop in small-caps in May. Growth stocks also look pretty good relative to value stocks, but again, the data is not strong or consistent enough right now to warrant a deliberate move at the portfolio level. Foreign stocks have had a significant run-up relative to domestic stocks, and are presently in a fair-value range.

The alternative, or absolute return focused, asset group has fared well in this recent down market. This area of the portfolio currently comprises four different mutual funds and

managed to return a positive 1.0% for the quarter. As some of you are aware, this is a new strategic allocation to all the portfolios which should add even more diversification to the portfolios. I've been advocating a non-correlated asset class for years, and now I'm finally able to incorporate this into the investment process.

Conclusion

Watching stocks go down isn't fun, but I must confess that as valuations have become increasingly more appealing, I'm feeling a growing sense of excitement that a good buying opportunity could be near. As long-term investors, I look for the silver lining in a down market: The potential for better-than-average returns in the future. By objectively looking at the data and considering what it implies in the real world, I can begin to differentiate between a serious long-term threat to investors and the short-term noise that causes many market participants to react based on emotion or fear. In recent years, the fundamentals have been generally good or improving in most parts of the world, so there has been little in the way of market-rattling fear and a notable dearth of attractively priced asset classes.

But if investors around the globe do act based on irrational fear, bringing markets lower in the shorter term as they demand a greater premium for taking on risk, I will welcome the opportunities it creates for longer-term investors like us.

I thank you for your confidence and trust.

Best Regards,

Jim Cheadle
Ponderosa Investment Group, LLC

Contact Information

4888 NW Bethany Blvd. Suite K5, #154
Portland, OR 97229

Phone # (503) 286-0005
Fax# (503) 286-1050
Cell # (971) 227-0097
E-mail = jcheadle@ponderosaig.com

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