Ponderosa Investment Group LLC
# INVESTMENT LETTER

Third Quarter 2006 · v2

## Quarterly Investment Commentary

**SUMMARY:**
Despite rising stock prices, valuations remain attractive thanks to a decent earnings environment.

Why do stocks measure as being cheap right now? Investors seem to believe that a significant economic downturn is likely enough that they are pricing stocks based on a potentially big decline in earnings.

In my view, broad risk levels are higher than average right now, and I'm no different from the rest of the market in that these risks impact my enthusiasm for stocks. But good valuations provide a cushion.

I'm reducing the small-cap exposure in the portfolios and moving the proceeds into large-caps. Small-cap valuations are near the high end of their historical range relative to large-caps, and cyclical considerations also favor a lower small-cap weighting.

*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 with my clients.*

Returns were generally good in the third quarter. The large-cap S&P 500 index ended up 5.6% for the quarter. Small caps were nearly flat, gaining 0.4%. Value outpaced growth across all markets. Domestic investment-grade bonds and international stocks were each up about 4%, while short-term local currency emerging-markets bonds gained almost 3%.

There has been a lot in the news lately regarding the Dow Jones Industrial Average "finally" reaching record levels first touched over six years ago (though the NASDAQ remains far below its peak). What is interesting is that when you look at this index from a total return perspective, which includes dividends, the index reached a new record level back on 5/27/05.

### Review of Equity Valuations

With oil prices dropping and the Fed finally pausing after a lengthy string of rate hikes, the markets have had a nice run in the past few months. From its most recent bottom in mid-July, the S&P 500 is up almost 9%. Normally a rising stock market makes stocks more expensive, but earnings have also been positive over this stretch, which have kept valuations from changing as much as one might think. The valuation model I follow estimates that the S&P 500 index is roughly 20% below fair value. Several other approaches tell a similar story, and even the more conservative of these valuation methods suggest the market is at worst in a fair-value range. (This is not to say that all experts believe the market is undervalued—some do not—but they generally use quite different valuation methods.

Why do stocks measure as being cheap right now? Investors seem to believe that a significant economic downturn is likely enough that they are pricing stocks based on a potentially big decline in earnings. There are many factors that could contribute to declining earnings going forward—a housing-induced recession, underfunded employee liabilities such as pensions and health insur ance, and even a simple reversion to normal profit margins—but it's really only a perfect storm that would cause earnings to drop so much and/or over so prolonged a period that it would justify current valuations.

The stock market is not always right (I'm reminded of the quip about the market having predicted nine of the last five recessions) and if it is wrong then stocks really are undervalued. But, in my view, broad risk levels are higher than average right now, and I'm no different from the rest of the market in that these risks impact my enthusiasm for stocks. In addition to the above-mentioned factors, there remain problems associated with our current account and federal budget deficits, the looming threats of Social Security and Medicare liabilities, high levels of consumer debt, and the continuing risk of an economically damaging terrorist attack (to name a few). These bigger-picture risks are on top of normal cyclical risk; with the economy slowing and the housing market deteriorating, recession risk has risen. These risks are material enough to make me more cautious than I otherwise would be in deciding whether to overweight equities.

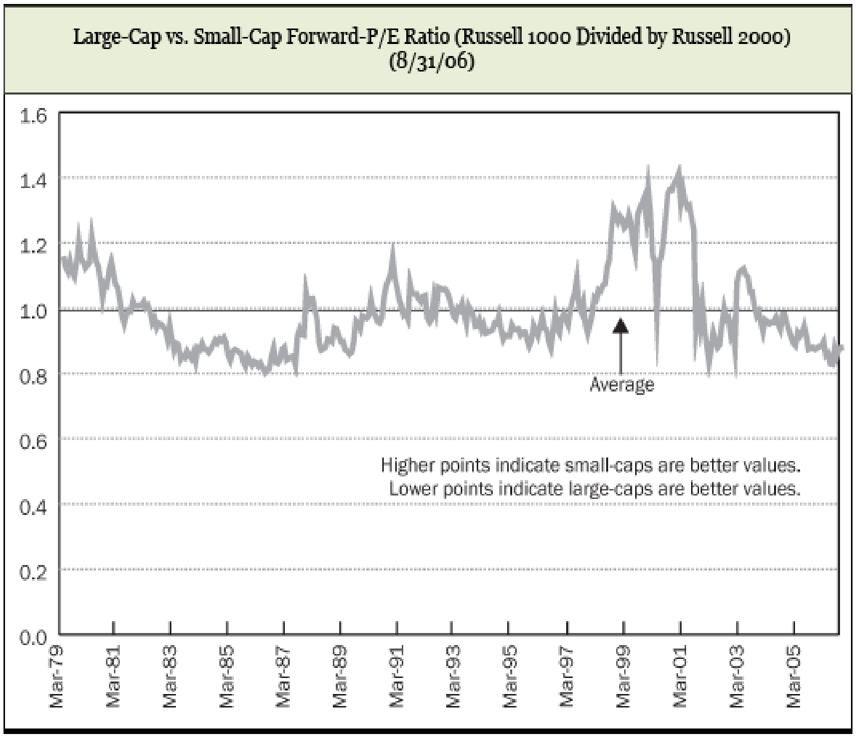
On the positive side, it is entirely possible that the U.S. economy will have a soft landing and continue to expand, and it's nice to know that stocks are priced with a big valuation cushion, since this reduces the downside risk somewhat (most bear markets, for example, start from a point of high valuation). As long as stock prices are factoring in a higher risk premium, stocks will continue to look cheap relative to valuation comparisons over the past 25 years. However, if investors' risk perceptions improve, the resulting higher valuations would drive a spike in returns (all other things being equal).

Among other equity asset classes, foreign stock valuations are in line with their historical average relative to the U.S., I remain slightly overweight foreign stocks. Among domestic equities, growth stocks look slightly cheap relative to value stocks on a statistical basis, an opinion which has also been voiced by many of the managers I listen to and follow. The one equity area I find sufficiently compelling to take a tactical weighting is in the valuation relationship between large-cap and small-cap domestic equities.

### Explanation of the Small-Cap Reduction

Over the next month I will start reducing the small-cap exposure in portfolios and move the proceeds into large-caps. In reaching this decision, I've looked at data from several sources, and in most cases these metrics showed small-cap valuations at or near the high end of their historical range relative to large-caps. The chart below shows the historical relationship between large-cap and small-cap P/E ratios. A ratio of ratios may be difficult to get one's arms around, but it's worth understanding. A P/E ratio on its own tells us how much it costs to buy a dollar of earnings: a higher P/E ratio means you are paying a higher price for that dollar, and a lower P/E ratio means you are paying a lower price. This chart is nothing more than a way of comparing the "costliness" of large-caps and small-caps to one another based on their P/Es. As an example, if a dollar of earnings from the average large-cap company cost $18 (which is a P/E of 18x) and a dollar of earnings from the average small-cap company cost $20 (a P/E of 20x), then the "ratio of ratios" would show that large-caps cost 90% of what small caps cost (18 divided by 20 is 0.9). Right now, this data shows that small-caps are expensive relative to large-caps. In fact, they are nearly as expensive as they've ever been, an observation supported by other data sources as well.

I also believe that cyclical considerations favor a lower small-cap weighting. We're well into the economic cycle, and small-caps' best periods of relative performance typically come early in the




cycle. Combined with the valuation backdrop, I think the odds are very good that large-caps will outperform small-caps on average over the few years.

I want to emphasize that the basis for underweighting small caps is relative. Large-caps are not necessarily a compelling absolute return opportunity on their own, but small-caps are clearly less attractive than large-caps, and as such I want to shift the portfolio asset allocation accordingly. I want to caution that there is no way to know for sure how long it will take for this move to pay off. My confidence is based on a longer time frame, one that could be as long as five years, but it is impossible to successfully predict the short term.

**The Economy and Bonds**

Thanks to slowing earnings, dropping oil prices and a deteriorating real estate market, the Federal Reserve has finally put on hold what has turned out to be one of the sharpest cycles of rate increases on record. Economic forecasting is extremely difficult, but it's pretty clear that the risk of recession is greater today than in recent years. For me, that means I need to manage the portfolios with an eye towards this risk, as well as others. High-quality bonds are generally the best-performing asset class during recessions, and as such I believe bonds still have an important role to play in balanced portfolios (bonds help mute the volatility of equities in other scenarios as well). The bottom line is that I don't need to be able to forecast the economy with precision in order to make sound portfolio decisions.

**Conclusion**

Although the equity market has had a nice run in the past few months, stock valuations are still measured as being cheap. I'm pleased that there are tactical opportunities in large-caps versus small-caps within the portfolios. I'm confident this move will modestly improve the return prospects while helping mitigate certain risks over coming years.

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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