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Five Seasons Financial Planning

Guiding You to a Brighter Financial Future

Seasonal Musings

October 2006

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Hi Paul,

Welcome to another issue of "Seasonal Musings", the online newsletter from Five Seasons Financial Planning (FSFP). This month we'll dissect the stock market's performance in the third quarter and discuss our investment outlook for the coming quarters. As usual, if there are financial planning or investment topics you'd like us to cover in future issues, please drop us a line.

In Like a Lamb, Out Like a Lion

Third Quarter Stock Market Performance

It never ceases to amaze me how financial markets are able to confound the consensus opinion. Here we sat in the middle of July with most of the major stock indices revisiting their lows for the year and the prospect of the 2 worst months of the year historically (August and September) still to come. On top of that, market participants were also keenly aware that stocks historically don't perform well in years with mid-term elections and that it looked like the third quarter would be the first in several years to generate less-than-double-digit profit growth.

So what do stocks do? Spurred on by declining oil prices, a stirring bond market rally, and the prospect of a kinder, gentler Federal Reserve, the S&P 500 ends the third quarter up a very respectable 5 1/2%, and the Dow registers a new all- time high soon after.

The moral of the story? More often than not, it pays to be a contrarian investor if you're patient and disciplined. Consider that through July 31, 7 of the 10 mutual funds with the largest net redemptions were either in the large-cap growth or large-cap blend category. These groups led the charge higher in the third quarter and include one of my absolute favorite vehicles for hourly clients, the Vanguard S&P 500 Fund. As a crusty old bond trader once told me, "the markets move in the direction that [inconveniences] (my word, not his) the most people."

A New Sheriff in Town?

New Leadership in the Stock Market

While large-cap stock funds, and S&P 500 index funds and ETFs in particular, led the charge last quarter, smaller cap stocks and actively managed mutual funds as a group lagged badly. Large-cap stocks outperformed mid-caps, which outperformed small- caps, which outperformed micro-caps. In fact, small- cap mutual funds in aggregate fell in the third quarter. As a result, the average actively managed stock mutual fund only rose 2.5%, lagging the S&P 500 by more than half.

Many market strategists, myself included, have been calling for a rotation out of small-cap stocks into large. After being punished in the early months of this year, it looks like we're being rewarded once again. On a year-over-year basis, large-cap stocks have now outperformed small- and mid-caps, and recently allocated client portfolios are reaping the benefits.

The other shift in the wind we've been looking forward to is for growth stocks to start outperforming value stocks. Value stocks across the board have trounced their growth counterparts since the bubble burst in the spring of 2000. This value vs. growth horserace tends to flipflop back and forth for years at a time, but 6 1/2 years is historically a long time for either investing style to dominate.

In the past 2 months, growth stocks have outperformed their value counterparts. It's probably too early to call an end to value's domination, but there have been other signs that perhaps this is the start of a sea-change.

For one, tech stocks historically tend to perform well in the months following a peak in oil prices. For another, there seems to be increasing interest in taking tech-related companies private. A couple of our client holdings have been targeted just in the last few months, and the recent deal to take $17 bln Freescale Semiconductor private has focused interest on an industry not historically attractive to private equity players. And finally, our own stock screens are generating a lot of names in the tech arena and in the semiconductor space in particular. So obviously I'm talking my position, but I wouldn't be surprised to see tech stocks lead a growth stock revival starting in the next couple of quarters.

If you'd like more information on our investment philosophy or stock-picking methodology, please visit us at www.FiveSeasonsFinancialPlanning.com or drop us a line using the contact info below.

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Best wishes,

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