MARCH 2006 NEWSLETTER

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Complacency Rattled

Triggered by a sell-off in China and the possibility of slower growth, U.S. markets sold-off sharply at the end of February. Former Fed chief Alan Greenspan's mention of a possible recession, and a report that orders for durable goods were surprisingly weak in January spooked investors. The S&P 500 Index fell 3.5%, the largest single-day drop since the September 11th attacks.

For the month, the Dow Jones Industrial Average closed 2.6% lower, the S&P 500 Index finished down 2.1% and the Nasdaq Composite Index declined 1.9%. EAFE was off only slightly at -0.1%.

Pundits overreacted to the first single day decline in excess of 2% in 45 months. Yet, market history tells us that a move of this magnitude is hardly abnormal. The lack of such a drop in recent years was what was unusual - investors have been conditioned by the unusually low volatility of 2005 and 2006.

While we hadn't seen such a dramatic one-day decline in a long time, we need only look back to last May and June to find a 15% drop in the EAFE Index and 7.5% in the S&P 500, top to bottom over the course of five weeks. Emerging market funds lost over 25% during that period, while Matthews China dropped over 17%. That downdraft attracted far less media attention. Markets then resumed their upward climb through the end of the year.

If a jolt of a few percent in your portfolio causes alarm, you may want to use this opportunity to revisit your asset allocation. Perhaps you should reduce equities and add more fixed income to buffer the shocks the markets will offer. As to the apparent triggers, we see no reason to panic.

China's transition from communism to capitalism is a fascinating story. When the government first permitted stock trading in 1990, it divided ownership of listed companies into tradable and nontradable shares, in part to keep control of the companies going public. About a third of each listed company's shares could be traded publicly. Then two years ago, plans were made to make all shares tradable. Now, the lockup periods for selling the nontradable shares are starting to expire.

When you consider that the isolated Shanghai market (largely closed to foreign investors) was up 130% last year and 300% over the last year and a half, a drop is to be expected. State investors and other powerful institutions began taking advantage of their new ability to trade and take profits.

It's interesting that share prices of the very same companies on more international markets such as the Hong Kong exchange, dropped only slightly. According to a recent study by JPMorgan Chase, in early February 37 Chinese companies were listed on both the Shanghai and Hong Kong stock exchanges. Of those 37, eight traded in Shanghai at twice the valuation that they had on the Hong Kong exchange, largely due to government restrictions on citizens investing abroad.

As to the other trigger, of course, a recession is always possible. However, most experts now see a healthy slowing and soft landing from the past couple of years of interest rate increases. Inflation is not currently a problem.

Certainly stock markets can be volatile for short periods, but over time patience and discipline are usually rewarded. Don't focus on short-term market turbulence in the context of achieving your long-term financial goals.

As always, some funds brought in relatively good returns in February: Utilities and natural resources were the top performing domestic fund categories, followed by mid-cap value and blend funds. At the bottom were financials, health and large growth. Small-caps outperformed large-caps and value outperformed growth. Real estate funds as a group gave back 1.5% last month but are still ahead 5% for the year.

Internationals ended the month ahead with Japan at the lead followed by Pacific region and diversified smallcaps. Large-cap foreign funds were slightly negative and Latin American funds were down 3%.

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Treasuries rose solidly higher as a flight to quality pushed yields to two-month lows.

As Upgraders, we don't look for meaning in one day market action. Some speculate that the selloff represents a move away from international funds, but in Upgrading, we simply follow the ranks. If international funds falter, we'll see that in the scores.

Long term investors know that market volatility isn't in the upgrader rank on their 12, 6, 3, and1 month total returns and a negative one month return may not counteract strong 12 month performance. In fact, the ranks this month are fairly similar to last month: And real estate retained its top standings although they, too, suffered last month.

We believe this is a benefit of our strategy: the lag in our scoring system prevents rash decisions based on what might only be a blip in the market. Portfolio changes are triggered by shifts in long term market trends, not by one day market action.

Thank you for your business…

P. Michael Valley II

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