

## 1<sup>st</sup> Quarter Review & Preview

### Oil and Energy Prices Dominate the 1<sup>st</sup> Quarter

#### Overview

Coming off a strong rally to close out 2004, the **stock market stumbled** out of the gate in the **1<sup>st</sup> quarter**. **Rising oil prices, steady interest rate hikes and slower corporate profit growth** all affected stock performance.

**Investors appeared to set aside** some of the **worries** that had hindered the market in recent times. **Terrorism threats** and the **Iraq War** seemed to take a backseat, and last year's heated **Presidential election** felt like a relic of the ancient past. There were some **favorable economic trends**, such as improved **job growth** and **increased business spending**. The **housing market remained robust** as well even as interest rates continued to move higher.

The growing **thirst for oil**, spurred on by rapid increases in **demand** from **China and India**, and a persistent demand from the U.S., kept **oil prices stubbornly high**, as much as 30% above the level of a year ago. Even though this **provided a boost** to stock prices of **oil companies** and related businesses, **it created a potential problem** for the economy and the **stock market** for the rest of 2005.

**Despite the economic risks created by higher oil prices, rising interest rates and the continued weakness of the dollar, all are manageable.** It is possible that they **could become less significant issues** as time goes on,

and that would likely help the market rebound from its slow start. **The Federal Reserve seems determined to keep inflation under control and help stabilize the dollar.** If today's economic concerns subside, the **sluggish markets of the 1<sup>st</sup> quarter could turn out to look like a buying opportunity.**

#### Economy

The U.S. economy (as measured by **Gross Domestic Product**) grew at a rate of **3.8%** in the **4<sup>th</sup> quarter of 2004**, and should be close to that when 1st quarter numbers are released. **Inflation rose to an annual rate of 3.0% in 2004**, still modest by historical standards. **Core inflation** was up **just 2.4%**, despite the rapid increase in commodity and oil prices. The **obvious concern** is that if **oil prices** continue to rise, **higher inflation could hamper economic growth.**

**Consumer spending slowed in 2004 but remains at a healthy rate of 3.0% to 4.0%.** **Business spending** was more impressive, **growing at an 8.0% clip.** However, spending on technology grew only by a little more than 5.0%, down from double-digit growth rates of recent periods. **Job growth has become steady**, with the economy adding new jobs at a rate of **160,000 per month** over the **past six months**, while **unemployment declined** in that same period, falling from **5.5% to 5.2%**. As a result of the improved labor market, the **"Risk of Recession" indicator** produced by the website Economy.com stood at just **13.3% in February, well below the 38.8% level it reached last July.**

**Defense spending** continues to be a steady contributor to the economy as

replacement demand from the Iraq war and export activity driven by the weaker dollar has kept those businesses going strong. **Corporate profits remain solid and are expected to grow at a rate of 8% in the 1<sup>st</sup> quarter of 2005.** Most companies are in **good financial shape.** At the same time, individuals appear to be holding up well, with **consumer spending, saving and credit trends all improving in recent months.**

#### U.S. Stock Markets

The **broad market**, as measured by the **Russell 3000 Index**, **lost 2.2%** for the first quarter of 2005. **Large cap stocks held up better than small caps** during the three-month period, losing **-1.91% vs. -5.34%.**

#### Bob's Corner

##### Two thoughts for this quarter:

**First:** Thank you to everyone who has given us referrals over the past year. We took in over \$15M dollars last year in client referrals alone. In the same breath, the referring client's fees went down by an average of 0.20% per year!

**Second:** It appears that 2005 may be similar to 2004 in that PATIENCE will be the key to success. With so many uncertainties hanging over us, we could see the bulk of our returns come in short bursts. We will continue to make the strategic long-term and tactical short-term reallocations to take advantage of the market bargains!

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THANK YOU FOR YOUR BUSINESS!

This occurred despite several **notable challenges** confronting such prominent **large companies** as **General Motors, AIG and Fannie Mae**. All three stocks, staples in many large-cap portfolios, **declined more than 20%** during the period.

**Value stocks again outperformed growth stocks**, due in large part to the strength of energy and utility issues. **Dividend growth**, a notable trend in recent months, also worked to the benefit of value investors. More than **22% of companies listed in the Standard & Poor's 500 initiated dividend payments or increased their dividend in the 1<sup>st</sup> quarter of 2005**. The combination of a more favorable tax structure for corporate dividends and the sideways direction of the market worked to the benefit of dividend-paying stocks. Overall, value stocks (measured by the **Russell 3000® Value Index**) **lost just -0.26%** during the quarter while growth stocks (measured by the **Russell 3000® Growth Index**) **declined by -4.32%**.

The clear **winners**, from an **industry perspective**, were **energy and natural resources funds, gaining 13%** for the period. Companies in this sector are enjoying solid profits due, of course, to rising oil prices and strong demand. The **materials sector** also showed a modest **gain of 1.14%**, boosted by strong global demand for chemicals, metals and equipment. On the opposite end of the scale, **technology and telecommunications stocks** again were **hard hit**, as **declines** affecting stocks such as **Microsoft, Ebay, AT&T** and the Regional Bell operating companies hurt both sectors. The falloff in prices was **due in part to slowing growth among the mature titans of technology and uncertainties over how planned telecom mergers will turn out**. All other sectors declined modestly in line with overall concerns about the direction of the market.

### **Bond Markets**

As has been the case for some time, **bond markets** again showed **surprising resiliency**. Intermediate and long-term bonds held up

reasonably well despite two more interest rate hikes by the Fed during the 1<sup>st</sup> quarter.

**Short-term interest rates are up 1.60% in the past 12 months, but the yield on the benchmark 10-year Treasury Note has risen a mere 0.30% in that same period.** It demonstrates the concern bond investors have over the direction of oil prices and slower corporate profit growth. **The only bond fund categories that generated positive returns for the period were ultra-short issues and long-term bonds.**

**High-yield and emerging market bonds** showed some weakness, **declining -1.6% and -1.3% respectively.** The most **notable concern** raised in the high-yield market in the 1<sup>st</sup> quarter revolved around **General Motors**. It is threatened with seeing its credit rating lowered to **junk bond status**, which could force a number of institutional buyers, such as pension plans, to sell their holdings of GM bonds.

**Investment-grade global bonds declined during the quarter, as the dollar rallied against both the euro and the yen**, creating a negative impact on returns in global bond funds. While

the dollar has stabilized recently, the long-term budget and trade deficits will likely prevent any sustained rally in the currency markets.

### **International Markets**

In contrast to domestic market trends, **small cap and emerging market issues fared better overseas.** **Foreign small/mid cap funds gained 3.0%** and diversified **emerging market funds rose 1.2%** during the 1<sup>st</sup> quarter.

Even as interest rates and oil prices move higher, most **emerging market economies** appear to be **fundamentally sound**. Growth has slowed in **India and China**, but their economies are **still expanding** at a rate of **6.0% to 9.0%/year** - well above the growth rate of developed markets. **Pacific ex-Japan stocks** also **performed well** last quarter, as did most **Latin American stocks**, most notably in resource rich **Brazil**.

European stocks generated a gain of 1.4% for the period, but **Japanese stock funds lost -2.2%** amid concerns about a disappointing economic recovery in that country. A confidence survey issued by the Bank of Tankan showed a decline in March and industrial production turned in its worst performance in a year.

### **Performance Update**

<b>Market Index</b>	<b>1<sup>st</sup> Qtr</b>	<b>1-Year</b>	<b>2-Year</b>	<b>3-Year</b>
DJ Ind. Average	-1.59	3.99	17.38	2.69
S&P 500	-2.13	6.63	20.01	2.73
Russell 2000	-5.60	4.19	29.85	6.68
S&P Mid-Cap 400	-0.40	10.43	28.27	8.01
<b>Russell 3000</b>	<b>-2.20</b>	<b>7.09</b>	<b>21.62</b>	<b>3.69</b>
MSCI EAFE	-1.26	12.88	29.86	9.19
NASDAQ Comp.	-8.10	0.25	22.06	2.70
Lehman High-Yield	-1.61	6.84	14.45	10.98
Lehman Agg. Bond	-0.48	1.15	3.25	5.99
Lehman Credit Idx.	-1.05	0.84	4.65	7.51
Lehman Gov. Bond	-0.42	0.11	2.15	5.77

## Outlook

### Economy

Consensus forecasts for **economic growth and inflation** for the rest of 2005 look a lot like 2004, with the economy growing by **3.7%** and inflation remaining in the **2.5% to 3.0% range**. **But the biggest wildcard is the direction of oil prices**. If they remain at elevated levels, the economy could pay a huge price. Higher costs at the **gas pump effectively serve as a tax** on consumers and businesses, and that could have a **negative impact on economic growth**.

While much of the **blame for booming energy demand** is directed at **China's fast-growing economy**, the **U.S. still remains the world's biggest energy buyer**. Unlike past oil price increases, **consumers have been slow to react to the latest price hike and demand continues unabated**. In the view of many economists, **we may be nearing a point, however, where demand will slow** in response to these price hikes. And never sell short American ingenuity, as both Ford and GM have announced several **hybrid vehicles** with substantially improved gas mileage. Toyota and Honda are already selling hybrids and their **increasing popularity** could help **slow U.S. oil demand in coming years**.

**On the supply side, low volume oil wells have been activated** and OPEC announced **production hikes** on three different occasions. **The hope is that a combination of tempered demand by the U.S. and increased production by other countries will result in a dramatic drop in oil prices in the second half of 2005**. If that happens, it could be the jumpstart that tames inflation and **triggers a robust and extended business cycle that could last several years**.

### U.S. Stock Markets

Given the recent struggles, stock

markets appear to be **undervalued by about 8.0% to 16.0%** using consensus estimates of corporate profit growth and interest rates over the next twelve months. **We think there is room for healthy gains of 10.0% to 15.0% in equities over the next year if oil prices cool and the Fed avoids overreacting to inflation concerns**.

**Corporate profits** are likely to slow to their **historic average growth rate of 8%** and **large cap stocks are again expected to outperform small cap issues**. **Value stocks** will retain their **advantage** from both a dividend and total return standpoint. **However, growth stocks may be poised for a recovery**, as recent weakness in this sector has made a number of stocks **more attractive**.

The recent Merrill Lynch Global Fund Manager survey found that **energy, industrials, materials, pharmaceuticals and telecoms are the most favored industry sectors**. Energy certainly has short-term momentum, but could be subject to correction if oil prices level off. **We continue to favor materials due to strong global demand**. **Biotech and pharmaceutical stocks are also attractive**, given **favorable demographic trends, new product discoveries**, and strong growth in both revenue and cash flow.

### Bond Markets

**As inflation fears begin to take center stage, the currency issues will take a**

**back seat in the bond investor's eye**. The Federal Reserve appears poised to continue its money-tightening policy in the months ahead. The 10-year yield should edge towards 5.0% by the end of the year, barring any more oil price shocks.

**Look for investment grade corporate and foreign bonds to outperform government and high-yield issues as the year progresses**. Additional downgrades on GM's debt or changes in regulations for Fannie Mae and Freddie Mac due to recent problems could add a degree of volatility to the bond market in the months ahead.

### International Markets

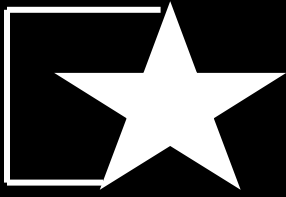
**Emerging market and small cap funds will remain attractive in the coming months, but a more selective approach will be required**. For example, **South Korea**, a top-performing market in the 1<sup>st</sup> quarter, has seen a slowdown in industrial production. In addition, small cap stocks in **Japan** may **come under pressure** if that country's economic weakness persists.

The stabilization of the euro versus the dollar and healthy money supply growth of 6.4% in the Euro zone nations should give European stocks a boost throughout 2005. However, **overall economic growth in Europe** continues to hover **around 1.5% to 2.0%, well below the growth rate** enjoyed by the **U.S. and developing markets**.

## Summary

Oil prices were the overriding issue affecting investors in the 1<sup>st</sup> quarter, and still poses a real risk to economic growth and equity returns. But given signs of moderating economic growth in China and India and plans by OPEC to boost production, **the supply/demand picture for oil should improve**.

It also appears that investing in energy and oil issues has become increasingly speculative. A Goldman Sachs analyst/trader recently projected that oil will reach \$105/barrel (almost double where it stands today). However, the prediction seems less than objective given that Goldman Sachs sponsors a commodity index that is more than 60% invested in energy stocks! Most fundamental analysts share the view that oil prices will moderate over the next few months. In fact, many oil companies are working with forecasts of \$40 to \$45/barrel oil. **If oil prices decline, even slightly, a nice relief rally in stocks could follow**.



# All Star Quarterly

## The Basics of ETF's

**Exchange Traded Funds (ETFs)** have become one of the **fastest growing investment vehicles** in financial markets today. In fact, assets invested in ETFs grew by 50% in 2004, to over \$225 billion at year end.

What is behind this rapid growth and popularity of these relatively new investment vehicles? Their unique structure can provide investors with **several key benefits**:

- **Low Expenses** - Management expenses for exchange-traded funds are a fraction of the expenses for a typical actively managed mutual fund, or even index funds.
- **Tax Efficiency** - Unlike mutual funds, most exchange-traded funds have no capital gains distributions.
- **Trading Flexibility** - ETFs can be continuously bought and sold throughout the day, just like a stock. Mutual funds are bought and sold at the end of the day net asset value.
- **Diversification and Asset Allocation** - In addition to being able to provide quick, efficient diversification, today's ETF's can provide targeted asset allocation to almost every asset class.

**The first ETF was launched in 1993**, when the "Spider" (SPY) was created to match the S&P 500 Index. Similar index products followed and they have gradually become more popular among institutional and index investors. **Popularity soared in 2000** when the "cube", QQQQ, was created to match the popular **NASDAQ 100 Index**. This remains the most actively traded ETF to this day, and All Star Financial was one of the first investors in the QQQQ during the month of its launch in 2000.

**ETF products are multiplying like rabbits**, with dozens coming to market every year. All Star Financial carefully reviews the investment process and structure of these new products for you. Many are no longer just "passive index" products, but **provide active management or a "dynamic indexing"** component that has been able to **outperform the market for less than the cost of an index fund**. Look at the performance of the **Intellidex**, which is the methodology behind the new PowerShares Dynamic Market ETF:

	<b>Average Annual Returns</b>			
	<u>1-year</u>	<u>3-year</u>	<u>5-year</u>	<u>10-year</u>
Market Intellidex	20.06%	11.78%	8.74%	16.16%
S&P 500 Index	<u>10.88%</u>	<u>1.82%</u>	<u>-3.78%</u>	<u>10.19%</u>
<b>Added Value/Year</b>	<b>+9.18%</b>	<b>+9.96%</b>	<b>+12.52%</b>	<b>+5.97%</b>

They are known by **different brand names** such as **iShares**, **PowerShares**, or **VIPERS**, and they represent the best of **low-cost institutional investments** that are **managed by quality companies** such as **Barclays Global Investors** and **Vanguard Funds**.