

## 4th Quarter Review & Preview

### Still Standing After This Long Year

#### Overview

**2005 will be remembered as a year when disasters, some natural, some man-made, dominated events in the world. Everything from the aftermath of a tsunami to a record-setting hurricane season to continued bloodshed in Iraq created an unsettling atmosphere. On the economic front, the Federal Reserve continued to push short-term interest rates higher while oil prices skyrocketed. DESPITE ALL OF THESE HURDLES, THE U.S. ECONOMY MANAGED TO CHUG ALONG AT A STEADY PACE, AND THE MARKETS AT LEAST HELD THEIR GROUND.**

Corporate earnings continued to meet or exceed expectations, as companies maintained their string of double-digit profit growth. Business spending improved as well, and all of these factors contributed to a rally in the markets that lasted from August through November. Hopes that it would extend to a full, year-end rally fizzled, however, where markets took a step back in December.

For the year, U.S. stock market indexes didn't move significantly from where they ended in the previous year. The story was different in other parts of the world, where equity markets generally gained much more ground.

One economic statistic rising still came in at eyebrows is the inflation rate, which crept to its highest level in years, but a manageable 3.5%

annual rate of growth (through November). This happened in an environment where oil prices jumped 40%. The Federal Reserve (the Fed) under Alan Greenspan has greatly emphasized inflation-proofing the economy through its interest rate moves. As the New Year begins, Greenspan steps down (after 19 years) and the reins are handed over to Ben Bernanke. Fed-watchers will be keeping a close eye to see how, on Bernanke's watch, the Fed manages money flows in what could be a changing inflationary environment.

For most non-All Star Financial investors, 2006 starts in a place not all that different from where we were a year ago. Long-term interest rates didn't move much at all, despite the continued upticks in short-term rates. Equity markets are coming off a fairly flat year, and the economy remains positive, but not without question marks.

#### Economy

##### \*The 4th Quarter\*

The economy showed true resilience again in the 4<sup>th</sup> quarter. Problems that cropped up earlier in the year, ranging from higher oil prices to Fed interest rate hikes to bulging government deficits and the aftermath of the devastating hurricanes didn't go away. But neither did corporate profits, and businesses continued to show a greater propensity to invest in new equipment and new hires.

The Federal Reserve bumped interest rates two more times in the quarter, their 12<sup>th</sup> and 13<sup>th</sup> rate hikes in 18 months.

The Federal Funds rate, which had dropped to a low of 1% 18 months ago,

is now at 4.25%. But the Fed's actions haven't seemed to slow the economy to any great extent, and inflation, while higher, remains in a reasonable range.

The Fed's actions did result in higher interest rates on the shorter end of the bond maturity scale, and at the end of 2005, a rare "yield curve inversion" occurred, with yields on 2-year U.S. Treasury notes actually higher than the yield on 10-year T-Notes (see the "Bonds" section for more on this).

The general rise in short-term rates and a mood swing about the direction of interest rates over the long term seemed to cool what has been a red-hot housing market in many parts of the country. However, consumer spending remains healthy.

##### \*Looking Ahead\*

The housing market is losing some steam and interest rates are edging higher. It seems likely that a spending boom built on the back of mortgage refinancings could take a breather. But if consumers do cut back, the hope is that businesses, buoyed by strong profit growth, will step up to the plate and keep the economy moving at a steady pace by boosting their investment. Hiring seems to be on the rise, and that could help keep things humming along for much of the year.

#### ASF Contact Info:

Phone: 952-896-3820  
 Fax: 952-896-3819  
 Toll Free: 888-809-7901  
 E-mail: [asf@allstarfinancial.com](mailto:asf@allstarfinancial.com)  
 Website: [www.allstarfinancial.com](http://www.allstarfinancial.com)

Bob Klefsaas, President: 952-896-3816  
 Maren Aipperspach, Vice President: 952-896-3817  
 Bruce Bonner, Research Analyst: 952-896-3818  
 Brandt Colville, Account Executive: 952-896-3815  
 Paul Sommerstad, Account Executive: 952-896-3835  
 Trent Klatt, Account Executive: 952-896-3826

Energy prices remain a primary focus of the markets. While the price of a barrel of oil peaked near \$70 in August, it drifted closer to the \$60/barrel range by the end of the year. **The direction of oil and natural gas prices seems difficult to predict in 2006, but it is fair to presume that strong energy demand could send prices up at some point this year.**

**Other risks facing the markets include** the possibility that **housing prices may decline sharply**, particularly if interest rates move higher. **Also, if an inflation threat persists**, the Federal Reserve may be obligated to boost interest rates even further. **FINALLY, THE CURRENT ECONOMIC EXPANSION AND BULL MARKET, NOW SEVERAL YEARS OLD, COULD BE ON THEIR LAST LEGS AND POTENTIALLY ALTER. HOWEVER, THE TIMING OF SUCH EVENTS IS ALWAYS DIFFICULT TO PIN DOWN.**

### U.S. Stock Markets

#### \*The 4th Quarter\*

**Trends that had been expected** since the beginning of the year waited until the 4th quarter to occur. **Large-cap** stocks, which have underperformed the rest of the market for most of the decade, **finally led the market** in the three-month period. The **large-cap** Russell 1000 Index gained **2.1%**, while the **small-cap** benchmark, the Russell 2000 Index, rose just **1.1%**.

The same was true of long-beleaguered **growth stocks**. The Russell Growth Index earned **2.9%** in the 4<sup>th</sup> quarter, compared to only **1.2 %** for the **Russell Value Index**.

Service industries represented the best-performing sectors of the stock market. Both **business services (+8.7%)** and **financial services (+6.7%)** shined. On the other side of the coin, **energy stocks (-6.9%), utilities (-2.5%)** and **telecom stocks (-3.9%)** detracted from the market's

performance. Even with the setback for energy and utilities stocks in the 4<sup>th</sup> quarter, those sectors were among the best performers for the year, driven by the trend toward higher energy costs.

**Stock buybacks, mergers and acquisitions were a big part of the story for stocks throughout the year.** Many companies chose to put their strong profits to work to either buyback their own shares or to purchase other companies. **M&A activity, by one estimate, topped a whopping \$2.7 trillion in 2005.** Worldwide, merger business **rose by 38%**. All of these factors benefited the markets during 2005.

#### \*Looking Ahead\*

**A big question in the New Year is whether corporate profit growth can continue its long streak of double-digit gains**, as earnings expectations typically drive the direction of stock prices. The consensus forecast is that profit growth will come in at **10-12% for 2006**. If that **expectation is met, it should set the markets up for a solid year.**

That is particularly true given that stock valuations appear to be more attractive

than they were a year ago at this time. A Federal Reserve model shows that **stocks as a whole are undervalued by as much as 15%**. While some risks exist, a survey of money managers shows that 94% believe the market is fairly valued or undervalued, yet another positive sign for the year ahead.

**As the economic expansion matures, investors are likely to favor large, blue-chip companies over mid-cap and small-cap names.** This trend began in the fourth quarter and should continue into 2006. **Growth stocks** are also positioned to perform well this year. From an industry perspective, **technology and healthcare stocks are attractive sector plays.**

### Bond Markets

#### \*The 4th Quarter\*

A **rare event** occurred in the bond market at the **close of 2005 – an inverted yield curve**. The yield on 2-year Treasury notes exceeded that of longer-term Treasury securities, though only by a slight margin. **It was the first time an inversion occurred in the bond market since 2000.** While sometimes thought to be a **harbinger of**

## Performance Update

### Annualized Returns

Market Index	4th Qtr	1-Year	2-Year	3-Year
DJ Ind. Average	1.99	1.72	3.62	11.18
S&P 500	2.03	4.88	7.84	14.36
Russell 2000	0.81	3.32	9.93	20.65
S&P Mid-Cap 400	3.34	12.56	14.48	21.13
<b>Russell 3000</b>	<b>2.04</b>	<b>6.12</b>	<b>8.98</b>	<b>15.89</b>
MSCI EAFE	3.79	10.87	14.49	20.82
NASDAQ Comp.	2.49	1.37	4.91	18.18
Lehman High-Yield	0.68	2.74	6.84	13.75
Lehman Agg. Bond	0.59	2.43	3.37	3.62
Lehman Credit Idx.	0.49	1.96	3.58	4.93
Lehman Gov. Bond	0.67	2.65	3.06	2.82

an economic recession, the timing of the inversion, occurring during the light trading period of a holiday week, may not be so telling.

The flat-to-inverted yield curve scenario also could change given indications from the Federal Reserve in recent weeks that it may be close to finished with interest rate hikes for this cycle.

**Bonds managed small gains during the 4<sup>th</sup> quarter (.50% to .70%).** The best action during the quarter, as has been the case in all of 2005, was in **emerging market bonds**, which **rose 1.5%**. All other bond categories generated returns of less than 1% as credit spreads continued to decline and the yield curve flattened. Global bonds issued by developed countries lost ground mainly due to the strength of the dollar versus foreign currencies.

#### \*Looking Ahead\*

**Fed-watchers have plenty to do** as the year begins, carefully monitoring the Fed's stance on interest rates, while at the same time **bidding farewell to** longtime **Chairman Greenspan** and analyzing the style and substance of **new Chairman Bernanke**. By all indications, Bernanke's policy positions shouldn't differ much from Greenspan's. **One possible area of improvement is Bernanke's stated advocacy of market transparency.** It is hoped that means his pronouncements will be **more clear**, and not as subtle as the "Greenspeak" that market watchers had to endure over the past 19 years.

**Despite all of the Fed's efforts, long-term interest rates have barely budged. Heavy foreign investment from China and other countries has helped to keep interest rates at bay,** and that trend could continue. One study suggests foreign demand for U.S. debt securities is **keeping the yield on 10-year Treasury bonds a full 1.5% below where it would otherwise be.** Still, the general expectation (once again) is that long-term interest rates will move higher in 2006.

## International Markets

### \*The 4th Quarter\*

**GOING GLOBAL IS NOT JUST THE WAVE OF THE FUTURE, BUT IT WAS THE ATTITUDE TO TAKE IN 2005.**

It all started with an impressive comeback by **Japan**. **Stocks** in that country **rose 17%** in the 4<sup>th</sup> quarter, topping off a terrific year. **Japan's economic recovery seems to be the real thing**, as a combination of truly effective government reforms and a newfound desire among Japanese consumers to spend has put the country's economy on its strongest footing in years.

**Emerging markets continued their impressive run in the fourth quarter to end the year with a 31.5% gain.** Globally, **small-cap stocks (+10.8%) outpaced large-cap stocks (+6.8%)** during the last three months of the year.

**Nations rich in oil and other natural resources surged in recent months.** This includes a diverse list of countries, such as **Canada (+25%), Brazil (+47%)** and the **Philippines (+27%)**.

### \*Looking Ahead\*

**Even though they topped the market in 2005, foreign stocks don't look to be overvalued. Emerging market nations continue to improve their balance sheets and credit ratings.** The **regulatory and reporting framework of their stock markets is also improving, giving investors more confidence** in these often volatile markets.

**Japan remains a favorite of many investment managers.** Despite more than a decade of economic struggles, **Japan is still the financial leader in Asia.** While smaller "Pacific Tigers" such as **Taiwan, South Korea and Hong Kong** enjoy faster growth, Japan's economy appears to be back on track, and stocks should benefit as a result.

## Summary

Neither the 4<sup>th</sup> quarter nor 2005 offered investors exceptional returns, but given all of the external issues facing the market, from Iraq to Katrina to Fed interest rate hikes, the economy has demonstrated amazing resilience. More challenges lie ahead in 2006, but so do opportunities.

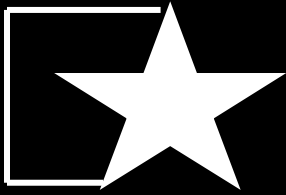
The cycle of short-term interest rate hikes could come to an end if the policies of the Federal Reserve change. Long-term rates may still have a ways to go. Inflation may be the biggest factor in the equation, and what happens there could depend in large part on whether oil prices move up significantly as they did in 2005.

U.S. stocks seem to offer reasonable value given the flat performance of the past year and the fact that earnings are still on the march. Foreign markets may again offer the best opportunities for equity investors in 2006.

As is our practice, we will constantly monitor market conditions, mutual fund performance and new investment opportunities to help keep your portfolio on a smooth path toward a secure financial future.

### **BOB'S CORNER**

Just a quick note to bring your attention to the continued outperformance of our portfolios relative to the risk we are taking. Not only short-term, but long-term numbers show a 1.8 to 5.2% per year better rate of return relative to the beta of the portfolio and the Russell 3000 broad market return. The All Star Financial disciplined process of monitoring the economic cycles and then overlaying the market cycle to give us an idea of what sectors will do well going forward, has given us the opportunity to be there before everyone else is. This is evident by looking at the strong position we took 13 months ago in small cap and emerging international stocks, as well as commodities around the world. These two sectors are now the rage. You were there well before it was cool.



# All Star Quarterly

## How Diversified Are You?

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Bonds 8.95	Small Growth 51.19	Small Value 29.14	Foreign Stocks 32.94	Foreign Stocks 8.06	Large Value 38.36	Large Growth 23.12	Large Value 35.18	Large Growth 38.71	Small Growth 43.09	Small Value 22.83	Small Value 14.02	Bonds 10.27	Small Growth 48.54	Small Value 22.25	Mid Stocks 12.56
Large Growth (0.26)	Mid Stocks 50.10	Large Value 13.81	Small Value 22.84	Large Growth 2.82	S&P 500 37.59	S&P 500 22.95	S&P 500 33.37	S&P 500 28.58	Large Growth 33.16	Mid Stocks 17.51	Bonds 8.42	Small Value (11.43)	Small Value 46.03	Foreign Stocks 20.70	Foreign Stocks 10.87
S&P 500 (3.17)	Small Value 41.70	Mid Stocks 11.91	Large Value 18.12	S&P 500 1.31	Large Growth 37.18	Large Value 21.64	Mid Stocks 32.26	Foreign Stocks 20.33	Foreign Stocks 27.37	Bonds 11.63	Mid Stocks (0.61)	Mid Stocks (14.51)	Foreign Stocks 39.17	Mid Value 16.49	Large Value 7.05
Mid Stocks (5.12)	Large Growth 4.16	Small Growth 7.77	Mid Stocks 13.96	Small Value (1.55)	Small Value 31.04	Small Value 21.37	Small Value 31.78	Mid Stocks 19.12	S&P 500 21.04	Large Value 7.01	Large Value (5.59)	Large Value (15.52)	Mid Stocks 35.61	Large Value 16.49	Large Growth 5.26
Large Value (8.08)	S&P 500 30.55	S&P 500 7.67	Small Growth 13.36	Large Value (1.98)	Mid Stocks 30.94	Mid Stocks 19.20	Large Value 34.49	Large Value 15.63	Mid Stocks 14.72	S&P 500 (9.10)	Small Growth (9.23)	Foreign Stocks (15.66)	Large Value 30.03	Small Growth 14.31	S&P 500 4.88
Small Growth (17.41)	Large Value 24.61	Bonds 7.40	S&P 500 9.99	Small Growth (2.43)	Small Value 25.75	Small Growth 11.26	Small Growth 12.95	Bonds 8.67	Russell 1000 Value 7.35	Foreign Stocks (1.96)	S&P 500 (11.89)	S&P 500 (22.10)	Large Value 29.75	S&P 500 10.88	Small Value 4.71
Small Value (21.77)	Bonds 16.00	Large Growth 9.00	Bonds 9.75	Bonds (2.92)	Bonds 18.48	Foreign Stocks 6.36	Bonds 9.68	Small Growth 1.23	Bonds (0.83)	Large Growth (22.42)	Foreign Stocks (20.42)	Large Growth (27.58)	S&P 500 28.68	Large Growth 6.80	Small Growth 4.15
Foreign Stocks (23.19)	Foreign Stocks 12.49	Foreign Stocks (11.85)	Large Growth 3.80	Mid Stocks (3.57)	Foreign Stocks 11.55	Bonds 3.61	Foreign Stocks 2.06	Small Value (6.45)	Small Value (1.49)	Small Growth (22.43)	Foreign Stocks (21.21)	Small Growth (30.26)	Bonds 4.11	Bonds 4.34	Bonds 2.43

Key: — — — = Foreign stocks; ————— = Large Growth stocks; ••••• = Small Value stocks

This is a question that needs to be addressed not just once every five years or even only once per year, but many times within a calendar year. If you believe in, and model your money management discipline around *Asset Allocation*, like we do at All Star Financial, you need to know that you never want all of your money doing well at the same time because the flip side of that statement would be that all of your money could be losing money. We want some of each. It is called an "Inverse Correlation of Styles," or in other words, complementary styles that help minimize your risk.

As you can see by the chart above, there is a very efficient inverse correlation between Large Growth stocks and Small Value stocks. Over 80% of the time, when one is in favor, the other is out of favor or less favorable. The same can be said between Foreign stocks and Large Cap Growth stocks, with approximately a 70% in favor to out of favor relationship. Rest assured that we are constantly monitoring our allocation to different styles and sectors and reallocating your exposure to give you the statistically best return for your level of risk!

**WHAT IS IN STORE FOR 2006?** Based on the chart, I would bet on a continued resurgence of Large Growth stocks that have underperformed, with the Foreign stocks continuing their dominance based on the growth in emerging markets and Japan's awakening from their economic slumber.

**REMEMBER:** "Do not put all of your eggs in one basket (Value vs. Growth, Large vs. Small) and all of your baskets on the same egg cart (Cash, Bonds, Domestic Equities, International Equities)."

AND

**"It's not how much you make, it's how much you keep."  
Never be afraid to sell high, take chips off the table.**