



All Star Quarterly

Fourth Quarter 2006

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4th Quarter Review

Stocks surge amid signs of a slower economy

Overview

Stock markets across the board ended 2006 on a strong note despite the fact that the U.S. economy continued to show signs of slowing. Two bellwether industries, housing and automobiles, limped through the 4th quarter. But in other parts of the economy, job growth and business investment made up much of the weakness.

2006 ended as the best year for stocks since 2003, with the S&P 500 Index gaining 13.6%, only its second double-digit return of the decade. Corporate earnings held up well in the 4th quarter as most companies report strong balance sheets. The market's surge was driven in large part by booming merger and acquisition activity.

Bond investors spent much of the past six months anticipating the Federal Reserve (the Fed) would trim short-term interest rates. It never happened and by all indications, the Fed is likely to hold the line on rates in the first months of 2007. New Fed chairman Ben Bernanke appears to, at least so far, be successfully engineering a "soft landing" for the economy, keeping the U.S. out of a recession.

Economy

The 4th Quarter

All signs continued to point to a slowing economy. After GDP growth peaked at 5.6% in the 1st quarter, growth slowed to 2.0% in the 3rd quarter (the most recent reported).

The decline in the housing market appeared to be the main culprit causing the slowdown. There were some reasons for optimism however, as existing home sales increased in October and November while the housing supply decreased. These could be signs the housing market has already passed its low point. Manufacturing industries, most notably the automobile sector, were also a drag on the economy in the 4th quarter.

More encouraging was stronger-than-expected consumer spending, which picked up during the quarter and grew at an annual rate of 5.7%. This was propelled, in large part, by solid wage gains (6.3%). Hiring remained strong across all regions and the unemployment rate hovered at a modest 4.5% rate. America's increasing reliance on the service sector benefited the economy in the 4th quarter due to continued growth in that segment. Corporate profits dipped slightly but still came in at a 12% growth rate.

Looking Ahead

The consensus of economist is that the growth will continue to slow, but a recession is likely to be avoided. GDP growth is expected to come in at less than 3%, well below recent years but

BOB'S CORNER

*"IT DOES NOT PAY TO
TAKE MORE RISK."*

As we have now experienced new highs in the DJIA and within spitting range of the S&P 500, we have to remember that the NASD is still only 50% of its original value 7 years ago. All four of our portfolios have outperformed the NASD and S&P 500 the last seven years, and we have done this with as much as 40-100% less risk! "Remember", It is not how much you make, "it's how much you keep". As the market fell in 2000-2002, we kept more and now you have more!

Welcome to our newest employee CPA -Lee Clintsman. If you have not had a chance to speak to Lee yet, I would encourage you to do so. In the short time he has been with us, he has already saved our clients and myself thousands of dollars in tax liability. Many have already refiled going back three years and are now getting Refunds!

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still faster than in Europe and Japan. Job and wage gains appear healthy enough to keep consumer spending at a reasonable level though it may not grow as quickly as 2006. Corporate profit growth could be more modest given the slower economic scenario, but should still manage to stay in the double-digit range. Inflation appears to be less of a concern at outset of 2007.

Whether the Fed becomes comfortable enough with the state of inflation to reduce short-term rates are open question. A key factor may be housing trends. If the downturn is over, the economy may be in a position to pick up steam without help from the Fed. The Fed must balance concerns about economic growth with inflation risks, created in large part now by wage gains and the always looming threat of any energy price spike.

An open issue that could affect the economy is related to mortgage debt. Many adjustable-rate mortgages will come due in 2007, forcing homeowners to seek fixed-rate financing. That could have an impact on consumer spending and possibly on GDP growth.

Stock Market

The 4th Quarter

Stocks roared to a strong close in the last three months of 2006. The Dow Jones Industrial Average reached a new high, topping out above the 12,500 level before closing the year a shade below that mark. On a total return basis, the small-cap Russell 2000 Index led the way for the year with a gain of 18.4%. The most prominent blue chip stocks, represented in the Dow Jones Industrial Average rose 16.3% while the broader S&P 500 gained 15.8%.

Gains in the 4th quarter were strong across the board. Still, small-cap

stocks enjoyed an edge, rising 8.9% compared to 7.7% for mid-caps and 7.1% for large-cap stocks. Microcaps were even more in favor, with a return topping 10% for the quarter. As was the case for much of the year, value stocks enjoyed an edge over growth. Within the Russell 3000, the Value Index gained 8.1% in the 4th quarter, while the Growth Index rose 6.1%. Performance was strong across most sectors, but value-style industries were the market leaders.

Telecommunications, utilities and real estate all posted double-digit gains while returns in traditional growth sectors such as Health and Technology were more modest.

Looking Ahead

The good run stocks enjoyed in 2006 may still have some life left in it.

Even if, as expected, corporate profit growth suffers a modest downturn, stock valuations remain attractive. Based on projected earnings, the price-to-price earnings ratio of the market is at a 15.

By comparison, the P/E ratio in the peak market of 2000 was close to twice as high. By this measure, stocks look attractively valued compared with most other asset classes.

While the Dow set new records in the 4th quarter, the S&P 500 remains below its record high of 1527 reached in March, 2000. The bulls appear determined to see that record broken, unless earnings prove to be a disappointment or the housing market declines in more dramatic fashion, additional gains are a reasonable expectation.

Performance Update

Annualized Returns

Market Index	4th Qtr	1-Year	2-Year	3-Year
DJ Ind. Average	7.30	19.00	10.14	8.51
S&P 500	6.66	15.80	10.20	10.43
Russell 2000	8.55	18.40	9.95	12.24
S&P Mid-Cap 400	6.98	10.32	11.43	13.08
Russell 3000	7.12	15.72	10.81	11.18
MSCI EAFE	10.04	23.47	17.00	17.41
NASDAQ Comp.	6.95	9.52	5.37	6.43
Lehman High-Yield	4.24	11.85	7.19	8.48
Lehman Agg. Bond	1.24	4.33	3.38	3.69
Lehman Credit Idx.	1.34	4.26	3.10	3.81
Lehman Gov. Bond	.84	3.48	3.06	3.20

Boosting the market is a high level of liquidity and a number of private equity firms looking for acquisition opportunities. That should also help propel merger and acquisition activity for much of 2007.

Bond Markets

The 4th Quarter

The bond market continued its unusual ways in the closing months of 2006. The yield curve remained partially inverted (short-term securities paying higher yields than long-term securities). The bond market appeared ready to see the economy slow more dramatically and the Fed to cut interest rates as a result. Neither scenario developed. However credit spreads in the bond market tightened in the 4th quarter, a sign of investor confidence.

Risk-takers were rewarded with emerging market bonds gaining 4.9% and high-yield (junk) bonds climbing 4.0%. By contrast, conservative investors who opted for government bonds funds saw a gain of less than 1.0% during the quarter. An even more conservative option, Treasury Inflation Protected Securities (TIPS) actually declined by 1.2%. Among the "in-between" performers were multi-sector investment grade bonds (up 2.6%), world bonds (up 2.0%) and ultra-short bonds (up 1.23%).

Looking Ahead

The outlook for the bond market remains fairly unpredictable, with much riding on the actions of the Federal reserve. The Fed has held

the line on short-term rates since June (after raising it 17 consecutive times up to that point), but its next move is likely to be toward lowering rates. However, expectations are that this is likely to happen later rather than sooner in 2007. Even with the Fed Funds rate sitting at 5.25%, yields on 10-year Treasuries remain low, ending 2006 at 4.68%.

Government spending and deficits, another concern for the bond market, may be a neutral factor in the incoming year. Although the government is spending at a rapid rate, tax collections appear sufficient to offset most of that spending. A potential concern for the bond market is whether foreign banks, a major buyer of U.S. bonds, will remain as involved in the domestic market in 2007.

International

The 4th Quarter

Gains in overseas markets were even more impressive than those here in the U.S. The MSCI EAFE Index, the primary benchmark for foreign stocks, gained 10.0% and the average foreign stock fund returned 13.1%. Leading the pack were emerging market stocks. As a whole, the group was up 17.9%, but Latin American and Asian (ex-Japan) stocks garnered gains of 22.3% and 21.1% respectively.

2006 proved to be a big year for China's stock market, capped off by a tremendous 4th quarter. Chinese stocks gained 35.7% in the last three months of the year alone, and rose 78.1% for the year. China's economy continues to grow rapidly and rising investor confidence has led to a floor of investment dollars flowing into that country.

Looking Ahead

With economic growth rates at modest levels in most developed nations, the best opportunities overseas are likely to be found in emerging markets once again in 2007. China, India, and other Asian markets along with many in Eastern Europe and Latin America are poised to enjoy another year of impressive growth, estimated to be about twice the rate of growth in developed markets. The trend is likely to continue for some time.

Developed markets in Europe and Asia also should be in a position for another positive year, albeit with less potential than their emerging market counterparts. Even the lagging Japanese market offers attractive valuations and opportunities for a solid return.

The biggest wild card overseas is ongoing geopolitical risks, ranging from the continued conflict in Iraq and other Middle Eastern nations to growing concerns about the direction of Russia's economic system under the increasingly firm hand of President Vladimir Putin.

Summary

Although we went into the 4th quarter with a larger-than-normal tactical cash position, our portfolios performed exceptionally well. We are increasingly confident that the "soft landing" scenario for the U.S. economy will occur, and plan to reposition our portfolios accordingly. Rebalancing the portfolios was delayed until 2007 for tax purposes, to avoid locking in gains on strong-performing assets in 2006. We are excited to bring on board several new "All Star" mutual funds and exchange-traded funds for your portfolio in the new year.



All Star Quarterly

“THE LONG TERM VIEW”



One of the big stories of 2006 was the Dow Jones Industrial Average breaking through to record levels. The broad-based S&P 500 Index is within 6 to 8 percentage points of its record level almost 7 years ago as well. Since the “tech bubble” burst in March 2000, market leadership has belonged to small cap and value-oriented stocks. Large cap growth stocks, such as those represented in the NASDAQ 100 Index (QQQQ) have lagged the broader markets. The NASDAQ 100 is only 50% its 2000 price level.

We thought it might be informative to look at a few of the top NASDAQ 100 Stocks and see how they compare financially to their “bubble” days. We found that all are very profitable, with exceptional growth rates, and selling at roughly half the valuation levels of 2000.

Company	2000 Sales	2000 Earnings	2000 P/E	2006 Sales	2006 Earnings	2006 P/E
Microsoft	22,956	9,421	54x	44,282	12,599	22x
Qualcomm	7,983	786	120x	19,315	1,989	31x
Google	19	-15	NA	6,139	1,465	56x

(millions)

Microsoft sales have more than doubled since 2000 and they are launching new versions of their flagship products in 2007. The cell phones that Qualcomm supplies are now more common than land-based phone lines. Google was a small start-up in 2000, and now it is the leading innovator on the Internet with billions of revenues and profits, as well as being a verb.

No wonder 77% of Investment Managers surveyed by Russell Investment Group are bullish on large growth stocks for 2007. The U.S. economy is becoming more service and technology-based and 2007 could be the year these stocks retake market leadership.