

The Advantage Advisor

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Market Commentary:

Over the past couple of months, I have pointed out that the rate of increase in the S&P-500 stock index was not sustainable, and that some sort of slowdown or correction was likely to occur. Little did I realize that a large part of that correction would occur in a single day! While the market drop on February 27th was unsettling, it was in reality a healthy release of pressures.

Let me take a step back for a moment and try to put things into perspective. The drop that we have just witnessed, while frightening and emotional, was not by any means a crash. Nor is it likely even to be the beginning of a bear market. The fundamental underpinnings for the market and the economy remain solid, and nothing in our forecast has changed.

In terms of magnitude, the current decline is not at all out of the ordinary. There were, as is usually the case, comparisons by the news media to the drop that the Dow Jones Industrials experienced back in 1987. This was amplified by the fact that the drop, at least on an intraday basis, was similar in terms of total points lost. However, in terms of percentage losses, the Dow dropped approximately 23% in 1987. That would equate to a drop of more than 2,800 points for the Dow Industrials in today's market.

The selling at the end of February began as the Chinese markets dropped 9% in value overnight. The selling then spread through Europe, causing declines of around 5% across the continent. Finally, the US markets joined in the selling, with the Dow dropping by 3.5% on the day. There were actually several computer glitches that occurred on the exchanges that added to the anxiety, but in the

Market Statistics for February

<u>Market Index</u>	<u>Closing Price</u>	<u>% Change</u>
Dow Jones Industrial Average	12,269	-1.56%
S&P-500 Stock Index	1,407	-0.81%
Russell 2000 Stock Index	793	0.72%
Shearson Treasury Bond Index	14,191	2.63%
Dow Jones World Stock Index	278	0.71%
Nasdaq Composite Index	2,416	0.04%

end the systems did return to normal.

One of the catalysts for the selling was a speech given by former Fed Chairman Alan Greenspan in which expressed concern that the US was heading toward a recession. This was in direct contradiction with statements made by the current Fed board that stated they believed the economy would slow somewhat but remain well on track. Later, Greenspan did back away from that statement and said there was a possibility of recession, but that it was not probable. His most recent statement is that there is around a 1/3 probability of recession. It is also interesting to note that he bases his observation mainly on the length of the current expansion rather than any observable economic evidence.

The vast majority of the cash that came out of stocks was invested directly into US Treasuries as investors sought a safe haven. That activity drove Treasury prices up substantially, driving interest rates down at the same time. The Treasury market will be a good indicator of when the market believes the correction to be over, as all of that money will come back out of the treasury markets to be reinvested in stocks.

I believe the chart of the **S&P-500 Stock Index** on page three will also help to keep things in

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The Economic Picture

As I mentioned in the Market Commentary section, even in spite of the recent market drop, nothing has changed in terms of our economic forecast. In fact, even while the financial markets were dropping, we were getting very good economic news. There was actually quite a bit of economic news released in February, so let me address things one a time as we look at the table to the right.

GDP growth was revised down from last month's 3.5% rate to a much more moderate 2.2%. This was an expected revision and in fact lines up with the Fed's projection of a slow growth that will bring inflationary pressures under control. The Employment Cost Index came in lower even in spite of gains in personal income. This is due largely to continuing gains in worker productivity and to a slowing of the rate of increase for benefits costs. Capacity Utilization rates also backed off a bit, confirming that the rate of growth has moderated, but not turned negative.

On the inflation front, the Consumer Price Index (CPI) cooled to a 0.2% monthly rate of in-

Current Economic Position: Stage 3—Growth

Economic Indicators

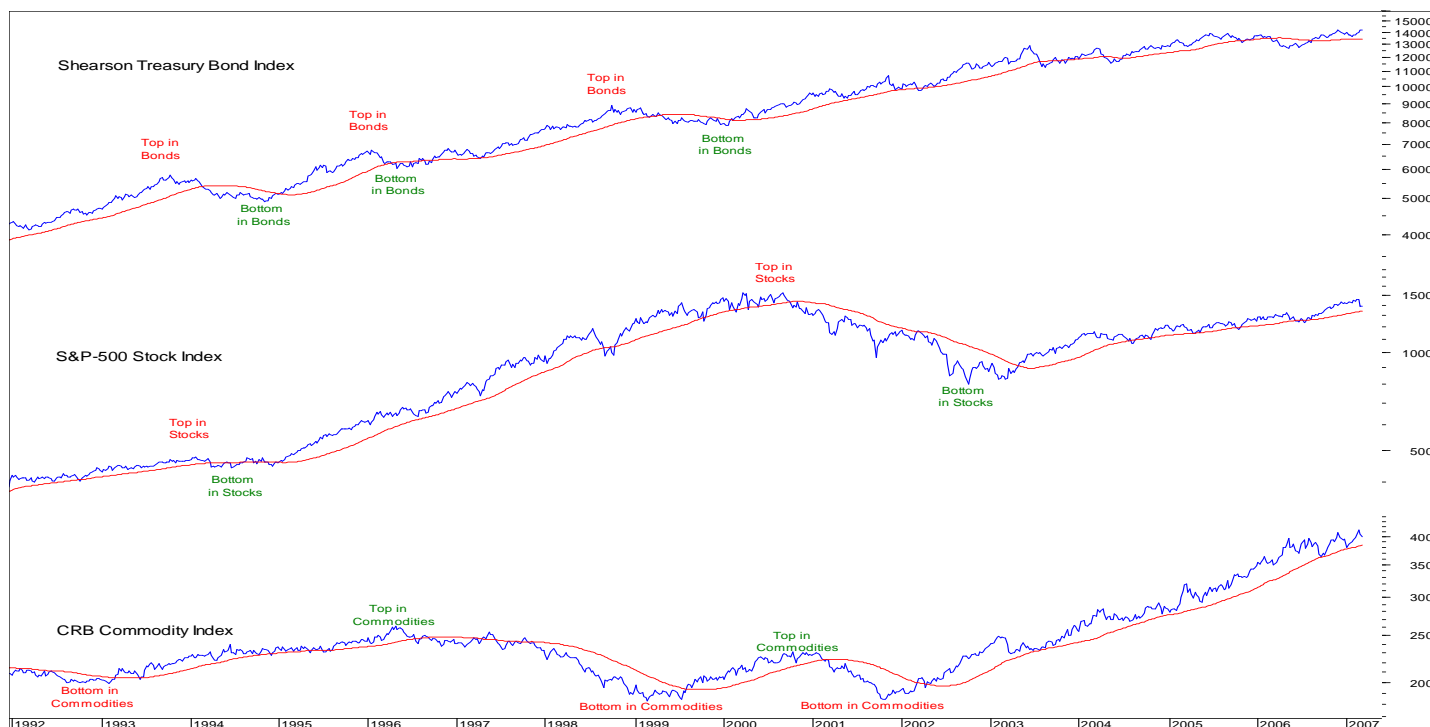
Growth	Latest	Prior
GDP	+2.2%↓	+2.0%
Productivity	+1.6%↓	-0.5%↓
Employment Cost Index	+0.8%	+1.0%
Capacity Utilization	81.2%	81.8%
Inflation		
Consumer Price Index	+0.2%	+0.4%↓
PCE Deflator	+0.2%	+0.3%↓
Implicit Price Deflator (GDP)	+1.6%↑	+1.9%
Sentiment		
Consumer Confidence Index	112.5	110.2↓
Unemployment Rate	+4.6%	+4.5%
Personal Income	+1.0%	+0.5%

↑=revised up, ↓=revised down

Source: Moody's Economy.com

crease even as the prior month's rate was revised downward. The PCE Deflator saw the same type of action as it slowed to a 0.2% monthly rate of increase. In both cases that corresponds to a 2.4% annual rate of increase, which remains at the high end of the Fed's comfort zone. Also on a positive note for inflation, the 5 year TIPS spread, which is a measure of the expected inflation rate, also ended the month at 2.4%. This is significantly lower than

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Source for Data: Investor's Fast Track

(Market Commentary, Continued from page 1)

perspective. You will note that there is a channel that is drawn on this chart which is bounded by blue lines and has a black line at the center. This regression channel is formed using historical prices and provides a 'normalized' range within which we can expect prices to remain while the uptrend continues. As you can see, we have indeed seen a sizable drop in prices, but it remains well within the channel, and still well above the bottom boundary. You should also note that the

(The Economic Picture, Continued from page 2)

where it was 12 months ago at 2.7%.

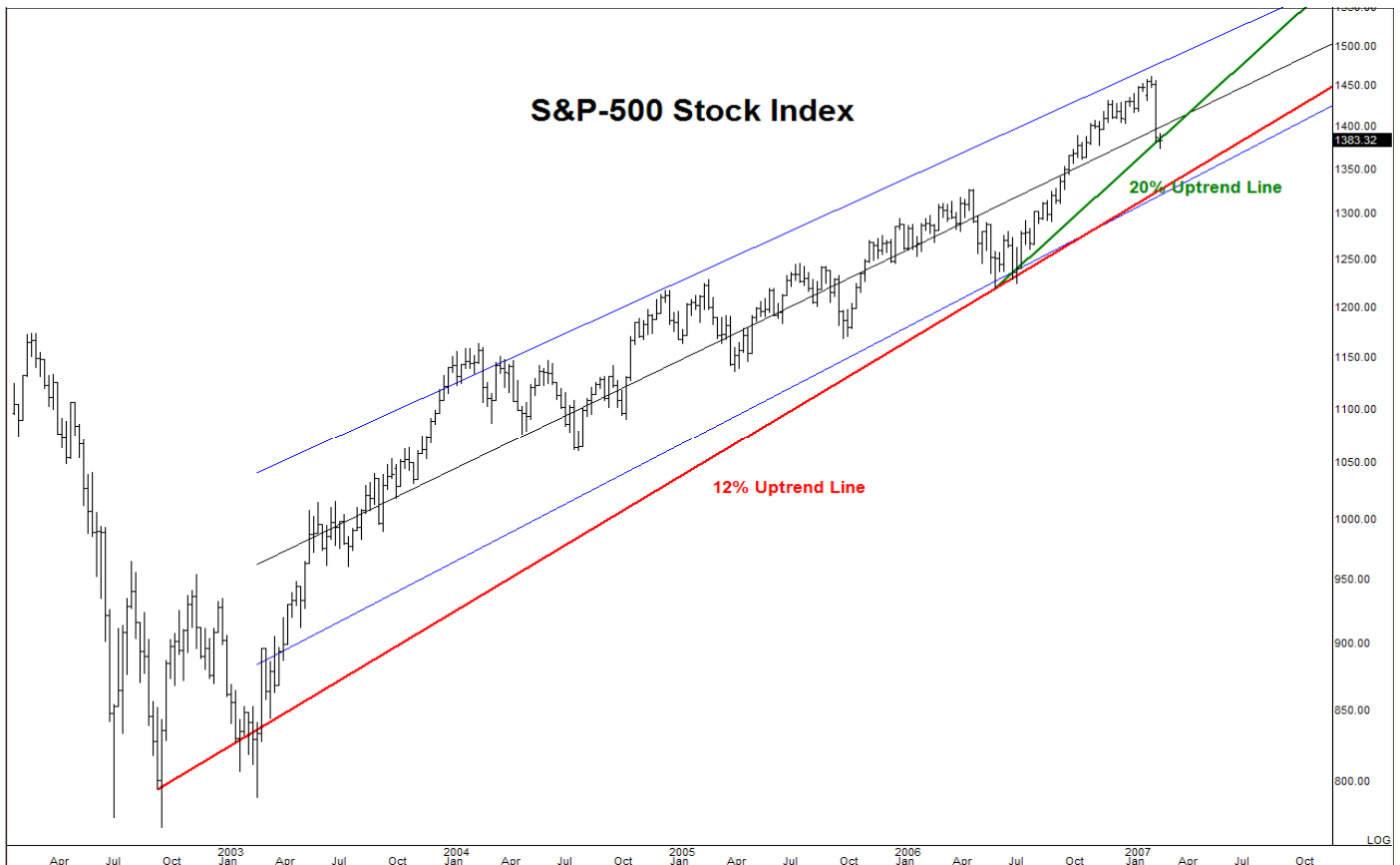
One of the most positive reports, which ironically was released on the 27th as the markets dropped, was the Consumer Confidence Index. This indicator posted a significant gain, climbing to 112.5 from the previous 110.3 level. Also on the sentiment front, personal incomes grew by a full 1.0% in January.

While there remain some weak spots in

recent uptrend line (shown in green) has slowed considerably from the 36% uptrend rate that we saw at the beginning of the year. The long-term 12% uptrend line (shown in red) is still intact, and should provide solid support, though I don't expect that we will touch that line with this pullback. Even if we did, it is comforting to note that the S&P-500 would still be higher than the previous peak seen last May. So, while the current pullback is not pleasant, it certainly is not disastrous.

As far as specific sectors are concerned, some are weathering the fallout better than others. As of the date of this writing, technology shares, as represented by the NASDAQ Composite Index, was down more than 7% from their highs, as was the NASDAQ Financial Index. Commodities prices also fell, pushing shares of gold mining companies down by almost 11.5%. The S&P-500 index was down 4.75% from its high as well.

On a relative value basis, the S&P-500 is actually fairly cheap. The median P/E ratio for the S&P-500 now stands at around 15 times projected



**Mutual Fund Expenses and Performance:
Picking a mutual fund by the lowest expense ratio is not a good primary consideration**

<u>Fund Name</u>	<u>Morningstar Fund Style</u>	<u>Expense Ratio</u>	<u>3yr Annualized Return*</u>	<u>5yr Annualized Return*</u>
Vanguard LifeStrategy Growth Fund	Large Cap Blend	0.26%	13.26%	9.09%
Columbia Strategic Investor - Z Shares	Large Cap Blend	0.99%	14.78%	14.61%
Franklin Mutual Qualified - A shares	Large Cap Blend	1.17%	17.11%	11.40%
Gabelli Asset Fund	Large Cap Blend	1.38%	15.76%	10.92%
S&P-500 Stock Index	N/A	0.00%	10.28%	5.12%

* Returns as of 9/30/2006

All of the above mutual funds invest in the same style – Large Cap Blend. Every one of these funds also outperformed the S&P-500 by a substantial margin in both the 3yr and 5yr periods. However, they all have very different expense ratios. The lowest of these expense ratios (0.26%) belongs to the Vanguard LifeStrategy Growth Fund. The highest ratio (1.38%) belongs to the Gabelli Asset Fund.

Advocates of low-cost investing would recommend picking a mutual fund based on the lowest expense ratio. In this case, that would be the Vanguard Fund. The idea is that lower mutual fund expenses allow more of the return generated by the fund to be passed on to the investor. However, the 5yr annualized return for that fund was only 9.09% while the return for the Gabelli fund was 10.92%. The Gabelli fund, even with its higher expense ratio outperformed the low cost fund by 1.83% per year. That means at the end of five years, the Gabelli fund was ahead of the Vanguard fund by 9.49% - more than one extra year of return for the Vanguard fund!

It is very interesting to note that neither of those funds were actually the best performer for the periods shown. It was actually the Columbia Strategic Investor fund that turned in the best 5yr performance. On a 3yr basis, it was the Franklin Mutual Qualified fund that ranked at the top. This demonstrates that while lower fund expenses are attractive in theory, in practice they are not good criteria to judge the performance of a mutual fund. In fact, in this limited example, the lowest cost fund finished in last place during both time periods. The fund selection criteria that Advantage Investing uses are summarized below:

Mutual Fund Selection Criteria:

- ◆ Sector/Style - What is the appropriate fund for the economic environment or sector?
- ◆ Risk/Reward - What is the cost in terms of risk or volatility for the returns generated by the fund?
- ◆ Relative Fund Performance - Are the current managers doing well compared to their peers?
- ◆ Tradability - What are the costs involved in trading as well as other restrictions?
- ◆ Fund Performance - What was the performance of the fund during the most recent similar economic stage?

*Note: Past Performance of any mutual fund cannot guarantee future results. Returns are as of 9/30/02006.
Sources: Investor's Fast Track, Morningstar Mutual Funds, and fund company prospectuses.*