

March 20, 2006

*“Everything that can be counted does not necessarily count; everything that counts cannot necessarily be counted.”*

*-Albert Einstein-*

Dear Friends of AAM,

Former President George H.W. Bush was invited to speak at the recent six-hour funeral ceremony of Coretta Scott King. At one point during his remarks, the senior Bush looked particularly startled. It was obvious something was awry. He composed himself, smiled and remarked, “It may be your lucky day. I’ve lost a page.”

We’ve noticed after almost fifteen years and thirty client letters that some of you appreciate brevity, while others go to great lengths to look for hidden messages along the lines of “I buried Paul” in your Advisor’s semi-annual missive. Given the availability of historical client letters at [www.alterasset.com](http://www.alterasset.com), and the realization that we’ve started to get repetitive every now and then, the 2005 year-end letter will largely report on the past year and our expectations for the coming year 2006 (towards that aim, it gives us a marginal edge when we write our letter approximately two and half months in to the “coming year.”)

In the second half of 2006, your Advisor will publish an *AAM Capital Allocation Handbook*. The handbook will contain highlights and important messages culled from client letters dating back to the early 1990’s. Some important themes have stood up well over the passage of time. For example:

- An investment program must be undertaken with a margin of safety.
- Shares of stock in public companies represent partial ownership in businesses.
- Since most shareholders do not have day-to-day operational control, it is important to identify management teams that have a track record of creating shareholder value.

We’ll refrain further from our future discourse on the past and recalibrate the focus to our present discussion of yesterday and tomorrow.

*“History is the science of what never happens twice.”*

*-Paul Vallery-*

## **BACK TO THE PAST**

Two thousand and five was a below trend period for U.S. equities and fixed income securities. It was a superior year for commodities and foreign equities. The year also marked the beginning of a visible softening in the residential real estate market.

Although we focus on bottom-up security selection, there is significant value in reviewing the investment world from a macro perspective. This top-down view can help us better understand how markets moved in 2005 and provide us with insight into 2006. We highlight five macro considerations below:

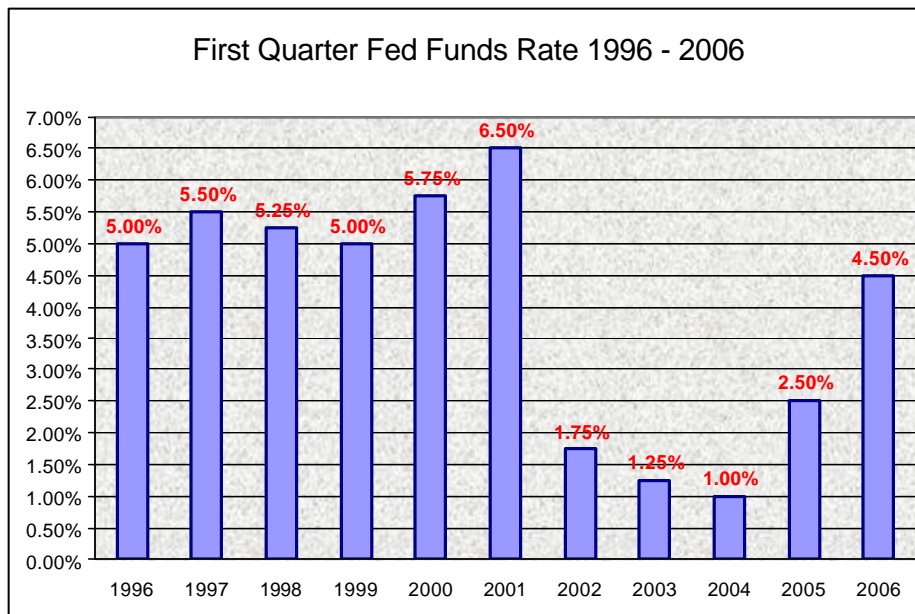
- 1) **Federal Reserve Policy** - Is monetary policy accommodating, restrictive or neutral?
- 2) **Momentum** - The market for investments is different from most other markets. Momentum investing is often the path of least resistance because people covet items in the investment market only after these items have gone up in price. Conversely, people shun investments that have gone down in price. This leads to markets where prices differ significantly from the underlying assets value.
- 3) **The Relative Value of Each Asset Class** - U.S. Equities are trading at fifteen times their earnings for 2007 and long-term interest rates sit at 4.7%. The Fed Model, which we have highlighted on several occasions, is flashing a substantive undervaluation in equities vs. bonds.
- 4) **Geopolitical Risk** - To what degree should the war in Iraq and the saber rattling from Iran affect your investment portfolio?
- 5) **Headline Risk** - How many jobs were created this month? Did the core rate of inflation move up? Will Congress stay Republican or shift to the Democrats in 2008—see pandemic. (We actually win twice with a line like that because supporters of both parties believe our reference is to the ENEMY.)

## **THE TALKING FEDS**

As highlighted in some detail in the 2005 mid-year letter, the current level and anticipated directional change in interest rates can portend asset class performance. The Federal Reserve at their January 31, 2006 meeting raised the Fed Funds rate, the often quoted interest rate that banks charge to lend each other money, to 4.50%.

## **THE TALKING FEDS CONTINUED**

The table that follows highlights the Fed Funds Rate from 1996 to 2006 during the first quarter of the year:



Last month, Ben Bernanke gave his first public speech as the new Chairman of the Federal Reserve. He devoted his entire speech to the importance of price stability (read: low inflation). Based on his talk, we can anticipate that the Fed under Bernanke's leadership will continue its effort to reverse an overly accommodating monetary stance that was initiated under Greenspan after the events on 9/11.

It is your Advisor's view that the Federal Reserve will raise the Fed Funds rate by an additional ½% to ¾% before the fall of 2006. This will complete a three-year tightening cycle that brings rates up to level last experienced in 2001. Higher interest rates have cooled the housing market and bond market – two asset classes that are primary beneficiaries of falling interest rates.

*"The stupid neither forgive nor forget; the naive forgive and forget; the wise forgive but do not forget."*  
- Thomas Szahsz-

## **TRENTON MAKES.....**

The momentum driven approach to capital allocation has not gone hungry as a result of the proliferation of hedge funds. The working mantra in the hedge fund community during 2005 was, "Get short anything that China makes and get long anything that China takes." For those of you local to World Headquarters, your Advisor suspected that someone probably came up with this thought while traveling Route 1, through Trenton, on their way to Philadelphia or New York. (There is clear symbolism tied into the central thesis of momentum investing here: borrow someone's ideas and then believe you are smart enough to take a profit before they do.)

## **TRENTON MAKES CONTINUED**

A great momentum theme in 2005 was natural gas. In 14 weeks it increased in price by 40%. Over the next 12 weeks, natural gas declined by 60%. The capacity to supply natural gas didn't change very much in 12 weeks (insert your own joke) and the intermediate term level of demand didn't budge. But somebody noticed the price was going up in mid September of 2005, he told two friends, and they told two friends, and so on. The person who top ticked natural gas on advice from a buddy, or an article in *The New York Times*, is still waiting for the bell to ring signaling it's time to sell.

Momentum stories always have varying degrees of logical appeal. Oil is going to \$200 a barrel because of world demand, geopolitical risk, and the inability to create more of it than there is in the ground (similar to they aren't building any more ocean front property). When one takes a bit of emotion and some logic, and mixes them together, the price for the potion is generally quite high.

Economic models and momentum arguments seem to regularly underestimate or disregard the adaptability of the human condition. People can stop driving Hummers down Main Street, USA, they'll let the house get two degrees colder in the winter, and the Government will develop a cohesive energy policy for the United States. (In the words of singer Meatloaf, "Now don't be sad, 'cause two out of three ain't bad.")

*"He had discovered a great law of human action, without knowing it - namely, that in order to make a man or boy covet a thing, it is only necessary to make the thing difficult to obtain."*

-Mark Twain-

## **YOU CAN PICK YOUR RELATIVES**

Markets in the short-term are voting machines driven by fear and greed. Over the long-term, they are weighing machines that are forced into balance with the rest of the universe. Day-to-day, there appears to be minimal regard for the relative value of markets. It seems to sneak up on us like the growth of a child.

- Why does a closed-end mutual fund like Boulder Total Return sell at discount to its net asset value when it beats the S&P 500 net of fees for five years running? At the same time, an exchange traded fund that simply tracks the S&P 500 (SPY) can sell at a slight premium to its underlying assets at a given moment.
- Why have richly valued small-cap stocks outperformed their large-cap brethren for the past six years? Small-caps now sport a forward PE of 26 compared to 15 for large-caps.
- Why does a company like Berkshire Hathaway sell at its most modest valuation in a decade when much of the company's capital is invested in sectors that have experienced strong growth such as energy, auto insurance, aviation and home building?

Our belief is that:

- Markets do arbitrage over time.
- Since we can't define "time", the price one is paying today for an asset must offer enough of a discount that waiting 3 to 5 years for a financial return is acceptable. It must have a margin of safety.

In your advisor's view, the secret of generating reasonable return is to make decisions with high probability outcomes. Although this makes intuitive sense, a number of investors prefer making lots of decisions with outcomes that they cannot handicap.

We see a number of valuation imbalances from our perch:

- The dollar is relatively expensive vs. the yen.
- Small cap stocks are expensive vs. large-cap stocks.
- Bonds are expensive vs. large-cap dividend paying stocks
- Long-term bonds are expensive vs. short term bonds.
- Oil stocks are expensive vs. pharmaceutical stocks.

The exercise of assessing long term relative value helps your Advisor understand where long-term opportunity exists.

**GEOPOLITICAL RISK**

*"Nearly all men can stand adversity, but if you want to test a man's character, give him power."*  
-Abraham Lincoln-

The potential for death and destruction creates a feeling of emotional helplessness. To retake control, we invest in oil at \$72 a barrel and gold at \$580 an ounce, abandoning fundamentals in exchange for a security blanket without insulation. The probability of violence, terrorism, or a war that materially impacts the interests of a free society is the type of low frequency high severity event that often leads one on to a tangential investment track that stops at the wrong station.

The desire for religious power, economic power, and just plain staying in power, has driven military conflict since the beginning of time.

That said, we believe investing like the world is coming to an end compromises the long-term viability of an investor's financial planning and, dare it be said, will lead to a disastrous outcome.

*"There are two ways to slide easily through life: to believe anything or to doubt everything; both ways save us from thinking."*  
-Alfred Korzybski-

## **HEADLINE RISK**

Back before CNN, CNBC, FOX and their 24-hour information cycle, we got our news from Rather, Jennings and Brokaw in the 30 minutes following our family dinner. Generally, when you have 30 minutes to discuss everything that happened in the world in the last 24 hours, a producer will tend to stick to the material items. When you have to fill 4,700% more time, small things get placed under a microscope and take on super-sized levels of significance. This can generate opportunities as people have a tendency to overreact to the news without performing their own independent research.

For example, the monthly jobs report is a highly anticipated data set released on the first Friday of each month by the U.S. Government. It is analyzed, picked over, and can move the entire market by hundreds of points as measured by the Dow Jones Industrials.

## **THE GREENING OF IT ALL**

As value investors, we seek to ride the tail-wind of relative value and monetary policy. We try to stay out of the way of momentum, and we hope to favorably leverage the emotions created by geopolitical and headline risk.

The 2005 performance of the major asset classes and our view of 2006 opportunities are highlighted in the remainder of this letter.

**Cash** - Money market instruments began 2005 yielding 1.5%. The Federal Reserve's tightening campaign has lifted taxable money market returns to over 4.0%. The current rate approximates recent history and is competitive with other asset classes. We believe continued Fed tightening will bring money market rates to 5% in 2006.

**Long-Term Government Bonds** - Long-term bonds with maturities of greater than ten years generated total returns of approximately 2.0% in 2005. As the Federal Reserve tightened, long-term bond prices declined bringing up yields slightly from the beginning of the year. Similar to 2005, we anticipate that the Long-Term Government Bond will not earn its coupon (currently 4.7%) as bond prices decline in the first half of 2006.

Corporate Bond holders may fair even worse as deal-hungry private equity firms employ debt to buyout cash flow generating businesses. These deals generally diminish the status of existing bondholders and weaken the corporate balance sheet.

**Real Estate** - The vigor of the residential real estate market began to dissipate in most areas of the country during the second half of 2005. The momentum buyer (flipper) and the effects of monetary policy on those home seekers looking to use adjustable rate mortgages (ARMs) softened demand for residential home purchases. During a period of decelerating demand, supply as measured by housing starts jumped by 12% year over year in January of 2006.

Despite the observable slowdown in the real estate market, there is still a lot of confidence in real estate. In a recently poll, only 15% of respondents believed that housing prices could fall over the next six months. This while the relative value of a new home, the price to rent ratio (the purchase price of a home vs. the rent it could generate in year), is at its highest point in years. We believe nationally that home prices will decline modestly in 2006.

**Hard Assets** - Hard assets are the most difficult to handicap because they do not produce cash flows. The momentum in gold, which climbed 17% in 2005, continued in the first quarter of 2006 with appreciation of an additional 7% through March 14<sup>th</sup>. We believe the climb in gold is likely to dissipate during the second quarter of 2006 as the Fed makes two more moves to increase short-term interest rates. In an environment of moderate inflation, the carrying cost of Gold (remember it pays no interest or dividends) will curb the momentum and overrun the headline and geopolitical risk that brought a shine to the yellow metal.

The future price of oil remains near the top of the cocktail party banter list. Supply continues to outstrip demand, but prices remain high because of external concerns. Speculators are already placing their bets on the 2006 hurricane season. There is the daily chatter out of the Middle East from Iran that they will choke off the oil supply like angry cobras in an alley, or something like that. With all of the momentum, headline risk, and geopolitical risk baked into the price of oil, it seems to already reflect the best case scenario for those who are long on crude.

**Common Stocks** - Foreign equities outpaced their U.S. brethren by a dramatic margin. We know this because many of our friends who sold all of their foreign stocks in the late 1990s when foreign stocks were weak were looking to get back in. The cost of reentry was 40% higher than the day they declared France and Germany to be devoid of any future economic opportunity.

Japan though was the real shining star in the international arena. Trading at reasonable relative valuations and characterized by absolute prices at half their level of 1989, the Land of the Rising Sun stands to benefit from the build out of China and India. Over the last two years, your Advisor has been generating exposure to Japanese securities and the opportunity remains meaningful to us over the next 3 to 5 years.

During the last six years, small capitalization stocks have outperformed their large capitalization counterparts. Now it appears as though the relative value of large vs. small companies has shifted in favor of the former.

We believe that 2006 will be a positive year for large capitalization equities as relative valuation and tighter monetary policy shifts investor sentiment. When the Fed tightens investors generally seek the perceived safety and liquidity of hefty businesses. In addition, massive amounts of capital on the sidelines in private equity and leveraged buyout pools augurs well for businesses with market capitalization in excess of \$5 billion.

*"Musicians don't retire; they stop when there's no more music in them."  
-Louis Armstrong-*

## **IN CONCLUSION**

It has been a wonderful fifteen years for your Advisor and we still feel the beat every morning. A number of our clients have been with us since the beginning. The start was in Forrestal Village, when our friend Pat K. came walking into the 50 square foot cubicle that was World Headquarters to ask, "What do you do in here with that satellite?"

As exciting as the growth of our business has been and continues to be, getting to know each of our client families, sharing triumphs and tragedies together, has provided texture to the passage of time. It keeps the flame burning bright, embedding us with an optimism that the next fifteen years will be even better than those that have passed.

Your Advisor is pleased to welcome Janice ("I am not Janet") Puccio as our Operations Associate. Janice has a B.S. in Business Administration from Rider College and twenty years of professional experience, including seventeen at a Berkshire Hathaway subsidiary. In a short period of time, Janice has made a significant impact. Her combination of intelligence, common sense, and a client service orientation are impressive. We hope you have the opportunity to meet her soon.

The 2006 Mid Year Report will be available in early August. We will be piloting our *Report by Email Program* at mid year under the direction of Michael Mancino. Your Advisor will have the capability to send your entire report by email as an Adobe PDF file and provide it to you several weeks earlier than the paper copy. If the pilot works as planned, we'll be offering it across our client base by year end.

In the interim, we look forward to speaking with you and visiting during the year. A copy of our Form ADV II is included along with AAM's privacy policy.

Best Wishes,



Howard



Steve



George