



# All Star Quarterly

First Quarter 2006

Volume 12 Issue 1

## 1st Quarter Review & Preview

### A Strong Start for Investors in 2006

#### Overview

Amid an **environment of mixed signals**, investors generally benefited from the direction of the markets in the 1st quarter. Fueled by positive news on the corporate earnings front, the **broad stock market gained more than 5%** in the first three months. Returns were **even stronger** in most **foreign markets**, while **bonds** were able to **hold their ground** for most of the quarter **until interest rates spiked** at the end of March.

Many of the **non-market stories** that impact the markets were the same issues talked about in 2005. The **Federal Reserve continued to raise interest rates**, boosting the Fed Funds target rate to 4.75% on March 28. By all indications, the latest Fed action, its **15th increase of 0.25%** dating back to **June 2004**, won't be the last. Another theme, **double-digit increases in corporate earnings**, occurred again in the first quarter with signs of more positive growth ahead. Finally, **small-cap stocks and foreign markets continued to play leadership roles in the market.**

Investors benefited as the U.S. economy continued moving forward. Even with concerns such as a possible **bubble in housing prices**, persistent fears of **energy-induced inflation** and record **budget and trade deficits**, the economy held its ground. But some **caution is advised going forward**, as **rising interest rates** and the possible **slowing of corporate profit growth** could dampen the **intermediate-term outlook for stocks.**

#### Economy

##### \*The 1st Quarter\*

While final data on the 4th quarter of 2005 showed Gross Domestic Product (GDP) growth of just 1.7%, signs for 1st quarter GDP numbers (not yet released at this writing) were more positive. Based on supporting data already available, **1st quarter growth could reach an annualized rate of 5%.** **Unemployment has dropped to 4.8%** and **capacity utilization**, a solid sign of economic strength, has held at **more than 80% for four consecutive months.**

Although oil prices continued to climb, the annualized **inflation rate** in February remained a **reasonable 3.6%.** **The core inflation rate (excluding food and energy costs)** was an even more encouraging **2.0% on an annualized basis.**

Another boon to the economy can be found in healthy balance sheets. **Corporations are benefiting from three years of solid profit growth.** **Personal balance sheets have improved** thanks to the boom in **housing prices** that boosted equity for many homeowners. **Both factors are helping to bolster business and consumer spending and should sustain moderate economic expansion going forward.**

##### \*Looking Ahead\*

To quote Jack Nicholson from the movie that borrowed part of the phrase for its title, **"What if this is as good as it gets?"** While **strong GDP growth is anticipated in the first quarter**, **slower growth is forecast for the rest of the year.** Wage growth could result from

the current strong employment situation, but the positive impact of that may be offset by a resulting **decline in housing values if the real estate bubble pops**, as many fear.

**The best hope is that if over-extended consumers are unable to boost the economy, business spending will make up the difference and continue to keep the nation out of a recession.** **Corporate profits could also continue to surprise to the upside in the first half of the year.**

#### BOB'S CORNER

**Not to brag**, but over the last 12 months our growth portfolio falls in the **top 3%** of all managers in our category. For the last three and five years, our numbers place us in the **top 13th and 8th** amongst our peers. The amazing part of this is that we are performing to this level after fees and with a risk that is, on average, **20% less aggressive than our peer group!**

Remember to **brag** about us to **your friends.** **Referrals** are our lifeblood and you get the **benefit of reduced fees!!**

**Thank you**, again, for your continued **trust** in the **All Star Financial Team.**

#### 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

## Stock Market

### \*The 1st Quarter\*

The **stock market** enjoyed strength virtually **across the board** in the opening three months of 2006, achieving its best start in years. The **Standard & Poor's 500** (+4.28%) logged its **best first quarter since 1999** and the **NASDAQ Composite Index** (+6.10%) its **best since 2000**. As they did in 2005, **small-cap stocks** continued to dominate the market, up (+13.9%) for the period. **Mid-cap stocks** gained (+7.4%) while **large-cap stocks** trailed with a still respectable increase of (+4.4%). The broad measure of the entire stock market, the **Russell 3000**, was up (+5.3%) for the quarter.

Among sectors of the market, strong demand for platinum, gold and silver drove **precious metals stocks** (+21%). **REITS** (+14%) were also strong on the heels of their solid returns in 2005. Telecommunication stocks also outpaced other sectors thanks in large part to merger activity involving AT&T and Bell South.

The **recent trend** of healthy returns in the stock market can be **attributed** in large part to growth in **corporate profits**. **Earnings were up 21% in the past year** and corporate profits now represent their highest percentage of the national income in four decades. In the 4th quarter of 2005, before-tax profits made up 11.6% of the national income, the largest share since 1966.

### \*Looking Ahead\*

Even with the strong start to the year, a recent poll of investment managers indicates most think that the rally could continue. **70% of managers** polled by the Russell Investment Manager Outlook are

**bullish about large-cap growth stocks**. Only 8% see the market as **overvalued** and on average, they still forecast an earnings growth rate of 12.8%.

**Early indications** are that the managers are right to be **bullish** about corporate profits. **1st quarter earnings reports** begin coming out in April and very few disappointments are expected. From a sector perspective, the managers appear to be most bullish about healthcare and technology stocks.

**There are some notes of caution; however, as 35% of the managers polled said they were bullish on cash**, indicating their limited expectations for stocks. **Beyond the near term, the outlook is a bit fuzzier**. The **economic recovery is getting long**

**in the tooth** and many forecasters expected the growth rate in both the **GDP** and **corporate earnings** to begin leveling off after the **2nd quarter**.

**Stock investors** will also be **closely watching the Federal Reserve**. If the Fed appears to be too aggressive in raising short-term interest rates, it **could dampen the enthusiasm** that exists in the **markets**.

## Bond Markets

### \*The 1st Quarter\*

**Bond markets** continued to face the consequences of the **Federal Reserve's two interest rate hikes in the 1st quarter**. In the final

## Performance Update

### Annualized Returns

Market Index	1st Qtr	1-Year	2-Year	3-Year
DJ Ind. Average	4.37	8.12	6.03	14.21
S&P 500	4.28	11.75	9.16	17.19
Russell 2000	13.65	24.40	13.85	28.01
S&P Mid-Cap 400	7.63	21.62	15.89	26.02
<b>Russell 3000</b>	<b>5.31</b>	<b>14.28</b>	<b>10.62</b>	<b>19.12</b>
MSCI EAFE	8.78	22.14	17.42	27.24
NASDAQ Comp.	6.10	17.03	8.32	20.36
Lehman High-Yield	2.89	7.43	7.13	12.06
Lehman Agg. Bond	-.65	2.26	1.70	2.92
Lehman Credit Idx.	-1.17	1.83	1.33	3.70
Lehman Gov. Bond	-.91	2.14	1.12	2.15

Federal Open Market Committee meeting chaired by Alan Greenspan (in January) and the first led by new chairman Ben Bernanke (in late March), the **Fed Funds rate was bumped from 4.25% to 4.75%**. What's more, Bernanke made it clear that due to inflationary concerns, the Fed was likely to **boost rates even further** in the months to come.

**Government bonds** took the **brunt of the damage** in reaction to these developments. Long government bonds declined **(-3.5%)** while Treasury Inflation Protected Securities (TIPS) **lost (-2.2%)**.

The broader bond market, as measured by, the **Lehman Aggregate Bond Index**, actually fared better, gaining **(+1.3%)**. Risk was rewarded during the quarter as **high-yield corporate** bonds gained **(+2.6%)** and **emerging market bonds** jumped **(+2.4%)**. Many issuers in emerging markets saw their credit quality upgraded, aided by the fact that oil-exporting nations were able to redeem bonds ahead of their maturity date. That was a far cry from the default-ridden era experienced by emerging market bond investors in the 1980s.

With short-term yields becoming more attractive to investors, ultra-short bonds gained 0.9% and money flowed into that segment of the market. Global bonds were flat for the period as currency fluctuations were minimal.

#### **\*Looking Ahead\***

**Given the Fed's stance on interest rates, expectations are muted for the bond market in the near term.** It appears the era of low interest rates around the globe is quickly passing as the Fed is not alone. **Central banks in Europe and Japan are also beginning to boost interest rates, which may pressure the Fed to continue to do the same.**

With interest rates moving **up overseas, U.S. debt** securities may become **less attractive**, and as a **result, the dollar could weaken** against other major currencies. But as the Fed wraps up its money-tightening period, the bond market should begin to look more attractive. That may occur later in the year.

### **Foreign Markets**

#### **\*The 1st Quarter\***

**Foreign equity markets generally outpaced even the solid returns for U.S. stocks.** As was the case in 2005, emerging markets continued to shine. The rapidly expanding economies of the **"BRIC" nations (Brazil, Russia, India and China)** continued to attract tremendous investment flows. The **MSCI Emerging Market Free Index** gained **(+17%)** during the 1st quarter.

**The growing middle class in India and China** are helping **boost the appeal of those markets.** **India** is the **leading provider of outsourcing services to the U.S.** (telephone service centers and software) while **China** has a **stronghold on the manufacture of consumer goods.** **Natural resources** such as metals and oil have **lifted the fortunes of Brazil and Russia.**

The **job market in Europe improved** considerably in recent months, and that boosted both consumer spending and business confidence. **Stocks in Europe** as a whole gained **(+13%)** in the 1st quarter, slightly outpacing the broad **MSCI EAFE Index** of non-U.S. stocks, which was up **(+10%)**. **Japan's gain** was a more modest **(+4.5%)** despite encouraging economic reports and the fact that the **Nikkei Index** reached its highest level since July 2000.

#### **\*Looking Ahead\***

**Just when the U.S. economy looks like it may be past its peak for the current cycle,** foreign markets seem to be on a different path. **Europe and Japan are seeing an upsurge in business activity** and a much healthier employment picture. Still, **overseas stocks look attractively valued compared to their U.S. counterparts.**

**Even red-hot emerging market stocks** seem to have **room to grow.** **GDP growth** in many developing nations is roughly **double the rate for developed economies** in just the past three years. While short-term volatility is an ongoing reality for emerging markets, the long-term outlook for stocks in this sector remains positive.

**In the past two years, investors had to work through a muddled start to realize gains for the year. In 2006, the reverse may be true. The best returns may occur early, with markets taking a breather late in the year.**

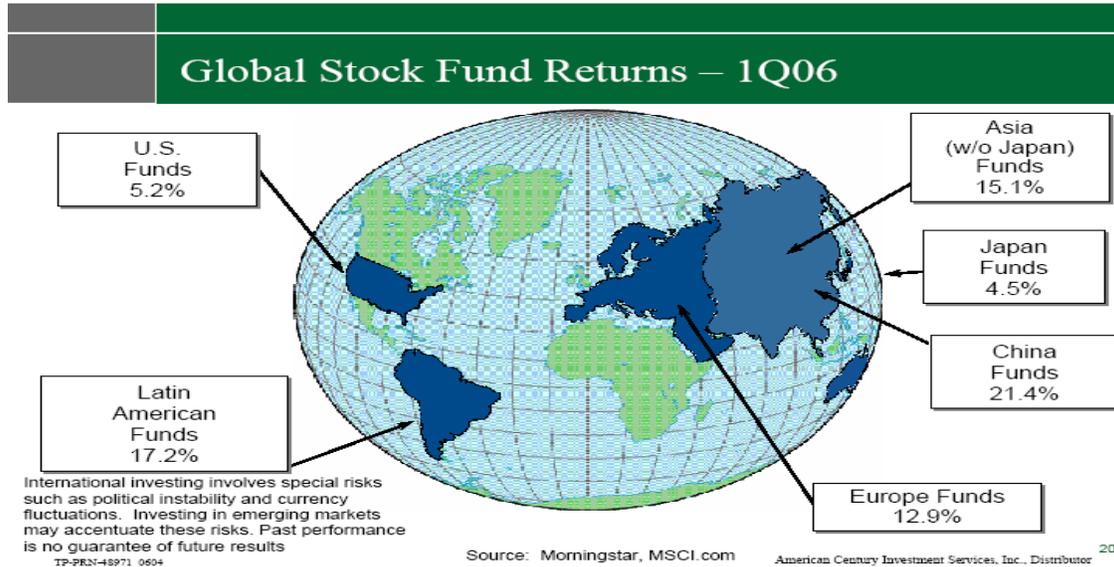
### **Summary**

**The 1st quarter's strong start may not be easily duplicated for stock investors, but there are still reasonable opportunities.** Foreign markets are particularly attractive and we have increased allocations accordingly. Bond markets will be hampered by money tightening policies of central banks in the near term, but better opportunities should exist later in the year. We are putting increasing emphasis on sectors that we think offer an advantage going forward, including commodities, healthcare and technology. As the market cycle extends, dividends will play a more significant role in the total return equation also.



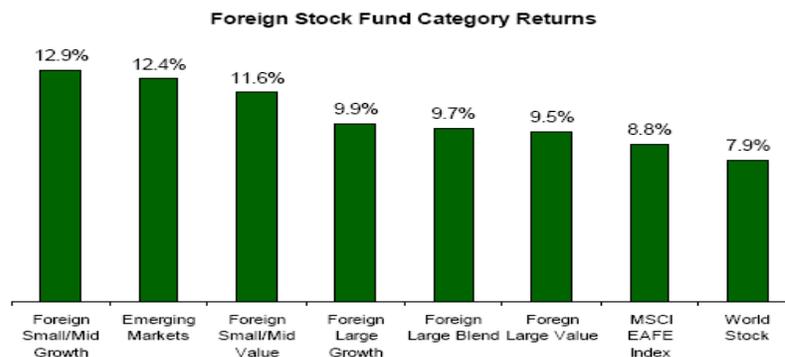
# All Star Quarterly

**This is why we have increased our International exposure!**



We believe the U.S. economy is at the tail end of a five-year expansion and will eventually go into a contracting and then a recessionary cycle. The international economies are not in step with our cycle. They still have room to expand and grow their corporate earnings. **LOOK FOR INTERNATIONAL MARKETS TO CONTINUE TO OUTPACE THE U.S. MARKET.**

## Foreign Fund Performance: 1Q06



Past performance is no guarantee of future results. In U.S. Dollar terms. Source: Morningstar, MSCI.com. International investing involves special risks such as political instability and currency fluctuations. Investing in emerging markets may accentuate these risks. The MSCI EAFE Index is an international index measuring market performance of 21 countries in Europe, Australasia, and the Far East. It's divided into 8 economic sectors and 32 industry groups.

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It was 27 months ago we sold our large cap international exposure and bought all small cap and emerging market international. Since that time the large cap foreign EAFE Index is up 21% and the small cap and emerging market indices are up 36% and 45%, respectively. **THAT MEANS WE CREATED AN ADDITIONAL 15 TO 24% BETTTER RETURN ON YOUR INTERNATIONAL EXPOSURE AS COMPARED TO JUST USING AN INDEX!**

**That is why you have us managing your assets!**