



All Star Quarterly

Third Quarter 2006

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3rd Quarter Review

Strong Third Quarter- A Trend or a Blip?

Overview

What began as a lackluster summer suddenly turned into a strong third quarter for both bonds and stocks, as the Federal Reserve (the Fed) put interest rates on hold after more than two years of rate hikes. The Russell 3000 gained 5% while bonds rose 2%. Investors saw the Dow Jones Industrial Average come within a shade of its all-time high (reached in January 2000).

A number of economic factors worked in favor of the markets and the Fed. One of the most notable was a surprising drop in energy prices. Crude oil futures peaked at close to \$77/barrel in early August before dropping close to the \$60/barrel mark by the end of September. That translated into favorable news at the gas pump, which, combined with declining home prices, created a more favorable inflation environment than existed earlier in the year.

While these were all good signs during the third quarter, some old-fashioned caution may be in order. It appears the Fed has won the battle against inflation. The next battle may be to keep the economy on track without slipping into a recession. The challenges include a soft housing market, slowing corporate profit growth and other weak economic signals.

Economy

The 3rd Quarter

The economy has managed to maintain a modest growth rate and there are signs that this trend may be ongoing. The manufacturing and service sectors continue to be positive contributors. Corporate profits averaged double-digit growth rates in the first half of the year, led by the energy, materials and industrial sectors. This double-digit growth earnings growth has been maintained for 17 consecutive quarters, with corporate profits now representing their highest percentage of the nation's Gross Domestic Product (GDP) in six decades.

The biggest threat to economic growth is the downturn in the housing market. Inventories of homes for sale have swelled while housing construction activity has declined. For the first time in a decade, median home prices fell over the past two months. The question now is whether this change in the housing market could lead consumers to reign in their spending and put a damper on the rest of the economy.

Despite those fears, retail sales grew in the third quarter. Personal income is on the rise. Job growth is slow but steady, with an average of 120,000 jobs created per month in the 3rd quarter. That was enough to keep the nation's unemployment rate below the 5% mark, what is traditionally considered a "full employment" economy.

Looking Ahead

Investors will be closely attuned to the state of the economy, especially the risk of slipping into a recession. The chances of a recession, placed by Mark Zandi, chief economist at Economy.com was 1 in 10 a year ago, and now stand at 1 in 4.

The housing market is one clear week spot, with the National Association of Housing market index falling in each of the last five months, to its lowest level since 1991. Domestic automakers are also struggling, with Ford and GM planning to cut output and reduce their workforces. Chrysler appears destined to follow the same course.

It isn't just homebuilders and automakers that are struggling. Industrial production dropped in August and new orders for durable goods have slid for two consecutive months. Indexes of leading economic indicators have turned negative over the summer, another sign that more struggles may lie ahead.

BOB'S CORNER

Welcome Nick Hohn

and

soon to be announced CPA

I want to make a special introduction to our newest account executive, Nick Hohn. Nick was a financial planner for Ameriprise Financial the last 8 years, after graduating from Mankato State University. He and his wife Gina live in Plymouth and currently have no children. Nick will help as a paraplanner and also as an account executive for All Star Financial clients. Nick enjoys golf and multiple other sports, so he fits right in. We will also be adding a C.P.A. before the end of the year and we are extremely excited about bringing your tax work in house. This will make your life much easier and more efficient.

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Corporate profits have been strong, but with a notable concern. In recent months, more companies have been revising their earnings estimates downward rather than in a positive direction. This is the first time during the current bull market that such a trend has developed.

The big question now is if the Fed can engineer a “soft landing” for the economy (avoiding a recession). The recent decline in energy prices certainly made things easier for the Fed terms of controlling inflation. If energy prices hold their ground near present levels, the inflation risk should be reduced. But economists seem less convinced about the economy’s near-term strength. Forecasts now call for GDP growth in 2007 of 2% to 2.5%, down from the previous forecast of 3% to 3.5%.

Stock Market

The 3rd Quarter

With energy prices falling and the Federal Reserve holding the line on interest rates, optimism reigned in the stock market, with the Russell 3000 Index gaining 4.6%. That is more than half of the market’s gain for the year. Notably, it was a one-sided affair favoring the biggest of the big-cap stocks.

The “flight-to-quality” by investors turned into a rush toward mega-cap stocks, reflected in the Dow Jones Industrial Average’s brush with a record. The Russell 1000 Index of large-cap stocks gained 5.1%, but the Russell Top 50 Index of the 50 largest stocks enjoyed an even loftier return of 8.4%. At the same time, the small-cap Russell 2000 Index barely remained in positive territory, rising 0.4%. Mid-cap stocks fell in between, with a return of 2.1%.

The Standard & Poor’s 500 Index, weighted to favor the largest stocks, gained 5.7% while the average domestic stock fund, typically diversified well beyond the largest companies, could muster just 1.9% for the period. The Russell Micro-Cap index lost 0.7% for the quarter.

There was a shift in leadership among stock sectors as well. After dominating much of the year, energy, materials and industrial stocks lost 1% to 3% for the quarter. The energy sell off was accelerated when two prominent hedge funds recorded huge losses in risky natural gas positions. Our own holdings in natural resources and commodities funds took a toll on our relative performance for the quarter. Based on our own conversations with fund managers, we remain confident about the long-term (3 to 5 year) horizon for these sectors.

Boosting the markets were many sectors that have struggled so far in 2006, including healthcare, telecommunications and technology. Utilities and financial companies also showed particular strength in the 3rd quarter.

Looking Ahead

While many economists are increasingly confident that the Federal Reserve has finished with interest rate hikes for the current cycle,

there is a reverse side to the coin. The Fed will only be convinced to do so if they read the economy as sufficiently weakening to offset an inflation threat. For that reason, it is not likely that the market can carry the momentum it gained in the third quarter straight through the closing months of 2006.

In an environment of such modest expectations for stock returns, dividends become a far more important element. Many public companies are boosting their dividend payouts, and we are actively seeking to make dividends a priority in our strategy going forward.

Large-cap stocks, even coming off their strong relative performance over the summer months, still remain favorably valued when compared to small-cap stocks. According to current forecasts sectors such as telecommunications, technology and healthcare are best positioned to benefit.

Annualized Returns

Market Index	3rd Qtr	1-Year	2-Year	3-Year
DJ Ind. Average	5.34	13.11	10.27	10.50
S&P 500	5.65	10.77	11.52	12.28
Russell 2000	.13	8.65	12.54	14.15
S&P Mid-Cap 400	-1.08	6.56	14.09	15.22
Russell 3000	4.64	10.22	12.37	12.98
MSCI EAFE	3.42	16.46	19.19	19.33
NASDAQ Comp.	3.97	4.96	9.12	8.11
Lehman High-Yield	4.07	8.07	7.39	9.07
Lehman Agg. Bond	3.81	3.67	3.23	3.38
Lehman Credit Idx.	4.51	3.39	3.06	3.52
Lehman Gov. Bond	3.54	3.30	2.88	2.76

Bond Markets

The 3rd quarter

Bonds rose 3.1% during the period, as investors became convinced that the Fed had finished raising interest rates. The most curious development of the quarter was a more pronounced inversion of the yield curve (where short-term interest rates are higher than long-term rates). The yield on 10-year U.S. Treasury notes dropped dramatically, from 5.15% at the end of the 2nd quarter to 4.64% as the 3rd quarter came to a close. During the same period, yields on 2-year Treasury notes fell somewhat less dramatically, from 5.16% to 4.70%. 3-month Treasury bill yields ended the third quarter at 4.88%.

Risk had its rewards during the period. Long-term government bonds led the pack, gaining 6.8%. By comparison, short-term and ultra-short bonds were up just 1.5%. Emerging market bonds returned 6.1% for the period, with world bonds (representing developed nations) up just 1.5%. Other areas of the bond market, such as multi-sector, high-yield, intermediate and municipal bond funds, gained 3% to 3.5% during the quarter.

Looking Ahead

The inverted yield curve represents a signal from the bond market that an economic slowdown is on tap for 2007. Assuming that occurs, interest rate cuts by the Federal Reserve are likely to follow. That sentiment should explain the dramatic rally for long-term bonds during the 3rd quarter.

Credit quality remains strong and there is a healthy level of new issues in the corporate bond market. The best opportunities in the months ahead are likely to be in higher quality segments and among short-term debt. We also remain encouraged by the outlook for high yield and emerging market bonds, anticipating a fairly stable environment that would benefit that group.

International

The 3rd quarter

International stocks continued what has been a solid year during the quarter. Leading the way once again were emerging market stocks. Pacific/Asian markets (ex-Japan) were up 5.7% while Diversified Emerging Markets nearly matched that performance, rising 5.3%. European and Latin American markets were close behind with gains of 4% to 5% for the quarter. Continued positive economic news wasn't enough to carry the Japanese however market however, which dropped 2%.

As was the case in the U.S., value stocks generally performed better than growth stocks and large-cap stocks enjoyed an advantage over small-cap issues. From a sector standpoint, mining and material stocks were particularly hard hit.

Economically speaking, overseas markets appear to be in generally solid shape. Employment is improving in Europe while inflation remains under control. Emerging markets also appear to be fundamentally sound, with rapid growth again occurring in China, India, Latin America and many parts of Asia.

Looking Ahead

We remain generally optimistic about the potential for overseas stocks to outpace domestic markets for the rest of 2006. Japanese stocks appear undervalued with solid growth prospects. European stocks are increasingly attractive as many large-cap companies in the region offer higher dividends than U.S. stocks.

There remain some potential red flags in selected areas of the global market, particularly among developing countries. Unrest over close elections could become an issue for investors in Mexico and Brazil. Thailand is just recovering from a bloodless coup. Protests in Hungary have created some issues in emerging European markets.

Another caution flag has been raised over a trend of nationalizing assets, particularly energy-related assets. This situation may be developing in Bolivia and Venezuela.

Russia is another country seeking to increase the government's participation in oil exploration projects funded by private companies.

Summary

The 3rd quarter was an impressive one for the markets, but we're more concerned about keeping our portfolio properly positioned for the long term. Though our relative performance lagged the market during the quarter, we remained true to our discipline.

- ✓ We tactically reduced our exposure to growth stocks during the period, given the evidence of weakening economic data and signs of potential earnings shortfalls on the horizon. This is part of our discipline, making tactical portfolio adjustments in order to moderate our portfolio's risk exposure.
- ✓ We maintained our positions in energy and natural resource holdings despite their decline in the 3rd quarter. Our view is that long-term, secular trends, such as rapid economic growth in countries like China and India (and the resulting boost in energy demand) will remain in place.
- ✓ It also should be noted that although, by the numbers, the stock market looked very strong in the 3rd quarter, the gains were concentrated in the largest of the large stocks, leaving much of the rest of the market behind.



All Star Quarterly

The “Mega-Cap” 3rd Quarter Rally

The biggest theme in the markets during the 3rd quarter was the unusually strong performance of the largest of the large-cap stocks; commonly known as “mega-cap” stocks. Their returns dominated market performance for the period, while the rest of the market had only modest returns, or in the case of some small cap and micro-cap stocks-negative returns.

We use the Russell 3000 Index to benchmark U.S. domestic equity market because its component stocks represent 98% of the total U.S. stock market. Looking at the stock returns across the market cap spectrum of this index shows how concentrated returns were in just the few largest stocks.

In other words, over 70% of the stock market returns for the 3rd quarter came from less than 2% of the available publicly traded companies in the U.S. market!

<u>Index</u>	<u>3rd Qtr. Returns</u>
Russell Top 50 Index - largest 50 companies (40% of market)	+8.37%
Russell Top 200 Index - largest 200 companies (70% of market)	+6.29%
Russell 1000 Index - largest 1000 companies (92% of market)	+5.06%
Russell 3000 Index - largest 3000 companies (98% of market)	+4.64%
Russell Mid-Cap Index - 800 companies (28% of market)	+2.11%
Russell 2000 Index - 2000 small companies (8% of market)	+0.44%
Russell Microcap Index - smallest 2000 companies (3% of market)	-0.67%

Some possible explanations for this performance anomaly:

- 1) **Valuation**-Large cap stocks have been attractively valued relative to the market for some time and this value was finally being realized, at least for the mega-caps.
- 2) **Flight to quality**-When the economy slows, as we are beginning to see evidence of, investments often flow to large, well known companies that are perceived as high-quality, such as Exxon, General Electric, Altria, and the other “mega-caps” that did well during the period.
- 3) **Momentum**-the Dow Jones Industrial Average was approaching its record high toward the end of the quarter and sometimes the market goes with the flow, piling into the latest group of “hot stocks”.

It would have been nice to have been fully invested in these “nifty 50” stocks during the quarter. But our discipline has not changed. We invest for the long-term, according to your risk tolerance, and use a broadly diversified portfolio of top managers and investment processes that have proven themselves over the long-term, not just one quarter.