

# **A LOOK AHEAD AT THE YEAR AHEAD**

**Ten Investment Themes for 2006 and Our  
Four Strategic Wealth Management Themes  
to Capitalize on Them**

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**THE MDE GROUP, INC.**

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## A Glance Back on The Year That Was

Before we can look forward to 2006, we feel it is only appropriate to assess the accuracy of our prior year predictions. As the title of this report indicates, our investment themes are more than cocktail party conversation. Rather they reflect our best thinking and ultimately are used to design investment strategies that may capitalize on these forecasts. We realize the inherent difficulty in making forecasts and fully expect to never be 100% correct. Nevertheless, we are pleased to report that seven of the ten forecasts we made last year, in our view, were assessed to be correct. The remaining three forecasts were partially correct, with some important caveats. Perhaps most importantly, our forecasts led to good investment performance in 2005 (a middling year for the markets) for our clients.

Where did we go wrong in 2005? We were clearly wrong on Energy prices, which surged 30% due to a variety of factors, including Hurricane Katrina. However, we were correct in assessing that the remainder of commodity prices would remain strong. In fact gold reached a 25-year high of \$518.90 per ounce at year-end. Volatility, as measured by VIX, ended the year lower than it started, but it did have two significant upward spikes intra-year. We will revisit the volatility theme in 2006 as we believe the markets have remained calm for far too long. Lastly, although we did not see major legislation pass that had a significant impact on the economy thus far, there were some items of note that have had a modest impact to date, but do have the potential to be very significant in the years ahead. For example, The Energy Tax Incentives Act of 2005 created a host of new tax incentives for both individuals and businesses to utilize more energy efficient products and services. Significant growth in alternative energy fuels may reduce political turmoil and improve world economic growth.

## Report Card For MDE's Investment Themes For 2005

Prediction	Assessment	Comments
1) The U.S. Dollar will stop its decline vs. the Euro and Yen, but will likely make new lows in the process.	Correct	The U.S. Dollar was up 12% against the Euro and the Yen.
2) Short-term interest rates will continue to rise at a "measured pace" throughout the first half of the year.	Correct	The U.S. Federal Funds rate started the year at 2.25% and finished at 4.25%.
3) Dividends will continue to matter.	Correct	Value stocks outperformed Growth stocks by 1.79% and dividends accounted for a significant percentage of the total return. High dividend strategies on the MDE Wealth Management platform, such as Schafer Cullen, turned in strong years.
4) Price Earnings multiples on the broad market indices will continue to contract.	Correct	The Forward P/E on the S&P 500 contracted from 17.55 to 16.41 as earnings growth for the index outpaced its price appreciation.
5) Pharmaceutical stocks will begin a "come back".	Correct	Healthcare was the third best performing sector in the S&P 500, after Energy and Utilities. Weakness in Pfizer and Merck was offset by strength in companies such as Wyeth, Genentech, and Amgen.

Prediction	Assessment	Comments
6) Energy prices will decline albeit with a few spikes, but commodities in general will remain strong.	Partially Correct	The Energy prediction was incorrect, as oil prices surged upward 30% from prior year levels. However, commodities were strong across the board with many components, such as gold, hitting multi-year highs.
7) Commitments to “Alternative Investments” will continue to grow rapidly as High Net Worth Investors and Institutions continue to gain additional familiarity and comfort with this asset class.	Correct	Cash flows into Alternative Investments continued to be positive, although growth rates slowed. Investments in alternative assets are estimated to be over \$1 trillion at the end of 2005.
8) Volatility as measured by VIX will increase.	Partially Correct	VIX ended the year near 12, relative to its starting value of 13.3. However, it did experience two mid-year spikes – one to 16 and the other to 18 on inflation fears and the aftermath of Hurricane Katrina.
9) Expect major legislation that will have a long-term impact on the U.S. economy.	Partially Correct	The Energy Tax Incentives Act of 2005 has had modest impact thus far, but has the potential to make alternative fuels mainstream. Reduced energy costs can improve both the political climate and world economy.
10) The most important event of 2005 will be something that no one is talking about.	Correct	Hurricane Katrina (and to a lesser extent Hurricanes Rita and Wilma) was the biggest news story in 2005, although its impact on the economy appears to be transitory.

## MDE's Ten Investment Themes for 2006

While we firmly believe that no one can know the unknowable or predict the unpredictable, we also realize that as wealth management advisors we are paid to deliver advice. So it is a core part of our job to analyze the world around us and to make investment recommendations based upon our best thinking. Our advice at MDE tends to be strategic and long-term in nature, but nimble enough to adapt to the ever-changing investment landscape.

With this in mind, we would like to share with you our thinking on some of the significant factors we believe will play an important role in the year that has just begun. Just as was the case last year, we can state with some confidence that some themes we offer for 2006 are likely to be correct, some incorrect, and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major themes of 2006 are neither on our list, nor on anyone else's. With these important facts in mind, we humbly offer you our top ten investment themes of 2006.

- GDP growth will slow down in 2006 as the home equity incentive loses steam.** The economy grew at a rapid 4.1% annual rate through the third quarter of last year. However, much of this growth was fueled by the real estate boom, a good 2004 stock market, and cash out refinancings. Many of these tailwinds have diminished, so we expect a return of growth to more modest levels in the 2% - 3.5% range over the course of 2006.
- Mergers and acquisition (M&A) and stock buyback activity will continue to remain at strong levels - above recent averages.** Cash on corporate balance sheets (trillions of dollars) remains at or above record levels. In addition, the American Jobs Creation Act of 2005 encourages U.S. firms to repatriate foreign earnings at low tax rates. These savings may be used toward mergers and acquisitions activity. Furthermore, the only way for larger firms like Johnson & Johnson (see Guidant takeover battle) to grow at double digit rates is through acquisition.
- Market returns will remain below their long-term averages of low teens, as rising interest rates, rising volatility, and a slowdown in housing activity helps offset good corporate earnings and a modestly**

**growing economy.** With the market up nearly 3% as of the second week of January, some people have speculated that we are poised to return to a 1990's-type market with averages easily topping the double-digit mark. We would be happy to be wrong on this count, but our long standing thesis of an absence of P/E multiple expansion and flat to rising tax rates and interest rates makes a runaway bull market unlikely in our view. We are also mindful of the fact that the current bull market, which began in the Fall of 2002, is getting long in the tooth.

4. **Volatility, as measured by VIX, will increase.** We have gone more than 3 years without a significant correction in the stock market. The temporary shocks that we experienced, such as in April 2004, were quickly followed by a rebound. The VIX, currently less than 12, has averaged 19.5 since the beginning of 1990. Granted, this time period included the inflation and deflation of an historical bubble, but the current VIX levels are teetering near their 12-month rolling average lows over any timeframe over the most recent 15 year period.
5. **The Fed will stop raising short-term interest rates in 2006 to avoid the potential negative implications of an inverted yield curve.** The current Federal Funds rate is at 4.25% and the benchmark 10-Year Treasury Note is yielding 4.33%. The yield curve will invert after one more 25 basis point increase in the Fed Funds rate, assuming no movement in the 10-year note. An inverted yield curve is the market's way of saying an economic slowdown lies ahead. For the past 25 years, every economic recession has been preceded by an inverted yield curve. However, there have been a few false signals with an inverted yield curve not followed by a recession in the period ahead. Is this one of those times? We cannot be sure, but we are sure that the Fed knows the negative "smoke signal" that an inverted yield curve suggests, and we believe that new Fed Chairman Ben Bernanke will at some point stop raising short-term interest rates to avoid the risk of pushing the economy into recession.
6. **While market forces will want to drive the 10-yr Treasury yield higher, structural reasons, and underlying fundamentals of controlled inflation and a slowing economy, will keep interest rates largely range-bound in 2006.** The ever-present twin trade and federal budget deficits continue to exist in large part due to foreign purchases (especially by Asian central banks) of U.S. Treasury securities. These purchases tend to depress long-term bond yields. In our view, the status quo remains more likely than a balanced near-term budget or positive trade surplus. Hence we expect a relatively range bound Treasury yield. Given the 4.25% Federal Funds rate, a long-term yield of less than 4% is unlikely due to the negative implications of an inverted yield curve, as discussed above.
7. **Oil prices will remain above \$50 for the bulk of the year and there will be increased interest (and further tax breaks) for alternative energy approaches.** The fundamentals – strong demand from China and India, a growing world economy, and high switching costs – suggest that oil prices will remain strong for the foreseeable future. Given that oil is a finite resource we believe alternative energy technologies will come to the forefront. At this point it is impossible to predict which alternative energies will emerge as a viable substitute for oil on large scale levels, but there are several candidates including fuel cells, nuclear, coal, solar, wind, and corn based products.
8. **Alternative investments continue to provide portfolio diversification benefits and risk mitigation, but selectivity is crucial.** As we have communicated in the past, the only thing common among alternative investments or hedge funds is their two-tiered compensation structure (asset based fee and incentive fee). However, the asset class as a whole generated disappointing returns in 2005, with the average market-neutral hedge fund up only 0.34%. In this sluggish environment, the only way to generate attractive returns is to take on more risk. In our view, this potential increase in risk will result in adverse fund specific events. Therefore, we believe selectivity remains critical, and a thorough understanding of the underlying strategies and risk management techniques is the best way to avoid missteps.
9. **Capital spending will continue to increase and keep the economy out of recession in 2006 in the event of a decline in consumer spending.** The cooling of the real estate market and refinancing boom removes an important source of disposable income for consumers. If the consumer does indeed spend more modestly in the

year ahead, we believe corporations, flush with cash, will pick up the financial slack thereby keeping the risk of a recession in 2006 at remote levels.

10. **International investing continues its momentum as investors look for the best global investment opportunities. International stocks in selected markets will continue to shine, albeit with higher volatility.** It is naïve to assume that the United States will outperform all other markets, despite its historical success and the size of its economy. The primary detriment of international investing is the excess volatility, relative to a portfolio of conservative domestic stocks. We trust the judgment of our global managers to search the world for the best investment opportunities across the globe. Over time, these managers, such as Brandes, UMB, and Polaris, should provide our clients with attractive risk adjusted returns.

## MDE's Four Strategic Wealth Management Themes for 2006

Investment themes in and of themselves are interesting, but of little value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Themes, we would like to offer Four Strategic Wealth Management Themes for 2006, along with specific techniques to implement them.

1. **Slowing U.S. Economy.** An economy the size of the U.S. cannot grow at rates over 4% forever. Inevitably, competitive forces and economic fundamentals drive growth closer to its long-term rates in the neighborhood of 3% per annum.
  - ◆ We favor opportunistic managers, such as Atalanta Sosnoff and Neuberger & Berman, who historically have been able to adroitly tilt their portfolios to companies that are growing, while avoiding companies headed for economic quicksand.
  - ◆ We continue to recommend international investments as a core part of our long-term portfolios. We fully expect an occasional “knee jerk” reaction with international funds falling in tandem with U.S. stocks on any bad domestic news, but over time, the market will separate the wheat from the chaff, and reward countries growing at much higher growth rates than the U.S.
2. **Flattening U.S. Yield Curve.** The norm for the economy is a positively sloped yield curve, with long-term rates higher than short-term rates. A flattening or inverted yield curve is a rarity, so when it occurs, unusual market movements often happen. In this yield environment, it generally pays to remain conservative.
  - ◆ We continue to favor low duration portfolios for our conventional fixed income investments, such as investment rated municipal bonds. A flat yield curve implies that the market is not paying a premium to hold long-term bonds, despite their higher interest rate risk. Prudence and investment history suggests short-term bonds offer the better risk / return tradeoff in the current market environment.
  - ◆ We continue to favor “alternative” fixed income investments, such as the Metropolitan West Strategic Income Fund, which earns its returns from a variety of approaches including spread trades and arbitrage transactions.
  - ◆ We continue to favor high yield municipal bond funds, such as that run by Nuveen Investments, that are able to capture excess returns not due to significantly increased default risk, but rather by purchasing under followed and often unrated bonds.
3. **Below Average U.S. Stock Market Returns.** If stock market returns are difficult to come by, we want to do the baseball equivalent of playing “small ball.” That is, our approach is to hit a bunch of singles, steal bases, and sacrifice bunt in order to score runs. How do we accomplish this in the investment world? We search for dividends, we write covered calls, we extract fee concessions, and we look outside the box.

- ◆ We continue to favor high dividend strategies, such as that of Schafer Cullen. In a low return environment, dividends may account for a material percentage of total return.
  - ◆ We continue to favor hybrid strategies, such as Wolverine's yield enhanced convertible program. Bond yield is supplemented by covered call writing, resulting in two sources of income.
4. **Increased Market Volatility.** Risk, almost by definition, comes to the forefront at unexpected times because if you were aware of an impending risk you could insure it. The problem is that many risks – Long Term Capital Management, 9/11, Katrina - are completely unexpected and have no historical precedent. Investors often forget that only a risk-free investment is devoid of economic loss. As long-term investors, we cannot do the equivalent of live in an economic cave forever. We must invest in a risky world, armed with knowledge, prudence and the best antidote for risk – diversification.
- ◆ We continue to maintain a strong commitment to alternative investments. Although on balance we were disappointed with the returns they provided in 2005, they did provide good downside protection during periods when the market experienced losses.
  - ◆ We recommend that all MDE clients hold broadly diversified portfolios. Rather than taking a “kitchen sink” approach, the MDE Investment Committee requires that each investment on its wealth management platform have merit on a stand-alone basis, in addition to its risk reduction properties for the overall portfolio.

One commonality among all of our 2006 themes is that an investment able to reduce downside losses and deliver mid to high single digit returns would be most welcome in the current market environment. Fortunately, there is such an investment called a structured product. A structured product uses derivatives to sell some of the potential upside gain of an investment in order to provide insurance against large losses. It is not quite a free lunch, but perhaps the next best thing. The cost, of course, is that if we experience a runaway bull market with returns well into the double digits, the structured product will likely get stopped out in the high single digit to very low-double digit range. We are still finalizing our approach for bringing this innovative investment product to our clients, but you will be hearing much more from us about structured products in the year ahead.

We at MDE look forward to the opportunity to discuss our Ten Investment Themes with you, as well as the ways in which our Four Strategic Wealth Management Themes can be custom tailored for your personal situation.