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## 2006: The Year in Review

Vigor, indigestion, and elation. Those were the three phases of last year's financial markets, and as such sequences go, you could hardly ask for better.

Total Return 2006	
Allen Trust Equities	15.14%
S&P 500	15.79%
Allen Trust Bonds	4.33%
Lehman Agg Bond	4.33%

*Note: Performance gross of fees*

While our quality-biased stock investments trailed by a hair on the upswing, we consider that a price worth paying if it means that your portfolios will be more buoyant on the downside (contrary to Irving Fisher's ill-timed words in 1929, we do not believe that stock prices ever achieve "permanently high" plateaus). We also are pleased by our bond investments, which though they eerily matched the Lehman Aggregate *to the basis point*, outperformed on a risk-adjusted basis insofar as they spared you the midyear whiplash (altogether your bond portfolios stayed in the black throughout the year while the Lehman index slipped into negative territory for the first half).

If you opened a newspaper or turned on the radio at any point in the Fourth Quarter, you doubtless got a good dose of celebration over the Dow Jones Industrial Average's recovery to new heights after a relatively slumberous few years (not to mention a 2005 in which the Dow was all but "dead money"). Indeed, it was impressive, and not just for the DJIA (+16.3%), but also for the broader S&P 500 Index, which gained 13.6%, and the NASDAQ Composite,

which gained 9.5%. Most notable, from our perspective, was stock investors' seemingly newfound (or at least rediscovered) affection for quality companies, toward which we have been reinvesting for a couple of years now.

Even the bond market, though bruised going into mid-year, bounced back as the Fed stopped hiking interest rates. The Lehman Aggregate Bond Index was up 4.3% for the year, against a backdrop of an inverting term structure of interest rates (whereby longer dated bonds pay less than shorter notes), which historically has portended recession. Not surprising, given a thus-far non-calamitous collapse in new construction and stalling home prices, plus lower energy prices and inflation's recent relent.

Unlike stock market investors, however, who for the first time in a while are bestowing their good graces on the sturdier assets as well as the flighty, many bond investors remain enamored of dross.

Just as we recognize the Dow Industrials' record highs, so should we throw some light on another record: 2006 eclipsed – by nearly 20% – the previous record for new junk bond issuance. What's more, a good chunk (or perhaps we should say a bad chunk!) of those new pieces were the worst of the worst, with 17% of issues carrying ratings of Caa or lower. Compare that with 1990, when just 4% of new junk was so junky (source: Wall Street Journal and Dealogic). In other words, risky, low-quality companies found it easy to borrow cash, just as vastly subprime homebuyers found it ever easier to borrow going into last summer's housing price peak. What's more, these low quality credits, though greater in number, are nonetheless paying less than a 4% spread over Treasury yields. Sometimes, 'tis better a borrower than a lender to be.

When we buy bonds, we are lenders. Perhaps you have guessed: we aren't buying high yield of this vintage! *William A. Harris, CFA*