INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

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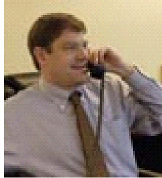

William A. Harris, CFA
Portfolio Manager

First Quarter Market Review

While stocks strode into 2007 with some of the swagger they had through the end of 2006, they cramped up in late February as a convergence of negative events sent investors scurrying, however, briefly, closer to the exits.

What precipitated the 3-4% slide across US stock indices? Former Fed Chief Alan Greenspan speculated that the US economy may enter recession later this year, the Chinese stock market dropped 9% in a day, and home mortgage defaults rose to such a worrisome level that some lenders themselves are now in distress.

The market may have absorbed any of these factors if they had arrived alone, but heavy news flow on all three hit over just two days, and after an almost uninterrupted rise in stocks over the preceding few months, investors saw wisdom in belaying further purchases for a moment. While there was some drama in all of this simply because the losses were concentrated into a single day, with the exception of another downward twitch in early March, the negativity hasn't had much in the way of resonance, at least as far as market *behavior* goes.

Keep in mind, however, that what investors and pundits say and what they do often differs. While there's still some jittery talk out there, there's not much bearish action backing it up. On the contrary, we're still seeing an affection for what can most charitably be called unquality, or in some cases, more appropriately, *dross.* For instance, despite problems in a highly significant part of the domestic credit markets – mortgages, where defaults concerns are now creeping up from the subprime to the higher rated Alt-A category – the single best performing bond sector in the First Quarter was the highly speculative, low low quality Triple-C, which by Merrill Lynch's CCC index returned 4.8% for the period, better than three times more than the broad bond market. In other words, despite voluble hand-wringing and finger-wagging over the dereliction of mortgage lenders and their regulators in funding high-risk credits, bond buyers remain happy as ever to keep doing so in the corporate realm.

A similar divergence between quality and unquality was seen in the stock market as well. For instance, the only major equity index to close out the quarter in the red was the Dow Jones Industrial Average, which lost 0.9%. In contrast to these big blue chips, mid- and small-caps kept their feet under them after February's stumble, finishing up 5.5% and 3.0% respectively (S&P Mid400 and Small600 indices).

What's going on here? People are talking scared, but bidding up the asset types least likely to ride out any sustained trauma in the markets. It's altogether a strange admixture of vocal fear and quiet greed, and, it is our position, one that may end unhappily for the speculators.

I'll close by paraphrasing a recent commentary by Peter Bernstein, an eminent and long-time market observer, author, and economist who says he keeps hearing people go on about today's low expected returns going forward: One response to an environment where expected returns are low across asset classes is to invest to those which offer marginally higher returns, taking comfort that volatility has been low and risk apparently absent. Another possible response, however, is to conclude that risk is not so much absent as it is *mispriced*, and therefore to withdraw toward safer harbors.

As for our current posture, we see too many investors adopting the first response. We increasingly favor the latter. Next month, I will review our year-to-date investment performance.

William A. Harris, CFA

Firm News

In its annual Money and Investments issue, BrainstormNW ("The Magazine for Northwest Decision Makers") has named Stuart Allen and Bill Harris to its list of Oregon's top financial advisors – Stuart for his leadership of Allen Trust Company, and Bill for his portfolio management work at Allen Capital. The list was built through peer nomination and recognition in the field.