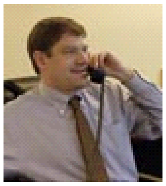
NOVEMBER 2006



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Income and Value: An Historical Context

Typically, we measure how well our portfolios perform on the basis of TOTAL return, which incorporates both investment price changes and investment income. The former component of total return – price behavior – is where we look for real long-term growth, but it tends to be the more volatile series and thus puts out more noise than information over short time periods. Portfolio income levels, whether interest from bonds or dividends from stocks, change more slowly than prices, and in the latter case of dividends have a long-term bias upwards. Because of their relative persistence across time periods, income yields can signal much about the underlying nature of general market environments and specific portfolios alike.

Using numbers from the good folks at Ibbotson Associates, let's look at today's income levels across various asset classes, and tie them to their historical averages. This can convey something about where we stand now relative to past norms, and about where we may stand tomorrow, insofar as the yields below relate the two components of total return, expressing income cash flows (yield's numerator) in terms of market value (yield's denominator).

Large Capitalization Stocks
The dividend yield on the S&P 500 is **1.8% today, versus a 4.2% historical average** for large cap stocks from 1925 through 2005. While dividend growth has been impressive since the 2003 cut in dividend tax rates and the corporate profit boom of the last few years, 1.8% still looks meager, and what's more, according to Standard & Poor's, the number of payout boosts slipped in three of the most recent four months through September 30…

Bonds
At a 4.6% yield, **today's five year Treasury note falls almost smack dab on its 4.7% historical mean** (at least until we incorporate inflation into the comparison; but more on that below). The **longer bond** though, also **yielding 4.6% presently, falls shy of its 5.2% average** from 1925 through 2005.

Real Estate Investment Trusts
Most grievously out of whack, perhaps, is the market for real estate investment trusts. I say this not because the housing market has been rolling belly up (simply put, REITs are not houses), but rather because **today's yield on the NAREIT Equity Index is 3.7% as contrasted with an 8.3% historical average** (1972-2005). This deviation can be partly explained by REITs' growing, mainstream acceptance as a diversifying asset class, but especially given the unfavorable tax treatment of REIT distributions, we don't think it can endure at such an extreme.

Cash Equivalents
Who remembers early 2004, when short paper could scarcely earn you anything? Well now, thanks to a yield curve whose inversion is only steepening, you get a yield *premium* for holding nearly liquid, nominally risk free assets. Three month **T-bills are paying 5.1% now (annualized), whereas the historical average has been 3.7%** (1925-2005).

The Critical Parameter: Inflation
When considering returns, inflation is a dominating characteristic of context. The rolling average of year-over-year **change in CPI for the last twelve months has been 3.7%, versus a 3.0% average from 1925-2005**. Adjusting downward to reflect that gap, most of today's yields look all the more paltry.

The Outlook
The numbers here are but a snapshot, freezing their respective markets in an instant. Building wealth – whether in the macro GDP sense or at the personal level, in your own portfolios – is a dynamic process which can't be bound meaningfully to any single metric or moment.

We can, however, ponder what might drive change in these yield numbers going forward: will it be shifts in the numerator (cash flows) or the denominator (market price levels)? If stock, long bond, and REIT yields are going to revert toward their historical norms, payouts must rise and/or prices must fall. While the story differs for each asset class, we believe there will be more burden on price than benefit from rising cash flows. The benefit, if it comes, is more likely to be in that critical parameter – barring a monetary crisis for the US dollar, inflation may well be moderating as the economy slows. *Bill Harris*