

# Sound Investments Inc.

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Third Quarter 2005

## Quarterly Investment Commentary

September was a good month for both the markets and our portfolios.

The overall markets have been stuck in a trading range but we continue to upgrade to the top performing funds.

.We continues to invest international markets. Less developed countries and Japan are performing well.

September Failed to live up to it's reputation as one of the least productive months for stocks, despite hurricane havoc in the Gulf, rising oil prices and rising short term interest rates. Stocks enjoyed their first positive September in 7 years, the broad market indices ended the third quarter with welcome gains. The S& P 500 Index gained 3.6% for the third quarter, finally pulling into positive territory for 2005, up 2.8%. The NASDAQ Compsted index rose 4.6% in the quarter leaving it down 1.1% for the year. And despite a 2.9% gain in the third quarter The Dow Jones Index remained down 2% for the year

September was a solid month for equity markets and, generally, a very strong month for our active managers. Small-cap stocks, foreign stocks, and growth stocks were particularly strong. For the full quarter, however, equity markets were under water. Concerns about oil prices, geopolitics, employment, and earnings all contributed to equities' weakness while fueling a bond rally. Our Mutual Funds did well again the major indexes.


## Stuck in a Trading Range

Over the past 75 years stocks have delivered rates of return of approximately 9.5%. However these returns were not achieved in a straight line. For instance the Dow Jones Average has progressed in step like fashion characterized by long bull markets with good returns alternating with trading range markets having lower returns. I well remember the markets of the 1970's with flat performance from the Dow for 10 years. Even then, there were opportunities in oil and gas and hard assets such as gold. What I try to do is upgrade to those areas of the market that bring best returns. We invest in the top performing no-load mutual funds, selling them when they fall in rank and upgrade to the current winners.

*The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.*



## The International Scene

Foreign equity markets remain buoyant, despite worries about economic activity in most Western economies. A number of influences support a positive market stance. The psychology is improving as worries fade about a competitive threat from dollar weakness and political uncertainties in Germany. Continued growth in China and political changes fostering economic growth in Japan lend support as well. Retail spending in some parts of the world, Japan and emerging markets, will likely continue to improve. Also China has revalued its currency and will gradually reflect a more realistic relationship with the rest of the world's major currencies. 

In some ways the Iraq war has helped too, similar to the 1870's when Britain used Gun Boat diplomacy to keep order which I believe underpins the case for international investing. Currently approximately 50% of the world's stock market value is outside the U.S. Over the past 5 years we have always had a strong foreign position in such funds as Oakmark International and more recently, Dodge and Cox International. At this time investments in Japan are rapidly moving up in the ranks. After a decade of stagnation, the Japanese economy seems to be on the mend. Sentiment seems unanimously positive towards toward their economic recovery and regulatory reform.

### **Good 3<sup>rd</sup> Quarter Earnings, but Future is Clouded**

Some of the nation's biggest most successful companies have posted very good third quarter earnings yet their stocks have been punished for lackluster profit forecasts. Wall Street focus is always on the future and potential for strong profits. The problem with earnings reports is that, no matter how good they are, they are already well in the past. Corporate profit forecasts are far more important, especially amid economic uncertainty.

Growing evidence suggests the economy has weathered high energy prices, and could continue to adept through the winter. A drop in oil prices below \$60 a barrel could be a positive sign. Yet members of the Federal Reserve rate-setting committee continue to indicate the Fed isn't done raising interest rates.

We suspect the global economy is unbalanced, characterized by excessive US consumption financed with recycled Asian trade surpluses. We also suspect there is considerable excess speculation in many housing markets around the world, including the coastal regions of the United States and many consumers are taking on risky debts. An eventual return to balance may have nasty implications for economic growth. The problem is forecasting the timing is very difficult. Notwithstanding the above, at this point we believe the market will move up. However we remain cautious and look for trends in the economy to take advantage of.

Yours Truly,

Ken Gilpin CFP