

Sound Investments Inc.

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First Quarter 2006

Quarterly Investment Commentary

Our Mutual Fund picks did considerably better than the market averages. We did this by focusing on investments that are moving – mainly International funds, Emerging markets and Mid-Cap funds.

Upgrading is based upon the observation, that few, if any money managers consistently excel. Instead we observe a wide range of performance returns, with only a small percentage of professional money managers investing in the right sectors of the equity markets at any given time.

This is because each money manager has a particular style that works well in some, but not all market environments. Market leadership rotates between large-caps and small-caps, growth and value styles, international and domestic areas. Leadership changes because economic conditions change. However most fund managers don't change their particular styles when the market leadership changes.

Since market leadership is forever changing we move incrementally towards the top ranked funds by progressively selling the lower ranked funds and investing in the new leaders. This continuous process provides an effective way to **invest in a broad range of investment opportunities as they develop.**

We use no load funds as they provide access to the talents and research of the country's leading money managers while they are at the top of their game.

United States stock indexes posted solid quarterly gains with the S&P 500 scoring it's best first quarter gain in nearly 7 years. The Dow Jones average was up 4% and sits within range of its all-time peak in Jan. 2000. Pundits predicating a rotation to large caps were disappointed as small and mid-caps far outpaced their larger brethren. The real story however has been in foreign stocks outlined below.

"A Rising Tide for Global Equities"

The big story this quarter is international mutual funds continue to lead the way with some of our selections up almost 10% for the quarter. For perspective this is only the third time in the last 25 years when international investments significantly outperformed our American markets. In early 1984 Internationals did well and again from Sept 1985 to July 1987. During the intervening years, internationals were weighed down by a strong U.S. dollar and a slowing globally economy. Also in the late 1990's large-cap U S Stocks were pretty tough to beat. In our quarterly review of Dec 2004 we predicated that internationals would do well for some time and still there is room to grow.

"A Key Trend -Thinking Globally"

A key trend underlying the current bull market is the growing importance of thinking globally. 2005 was the third straight year that foreign stocks outperformed domestic ones; 2006 should see more of the same for the following reasons:

1. We expect global long-term rates to remain benign in 2006 because we don't foresee significant inflation on the horizon.
2. Powerfully Strong Fundamentals. Both U.S. and foreign companies are enjoying impressive earnings growth rates. US firms are expecting to post a 13% earnings gain over 2005. Earnings expectations for foreign firms are increasing as well.
3. Equity Valuations Remain Cheap. In some of our mutual fund holdings (Dodge and Cox, Oakmark International) the average Price /earnings ratio is approx 12-

15 times and pays a dividend of 2-3%. This compares to US stocks Price /Earnings ratios of 18-20 with 1-2 % yield.

4. Surging Mergers and Acquisitions wave. 2005 turned out to be the best year for global mergers and acquisitions since 2000 and should continue which is a good indicator that stock prices should continue to rise.

If we are correct about the fundamentals outlined above then sentiment could decide the magnitude of stock returns going forward. If sentiment remains dour equities may be up around 10% if sentiment improves they could be up 20% or more.

Risk to our Outlook

- Foreign Long Term Interest Rates could rise
- The Global Yield Curve could invert : An inverted yield curve refers to short term interest rates than long term rates. This general leads to a recession.
- Stocks could price in higher taxes. Taxes on dividends and capital gains were reduced in 1993 but expire in 2008. If Congress does nothing, the taxes will rise so it depends on who wins the mid-term elections.
- Rekindled Protectionism.
- Iran relations deteriorate.
- U.S. Political Wind Shift. There are 3 sets of races in 2006: The senate, the House of Representatives and Gubernatorial elections. The Senate is highly likely to remain in Republican control. The democrats need to pick up 6 seats, yet have more up for reelection (17) than Republicans (15), and few of the those Republicans are vulnerable. The House of Representatives doesn't look much more promising for the Democrats. There are currently 231 republicans and 202 Democrats. The democrats need a net gain of 16 seats to take the house. It tough to beat an incumbent so short of 1994 revolt in reverse the Republicans will likely keep control of the House. We believe the Gubernatorial races are set up for significant Democrat gain. The Republicans have to defend 22 state house compared to just 14 for the Democrats. The governor's Manson provides key advantages in Presidential and redistricting so the Democrats may be a leg up in 2008. However, politics is harder to predict than the stock market!

Conclusion

Last quarter we ended with the phrase, "The trend is our friend" and this continues to be apropos. We expect to continue with our successes; that are investing in International Funds, Emerging Markets and reallocate to Midcap funds. As I outlined on the sidebar, since market leadership is forever changing we move incrementally towards the top ranked funds by progressively selling the lower ranked funds and investing in the new leaders. This continuous process provides an effective way to invest in a broad range of investment opportunities as they develop.

Yours Truly,



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