

Sound Investments Inc.

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Second 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 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 do not 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.

The second quarter of 2006 was a volatile one as stocks worldwide retreated from Mid May Highs taking most funds along for the ride. After nearing its all time high on May 10th the Dow Jones fell to its low for the year one month later. Yet this large cap index was the only one to elude a positive return for the quarter. The tech heavy NASDAQ index had been up more than 7% in Mid April, and then gave back all and more to finish down more than 7% for the quarter and 2% for the year. The broad based S&P 500 index ended down 2% for the quarter but up 2% for the year. Small caps did the best were up 16% in mid may before tumbling 7% to be up 8% for the year.

Overseas funds declines were steep, yet superior gains both before and after the drop kept internationals in the top ranks with year to date gains over 10% even after the pullback. European stocks were particularly strong while Japanese share fell sharply and most Asian funds slid.

Stock Market Corrections are Part of Investing

Stock market corrections are an inevitable part of investing. We have sailed through corrections in each of the past two springs. From early April 2004 to Mid May 2004 the S&P dropped 6% then gained 13% the rest of the year. Last spring the S&P 500 lost 7% then gained 11.5% in the balance of 2005.

No one can predict consistently when markets declines will happen nor how long they will last. All we know is that they will end. What we do is upgrade to that part of the market that gives us the best relative returns.

Nevertheless, the current decline may be easier to live with knowing it is expected and routine. A look back at stock market history shows that declines of 5% or more occur about 3 times a year and last an average of 1 to 1 ½ months. Moderate declines of 10% or more occur around once a year and typically last about 3 to 4 months. At the extreme end of the scale, bear markets – when stocks fall 20% or more --

happen about every 3 ½ years and last about a year on average. History shows that long-term investors come out ahead.

Risk to our Outlook Revisited

Three months ago I wrote how well international funds have done. I also listed several things that could derail my projections, primarily the conflict in the Middle East. The renewed conflict between Israel and Hezbollah caught the stock market off guard as many analysts search for an explanation. Many wonder how this latest action will affect our position in Iraq. Our Secretary of State, Condoleezza Rice like many before her searched for a diplomatic end to this conflict. Right or wrong we are involved there and it looks for some time. This Middle East war has the potential to put a damper on the market when it flares up from time to time. Compounding the problem is North Korea. At the same time in Mid May the market was over extended having enjoyed a good run and was looking for a reason to correct.

As I write this at the end of July the Dow Jones average has recovered and a lot of our holdings have come back as well. Seventy per-cents of the S&P members that have reported 2nd quarter results posted earnings that beat analyst's estimates. This down turn in June may or may not be that big of an issue. We continue to believe International Funds are the place to be for now. This Zig-Zag of the market always holds my interest.

A Period of Transition

After 17 consecutive rate hikes in the Fed Funds rate, the Fed appears to have finished its program of tightening monetary policy. Short term interest rates are now positioned at a mildly restrictive level, which should be enough to cap inflation, but without bucking growth. We believe the right amount of tightening was delivered to slow the economy but inflation is difficult to control.

If we are correct about the fundamentals outlined above then sentiment could decide the magnitude of stock returns going forward. Earnings continue to be an average of over 10% giving strong underpinning to stock prices. If sentiment remains down equities may be up around 10% if sentiment improves they could be up 20% or more.

We expect the results from the economy to be uneven but a variety of indicators suggest the Fed's program of slowing the economy the momentum of growth and damping the inflationary pressures and expectations. Indeed, as I write this at the end of July the latest information showed the economy had slowed so interest rates will not have to be raised which resulted in the Dow Jones going up past 11,200.

We appreciate your confidence and will continue to monitor results and make changes where warranted. Please feel free to call me at any time.

Yours Truly,

Ken Gilpin CFP