

Sound Investments Inc.

Kenneth A. Gilpin CFP

Third Quarter 2006

Quarterly Investment Commentary

We may be at a point where leadership is changing from international funds to large cap value U.S. equities. It takes several months for a new trend to be confirmed. We are moving incrementally to reposition our portfolios.

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.

After spending years on the sidelines the Dow Jones Industrial Average and S & P 500 are finally back in the limelight. Fueled by lower interest rates large cap U S Funds stirred last quarter posting 5% a return, their best return in years.

Among domestic funds, large cap value clearly led the way outperforming all other styles last quarter. Within sectors money moved away from energy and natural resources. Real estate funds, health, technology and communications stocks were up.

With the recent large cap U.S. strength, international funds lagged. Funds concentrating in European were strongest while Japanese and Latin America stocks were weakest.

Headlines are touting record US highs. After a stirring third quarter performance, the S&P 500 is near its all time high set in Jan 2000. But what are we really celebrating here? Investors are underwater after 6.5 years and the NASDAQ is still more than 50% below its 2000 peak. The table below shows the actual rates of return over the past 6 ½ years;

Returns from Mar 30th 2000 to Sept 31st 2006

	Cumulative	Annualized
Dow Jones	20.55%	2.92
S&P 500 Index	-2.8	-0.45
Wilshire 5000	-9.53	-1.53
NASDAQ 100	-64.74	-14.82

What we have done over this is move from small caps to some gold and then international and our returns have been significantly better averaging over 10% on our equity based mutual funds. We do this using the flexibility to follow market leadership means we can take advantage of good returns wherever they occur.

For nearly 3 years now we have invested in international and had relatively few changes.

Comparing the 75 year history of developed country foreign markets (i.e. Europe and Japan) to our own, the long term records are practically identical. European and U.S. markets have both returned about 11% over their entire history. But these long term records comprise of many fairly long and, in hindsight, easy to identify periods of over and under-performance.

The past 3 years is only the third period in the last quarter century when internationals outperformed U.S. equity stock funds. In early 1984 foreign investments did better for 4 months. Then, for nearly 2 years from Sept 1985 through July, 1987, internationals outperformed U.S. funds.

Natural market cycles eventually reward the underperformers. After the favored areas of the market enjoy superior performance for some time, the out of favor (and now better valued) sectors, play catch up. International funds have topped our ranks for the past 3 years, but even if the market begins to favor domestic funds we can't be sure what the next leaders will be. It's hard to tell whether the next leaders will be focused on growth or value or funds that invest in small cap or large cap. Since we use a rolling average to gage performance it takes about 4 to 6 months to show a trend. Currently large American cap value stocks are leading the way and we will move incremental this way.

We accept we can't predict the future but instead rely on two things 1) Performance (how a fund performs over the past 12, 6, 3 and 1 month periods) and 2) the broad fundamentals such as interest rates, currencies and the political environment, An example of the fundamentals is valuation as outlined below:

Fundamentals and Valuation

One of the biggest reasons stocks are likely to have some room to grow in the U.S. is that their prices aren't inflated as they were in 2000 when the internet and telecommunications led to a stock market burst. When evaluating a stock to purchase it is important to compare the company's stock price with the company's profits, which is called the price-to-earnings ratio (P/E). The P/E is calculated by dividing the per share stock price by the company's earnings per share typically over the last 12 months.

For example, a company's stock trading at \$50 a share 6 years ago that's now trading at 60 dollars a share may actually be better value today if the company's earnings are proportionately higher than they were 6 years ago. In January 2000, the Dow stocks were trading at a P/E ratio of 24 times their previous 12 months earnings. This means investors were willing to pay \$24 for every \$1 of earnings. Today the average P/E ratio Dow stocks is 19 times earnings which means investors are willing to pay \$19 for every \$1 of earnings. This makes a stock a much better value.

Should We Jump the Gun?

It's tempting to make wholesale changes at the first indication of a shift. If this new leadership is sustained we will upgrade to it soon enough.

Yours Truly,

Ken Gilpin CFP