Sound Investments Inc.

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Quarterly Investment Commentary

I would like to start off with a review of 2006. Despite a significant summer correction 2006, turned out to be a very profitable year. The average diversified US stock returned 12%, double the gains of 2005. Again for the fourth straight year internationals were the place to be. Internationals gained 18% on average.

Early in the year investor concerns over rising interest rates and oil prices led to an 8% drop in the S&P 500 index between May and June. Fear spread across the globe and the EAFE (Europe, Australia and Far East) index lost 10% and the emerging markets lost 25%. Then oil prices backed off from their mid summer highs and after 2 years of interest rate hikes; the Feds left rates unchanged, After an ugly May and June global Markets resurged in the second half through Dec.

Among U.S. 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. Luckily, we follow a momentum based stagy based on what scoring the returns over the last 12, 6, 3 and 1 months. It's more of a disciplined approach and aligns our portfolios to what's delivering results.

At the beginning of last year when stocks were stagnating and the market appeared directionless most experts expected mediocre returns. A pervasive forecast back then called for the end of small cap leadership and the rotation from value to growth. There was a lot of doubt whether international would hold up. In fact, Value and Internationals had a bang up year. Small caps held their own and Growth funds gained, to a lesser extend.

Over the past 3 years we have been heavily invested in international funds. In the Sept Quarterly report we discussed this past 3 years is only the third period in the last quarter century when internationals outperformed U.S. equity stock funds.

We may be at a point where leadership is changing from international funds to large cap value U.S. equities. It takes several months foe 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.

In my Sept quarterly review we talked about how after 6 years the Dow and S& P 500 finally came back and how we were gradually adding to our positions here. There was an interesting article in the USA Today on Jan 2nd 2007 that I summarized as follows:

1. Stocks are priced for Success. When last at this peak in Mar 2000 price earnings ratio were 28 now based on 2007 earnings the price earnings ratio is 15. Earnings have increased almost 70% and the cash on hand has doubled.
2. P-E ratio poised to Expand. For the last 3 years P-E ratios contracted, history has shown that since 1905 there have been 8 periods when P-E contracted but only 2 cases when they contracted 4 years in a row. History is on our side. If P-R expands by 1 point it is equivalent to a 6.6% increase in the S&P 500.
3. Free Cash to Spur Deals. There is an abundance of cash on company balance sheets and private-equity funds.
4. Supply of Stock is shrinking. Last year companies planned to spend, at least 437 billion to buy back their own shares. Add to that the 1.4 trillion in mergers and acquisitions and there are fewer shares in the market place.
5. Funds may Flow Back to the US. There might be less money flowing overseas now that the US market is going better and people are no longer enamored with the real estate market.
6. Year 3 of the Presidential Cycle is Bullish. The last time the market fell in the 3rd year of the president term was 1939.
7. Liquidity Spigot is Still Open. U S corporations have almost 610 billion in excess cash plus foreign central banks are also flush with US dollars including China ‘s 1 trillion plus reserves in greenbacks. Some of these funds are going to find their way into the stock market.
8. Skepticism remains high. A survey shows 36% if investors are bearish on stocks. The fact that there are stock skeptics suggest there are still buying power out there. Stocks would be more vulnerable if everyone were bullish because that would mean most investors are already full invested.
9. Big Caps Stocks are Due. Small cap stocks have posted better returns than their large cap brethren since 2000. As a result, large cap stocks are cheaper than smaller cap stocks. Also larger companies are more stable and better able to keep posting stronger earnings in a slower economy.

The above is all true, but I do not want to paint to rosie of a picture as we still have to deal with a tough real estate market and slower earnings growth.

We accept that 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, .

Conclusion

Despite some economic shadows there is good reason to be upbeat about stocks in 2007. Business is spending, offsetting weaker consumer sending and the Federal Reserve will likely start trimming interest rates by mid or late 2007. The upshot is, we should have a good year, even if profits rise only 7%.

Yours Truly,

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