

Sound Investments Inc.

Kenneth A. Gilpin CFP

Third Quarter 2007

The last Quarter Ending Sept 30th

Energy and Materials sectors continue to lead as global demand remains strong. Conversely, Financials and Consumer Discretionary groups were in negative territory ... obvious victims of the mounting housing and credit troubles. Overall this market favors stocks that thrive in the late-stages of the economic expansion.

We upgraded 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, and 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.

Stocks surged ahead during the month of September. The Dow moved ahead 4%, the broader S&P 500 index rose 3.6% and the tech heavy NASDAQ gained 4% for the month. We rode through a painful decline during the summer to enjoy a rebound in September.

The third quarter was a roller coaster for stocks, starting from the mid-summer highs followed by swift drops through mid August when bad sub prime loans drove the major indices down. Oil prices hit a high and the dollar hit a low against the dollar. The Federal Reserve helped in September with a half point cut in short term interest rates.

An action packed quarter, like the one that has passed, clearly demonstrates the value of a discipline approach to the market and to not react emotionally. I upgraded to investments that show strong long term performance.

Recently, the strongest area of the market is the natural resources, communications and technology sectors. Financial and other value sectors remain the weakest. The Dow and S&P easily outpaced the smaller companies in the Russell 2000. The combinations of rising demand from strong foreign economies along with a weak dollar boost the profits of large multi-national companies that derive a major portion of their earnings from overseas. For example, companies in the S&P 500 generate 46% of their revenue outside the US while technology stocks generate 56% of their revenue overseas

Overseas investments continue to do well. We have been overweighed in internationals nearly 4 years now. Many of our positions have nearly doubled. It is occasionally prudent to take some profits of our long term holdings and rebalance.

Black Monday ... 20 Years Later

I was a stockbroker in October 1987, the day of the big crash. At that time we had computers call Quotrons and counter would only go from 1 to 99 and start all over again at 1. On Monday, the day of the crash one of the things I remember most vividly was that the counter would go down to 99 and then start over so at the end of the day I could not tell how many hundred points it was down! For the record, it was down 508 points or an astounding 24% in 1987. It was nice to talk to some old friends about this time but being pragmatist we discussed what's next.

Beware of Doom and Gloom

Here is a few reasons I don't think the sky is falling:

1. The Dow climbed in the fourth quarter in each of the last 9 years, and 24 out of the past 27 years. The S&P has produced rallies in 13 out of the past 15 years. In fact, these last 3 months of the year generate 63% of the total return achieved by the S&P 500 stock index from 1990 through 2006
2. The Merger and Acquisition business is reviving. This is a significant prop under Wall Street. Many pundits predicated these purchases would not get done. Maybe the interest rates are higher, but deals are getting done. Also, the spread or difference between low rated debt used in mergers and risk free government bonds the spread remains low. This is a sign that channels of credit remain open and it's good for commerce.
3. In our last quarterly report we indicated earnings would be lower. This has been true, but a number of who export has done very well. Exports have surged, fueled by the lower US dollar. This is a real positive for the economy.
4. Federal and State spending remain extremely strong. This is an automatic stabilizer that keeps huge segment of the workforce employed and buying products and services. The defense sector is especially strong, alas, and will continue to be strong for some time to come.
5. There is still a labor shortage in almost every area of the nation for white-collar jobs.
6. The third and fourth year of a president's term is usually very good for stocks.

On the negative side, we are looking at a continued downward slide in house prices. There over 2 million vacant homes, a record high. Also 2.8 million homeowners could see the payments on their sub prime mortgages reset higher in the next 2 years, that could add to the problem. There is no quick solution here, but we do have a Federal Reserve Bank that is willing to step in and do what it takes. The Federal Reserve Bank has many different ways to resolve this issue. The Fed can buy assets from Banks, even junky assets and replace them with good, solid cash dollars.

The economy can withstand a vast amount of problems because a solid job market continues to support the consumption of goods and services. Unemployment is the key and employment information is difficult to get a read on but as long as it stays below 5% it should be OK. We are watching this closely.

No predications are easy but this one is tighter, and for some clients who are closer to retirement now is a good time to take some profits.

I think it is time to be rather cautious towards this market. We are in a very tricky area. It is more of a trader market and traders can reverse their opinion and actions at the drop of a hat. It's not the best time to be loaded up with equities. I think the best thing that could happen now is that the stock market would fluctuate within a trading range, while the main averages hold above their Aug 16th lows.

Conclusion

As our **defensiveness increases in an aging bull market**, we expect to leave some profits on the table. At this point, we are well positioned for what lies ahead and can easily make adjustments for what lies ahead depending how the technical and economic activity unfolds.