

INVESTMENT COMMENTARY

A PUBLICATION OF LARRY THOMPSON & ASSOCIATES, INC.

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Volume 11, Issue 1

1st Quarter 2007

The Markets

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	1.22	1.22	11.85	10.73	6.92	8.61
Russell 1000 Growth	1.19	1.19	7.06	7.02	3.48	5.51
Russell 1000 Value	1.25	1.25	16.81	14.41	10.24	10.85
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	4.37	4.37	11.79	15.72	12.91	12.71
Russell MidCap Growth	3.95	3.95	6.88	12.40	9.44	9.44
Russell MidCap Value	4.86	4.86	17.12	18.58	15.22	14.00
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	1.95	1.95	5.89	12.00	10.94	10.23
Russell 2000 Growth	2.47	2.47	1.56	9.41	7.87	6.30
Russell 2000 Value	1.46	1.46	10.39	14.47	13.61	13.46
<u>International Equity</u>						
MSCI World ex US	4.01	4.01	19.59	20.01	16.03	8.55
MSCI World ex US Growth	4.83	4.83	17.38	17.91	13.86	6.14
MSCI World ex US Value	3.20	3.20	21.78	22.08	18.17	10.75
MSCI Emerging Markets	2.34	2.34	21.03	27.97	24.84	8.77
<u>Real Estate</u>						
Nareit Equity REITs	3.46	3.46	21.76	22.55	22.07	14.66
<u>Domestic Fixed Income</u>						
LB Aggregate	1.50	1.50	6.58	3.31	5.35	6.46

Despite a decline in housing prices, a blowup in the sub-prime mortgage market, a steep sell-off in China and higher oil prices, most markets ended the quarter in positive territory – the Dow Jones Industrial Average (DJIA) being a notable exception.

Domestic Large Cap Markets

The Russell 1000 (domestic large-cap equities) returned 1.2% in the first quarter as the markets experienced increased volatility. The deterioration of the sub-prime mortgage market and fears of a slowdown in economic expansion weighed on investors' minds. Economic data released throughout the quarter supported these fears as the data substantiated suspicions that our economy was indeed slowing. Such events are not surprising after a fifth consecutive year of economic expansion and 17 consecutive rate hikes by the Fed.

The best performing sectors among larger companies included Materials, Utilities, and Telecommunications. The Materials sector continues to benefit from rising commodity prices, which is primarily the result of continued global growth. The Utilities sector was boosted by the proposed leveraged buyout of TXU, opening the doors for other takeovers in a

Investment Commentary is a newsletter dedicated to the issues, trends, and strategies surrounding both the individual and institutional investor. It is published quarterly by Larry Thompson & Associates, an independent investment management consulting firm based in Dallas, Texas.

historically quiet sector. The worst performing sectors included Financials, particularly commercial and investment banks with large exposures to the sub-prime mortgage market.

Domestic Small-cap and Mid-cap Markets

Despite expectations that investors might favor larger companies during a slowing economy, the small-cap markets narrowly outpaced their large-cap counterparts. The Russell 2000 (domestic small-cap) returned 2.0% for the quarter. The hero for the quarter, however, was the Russell MidCap Index, which significantly outperformed other capitalization ranges, gaining 4.4%.

Similar to the larger part of the market, the best performing small-cap sector was Materials, up 11%. Consumer Staples and Information Technology were also strong performers. Financials and Telecommunications were the worst performing sectors, down over 4% and 1% respectively for the quarter.

“Value” versus “Growth”

The whole idea of what makes a company a “value” company versus a “growth” company can be quite confusing. In fact, a given company may be included in the S&P Value Index, but be included in the Russell 1000 Growth Index. To add further confusion, some companies are actually split between Growth and Value. Irrespective of labeling issues, the value part of the markets have outperformed the growth part of the markets for going on six years now. There have been a few quarters where growth has finished ahead, but these periods have been few. This trend continued in the first quarter in both the large-cap and mid-cap parts of the domestic markets. However, growth bested value in the small-cap space.

There is increasing evidence that value’s domination of growth may be coming to an end. One measure of value opportunity is the discount to fair value, which is the amount by which the cheapest stocks are under-priced compared to the average stock. For example, the most recent value-over-growth trend began in early 2000 – at the end of the technology bubble. The discount to fair value was at an all time high at this time. Today, however, this measure is at the low end of its historic range.

The Russell 1000 Value Index (domestic large-cap value) posted a return of 1.3%, compared to a 1.2% return for the Russell 1000 Growth Index. The spread was a little greater in the mid-cap space, with the Russell MidCap Value Index returning 4.9% versus the Russell MidCap Growth Index coming in at 3.9%.

In the domestic small-cap arena, the Russell 2000 Growth Index returned 2.5%, significantly outperforming the Russell 2000 Value index, which returned 1.5%. This difference was primarily the result of the sharp decline in small-cap financial companies, which make up 34% of the Russell 2000 Value index, but only 9% of the Russell 2000 Growth index.

Real Estate Markets

Real estate investment trusts (REITs) started 2007 on a strong note, helped by a bidding war for Equity Office Properties, one of the largest REITs in the industry. However, early gains were erased amidst the broad market weakness and on concerns of high valuations and overly optimistic 2007 earnings expectations. Even so, the NAREIT Equity REITs Index

returned 3.5% with continued strength in regional malls only partially offset by a decline in apartments.

International Equities – Developed Markets

The first quarter of 2007 saw developed International equity markets outperform emerging international and the U.S. equity markets. The MSCI World Ex-US returned 4.0% for the first three months. As has been the trend over the past few years, the U.S. equity markets ranked very close to the bottom during the first quarter of this year when compared to other developed countries. Of the 23 developed markets, the U.S. ranked 20th with only Italy, Hong Kong and Ireland falling behind the U.S. The top performers were Finland, Singapore and Australia.

International Equities – Emerging Markets

After a stellar 2006, emerging markets began 2007 with a bout of instability. A 9% drop in the Chinese market in late February spread chaos to markets across the globe, resulting in lower stock prices worldwide. By the end of February, the MSCI Emerging Markets Index was in negative territory. Almost as fast as they sold off, Chinese stocks rebounded, as investors recognized that growth in China continues to be strong and the outlook seems bright. March returns for the MSCI Emerging Markets Index were 4%, leaving the index up 2.3% for the entire quarter.

The top performing emerging market countries were Peru, Morocco and Malaysia. The worst performers were Taiwan, India and Colombia.

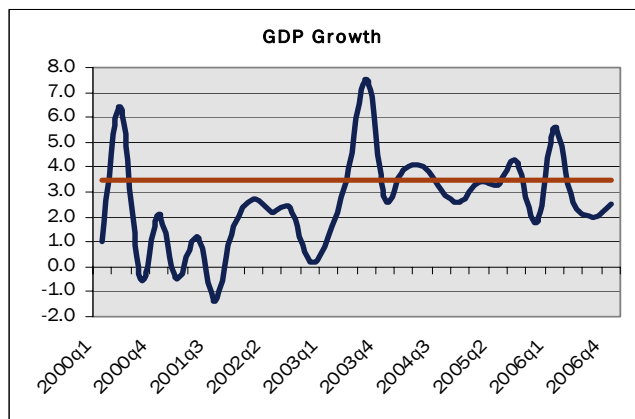
Domestic Fixed-Income Markets

The domestic bond market, as measured by the Lehman Brothers Aggregate Bond Index (LB Aggregate), gained 1.5% during the first quarter. The Fed Funds rate has been unchanged at 5.25% for six straight Fed meetings. However, speculation has begun as to when the Fed might begin lowering interest rates. Most predictions focus on some time close to the end of 2007.

Despite turmoil in the mortgage market, demand for high-yield bonds remained strong and led the way for those issues to outperform their investment grade counterparts. According to Morningstar Inc., the average high-yield bond fund had a total return of 2.60% in the first quarter. In contrast, funds that owned longer-term investment grade securities such as U.S. Treasuries posted gains of 1.20%, on average.

The Economy

As expected, the economy slowed in 2006. The latest economic growth data (GDP growth) for the fourth quarter showed the economy grew 2.5%. This figure is below the historical average of the economy, but it is not close to reaching the recessionary lows seen in 2000 and 2001. What concerns the markets today is what might happen to the



economy in the future. Heading into the first quarter, most economists were predicting similar growth in 2007 to that seen in 2006. However, the sub-prime mortgage explosion and overall housing weakness created doubt in these somewhat optimistic forecasts.

Even when the housing market was intact, homeowners and homebuyers were warned against throwing all caution to the wind. There were no shortage of articles speaking to the risks of “no equity” purchases, interest-only financing and the like.

The “perfect real estate storm” was created by high home prices, as a result of a robust real estate environment; very low mortgage rates, which allowed many renters the option to become first-time homeowners; and some willing and creative lenders who were all too happy to accommodate homebuyers who wanted more than they could really afford. The outcome was predictable. When people live on the “credit edge” and nothing can go wrong or else – things go wrong. And, just when rapid appreciation is needed to build positive equity, the market goes flat – or worse yet, turns down.

The homebuilding sector grew in importance during the recent real estate boom and became a leading driver of economic growth. The result, however, was an ever-increasing inventory of new homes. Now, housing prices have begun to fall. Likewise, lenders have tightened their requirements for loans. The result – sales of new homes have begun to decline and the home building industry is in turmoil. Economic pessimists argue that a glut of bank-repossessed homes will appear on the market later this year, further driving down prices and new home sales. Layoffs in the housing sector could rise and the overall economy could suffer. We believe the impact on the economy will most likely be mild, but it will contribute to slower growth.

The housing situation has put the Fed in a tough situation. It could choose to lower interest rates. If mortgage rates decline, this might allow borrowers to refinance to lower fixed-rate mortgages. The downside of this strategy is that lowering rates could lead to higher inflation at a time when inflation is showing signs of being contained. If it must choose, the Fed will choose to control inflation over saving the housing market.

The largest influence affecting inflation is the return of higher energy prices. The lack of a hurricane season in 2006 and a mild U.S. and European winter temporarily lowered energy prices, but there are many reasons why energy prices should rise back towards previously seen levels. The oil demand from China and India has not waned, world oil supply is struggling to meet the current demand and instability in the Middle East continues to be a worry. Iran has the world’s third largest oil reserves after Saudi Arabia and Canada and any disruption to its supply could be very negative for the global economy. If prices continue to rise, American consumers will once again be facing \$3+ gasoline prices this summer.



Another reason that inflation is still a threat is that the economy outside the housing sector continues to thrive. March unemployment dropped to 4.4%, the lowest level since spring 2001. As we have said before, as long as people have jobs, they will continue to spend money, boosting the economy. How much money consumers have left to spend is a bigger question. Retail sales are slowing and should continue

to slow during the year, although spending levels are still higher than last year. This will put pressure on companies to maintain the strong earnings growth experienced in 2006. Most companies will not be able to increase their sales and earnings at the same rate as they did last year.

So, where does this leave us? First, most market segments experienced a good first quarter – domestically and internationally. Since there did not seem to be high expectations for 2007, many investors were pleasantly surprised. Big pluses from the consumers’ and investors’ perspectives include continued wealth creation from financial assets, low unemployment, solid wage gains and low interest rates. On the “not so positive side”, we have problems in the housing market, continued uncertainty in the Middle East, investors’ risk appetite inching upward and a general economic slowdown.

From a market fundamentals perspective, price-earnings ratios are not extended, which suggests that equity markets are not overvalued at current levels. In all likelihood, earnings growth will not be as robust as in recent years and will probably return to the more normal levels of 5% to 10%. Given the aforementioned landscape, our 2007 domestic equity expectations parallel the above-stated earnings expectations – mid to high single digit returns. Of course, this is a purely fundamental view of our markets and does not include the myriad of external shocks that our markets may encounter along the way.

For a copy of LT&A’s 2007 Capital Markets Assumptions, please contact Li Wang at email address lwang@larrythompson.net or by telephone at 214-752-5430.*

* LT&A’s Capital Markets Assumptions will be available for distribution on April 20, 2007.

Special thanks to Alan Bergin, CFA, Jacob Bowland and Josh Greenleaf for their contributions to this issue of the *Investment Commentary*.