



# Bradley, Foster & Sargent, Inc.

## Quarterly Market Commentary

October 2006

### The Bull Market Climbs a Wall of Worry

Let me again suggest that the future has never been clear to me (give us a call when the next few months are obvious to you – or, for that matter, the next few hours).

Warren Buffet, 1966

For many of us in the investment business, the question most frequently asked of us by clients and friends is: “Where is the market going?” Or phrased another way, “What do you think about the market?” It would appear to be an entirely appropriate question to direct to investment professionals, as a large percentage of our waking hours is spent analyzing companies, industries, sectors of the stock market and the stock market itself. When asked this question, many investment professionals sound knowledgeable about the direction of the stock market – either because they actually think that they can accurately forecast its future behavior or because it might be embarrassing to admit that they don’t know.

At Bradley, Foster & Sargent, Inc., however, we are not embarrassed to admit that we do not know where the stock market is headed over the short term. We also admit freely that we don’t know in which direction such things as interest rates or the price of oil or gold are headed in the short term. And we find ourselves in good company in that regard, as investors such as Warren Buffet, Peter Lynch, and John Templeton all believe that it is impossible to predict the direction of the market with any degree of regularity. We do believe, however, that we can forecast with some accuracy the total return of the U.S. stock market over the long term (30 or more years), as there is much empirical data to draw on over the past 200 years.

While we believe that it is not possible to predict stock market movements over the near term with any degree of consistency, it is nonetheless pleasant to report that our January 2006 forecast that the S&P 500 Index might trade at 1360 by year-end is close to the mark, the Index trading currently at 1365. It is also agreeable to note that our prediction that large capitalization stocks would begin to outperform smaller capitalization stocks has also been realized thus far in 2006. At the market close on October 6, 2006, the 2006 year-to-date total return of the S&P 500 Index was 9.3% compared with 4.3% for the NASDAQ Composite. The realization that we cannot consistently predict the future direction of the market leads us not to attempt to be market timers.

Rather than analyzing every twist and turn of the market, we strive to understand companies, their industries, their stocks and how the stock market values them. The stock market is made up of thousands of companies and dozens of industries, and if we are able to follow and analyze good companies and purchase their shares at reasonable prices (which we accomplish with a fair degree of regularity), we can make very good money for our clients over the long term. At Bradley, Foster & Sargent, Inc., we also seek to understand the behavior of the stock market – its valuation in regard to historic metrics, its cycles which often seem to repeat themselves, how it reacts to changes in interest rates and inflation, and the often conflicting currents of supply and demand for

shares. This leads us to the stock market's current behavior, as the bull market continues to "climb a wall of worry."

### Climbing a Wall of Worry

Clearly, we are in the midst of a bull market. After bottoming in 2002, the bull market really took off just before the start of the war in Iraq in March 2003. Although still well below its historic high of 1550 in March 2003, the S&P 500 Index has rebounded 70%+ since its trough in 2002, while the NASDAQ has more than doubled. The upward move since early August has taken place mainly because investors became convinced that the Federal Reserve's campaign of raising interest rates is over. Over the past two months, the yield on the 10 year U.S. Treasury Note has dropped from 5.25% to 4.75%. The chart below shows the bull market since January 2003:



Over the past three years, there has been no shortage of things to worry about. The media has trumpeted one apparently intractable problem after another. Here is a short list to refresh your memory:

#### Ten Top Things Investors Have Worried About 2003-2006

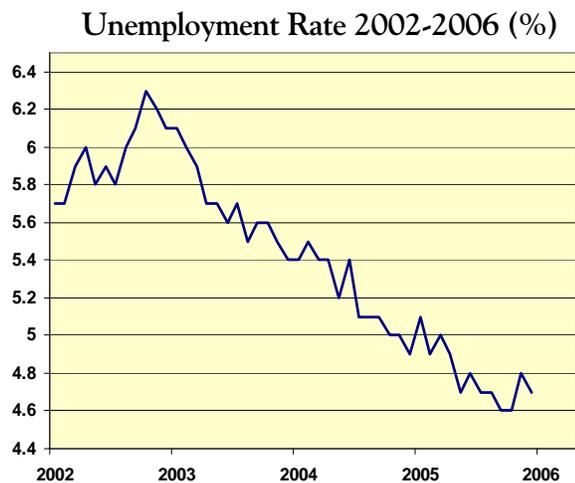
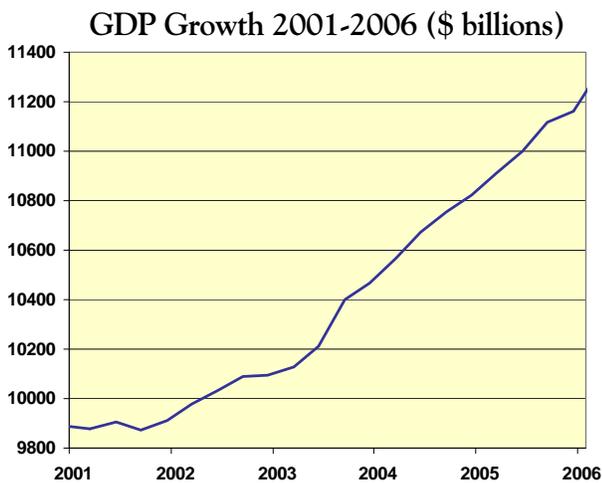
1. War in Iraq and Afghanistan
2. Terrorist Attack in U.S.
3. Large Budget Deficit
4. Large Current Account Deficit
5. Rising Interest Rates
6. Collapse in Housing Market
7. High Energy Prices
8. Weak U.S. Dollar
9. Coming Recession
10. 2004 and 2006 Elections

For novices to the stock market, it is natural to wonder: If there has been so much to worry about, how can there have been a bull market at all? Austin Pryor, in his newsletter *Sound Mind Investing*, explains this by suggesting that a bull market is a process rather than an event. At the end of the bear market in late 2002 and early 2003, there were few sellers of stocks at the margin. Most investors who had wanted to sell had already done so. Thus, even a small number of buyers at the margin can begin a new bull market if there are few sellers. As prices rise, most skeptics continue to doubt, i.e. "the wall of worry," but a few see better times ahead. As doubters incrementally convert to believers (buyers), prices continue to rise. A trend is established, and momentum investors jump on board. Prices rise further, reassuring still more skeptics, who buy stocks. And finally, when all

the worriers are converted, the bull market is over. Why? Because everyone who wants to buy stock has already done so. There are now few new buyers at the margin, and the process is ready to unwind, as believers become skeptics (sellers) again and the process continues.

### Anxiety vs. Reality

This “Wall of Worry” analysis deals largely with investor psychology and the supply of and demand for shares at the margin. This concept is important for investors to understand. It is also important to mention, however, that if investors’ dire forecasts actually take place, prices may indeed fall rapidly. For example, investors have worried that high interest rates and energy prices combined with a collapse in the housing market will lead to a recession in the U.S. If, in fact, the U.S. economy is not in the midst of a mid-cycle slowdown but actually rolls over into recession, this “Wall of Worry” bull market will be over. The stock market will pitch into a nasty correction or even bear market. Fortunately, the U.S. economy has been hitting on all cylinders as the charts below demonstrate:



### More Worries on the Horizon:

#### Mid-Term Elections

Voters will soon go to the polls for the mid-term elections. Some pollsters are predicting that the Democratic party will win one or both branches of Congress. If they win both, it will be first time that they control Congress

since 1994. This could lead to a level of political partisanship and rancor not seen since Watergate, including a possible attempt by Congress to impeach President Bush because of the Iraq war. It would certainly lead to an attempt to rescind the Bush Administration tax cuts including the 15% Federal tax on long term capital gains and dividends, although this step would face a likely veto by President Bush.

## North Korea

Despite warnings by the U.N., North Korea tested a nuclear bomb on October 8. The South Korean stock market sold off 3% the next day, but the U.S. market shrugged off the news, finishing higher. Having violated many treaty obligations over the past decades, North Korea now possesses both nuclear weapons and missiles with a range of 1500 miles. Intelligence sources report that North Korea is unlikely to have the technology to deliver a nuclear weapon on targets with its missiles for some time. Investors appear to be complacent about this situation, judging that it is not in the national interest of Japan, South Korea, Russia and especially China (which largely controls North Korea's energy and food supplies) to let this situation get out of control. If North Korea persists in its dangerous behavior, it is likely that both Japan and South Korea will develop nuclear weapons – something that China fears. This is potentially a very dangerous situation – especially if Kim Il Jung acts even more irrationally. We monitor this situation closely and factor it into our decision making process in our stock selection and when recommending asset allocation for our clients.

## Iran

The situation with Iran is even worse. Iran has considered America its mortal enemy since the Iranian Islamic revolution overthrew the Shah in 1979. Iran regularly calls the U.S. the “Great Satan.” The catalogue of violence and terrorism sponsored by Iran over the past 27 years is breathtaking. Examples include Iran's seizing of the U.S. embassy in Tehran in 1979, holding 52 hostages for 444 days, and the suicide bombing of the Marine barracks in Lebanon in 1983 by Hezbollah, which is effectively a wholly-owned Lebanese subsidiary of Iran's Revolutionary Guards. 243 Marines were killed in the attack. More recently, Hezbollah invaded Northern Israel and kidnapped and killed Israeli soldiers. During the subsequent conflict, Hezbollah fired 1200+ short range rockets on Israeli towns and settlements. According to the U.S. State Department, Iran is “the leading state sponsor of terror” in the world. U.S. Director of National Intelligence John Negroponte has stated that Iran will be in a position to have a nuclear weapon by the beginning of the next decade. The International Atomic Energy Agency Board of Governors found Iran in breach of its Non-Proliferation Treaty Safeguard Agreement in 2004. Numerous pledges by Iran to cooperate have been broken. The U.N. Security Council is now considering sanctions on Iran. On October 25, 2005, Iranian President Mahmoud Ahmadinejad was quoted during a meeting with students at the Iranian Interior Ministry as follows: “The annihilation of the Zionist regime will come... Israel must be wiped off the map... And God willing, with the force of God behind it, we shall soon experience a world without the United States and Zionism.” The multi-decade problem with Iran is not going to disappear very soon. Once again we follow this situation very closely, as it potentially has major ramifications for stock markets globally.

## Conclusion

As investors, what are we to make of these seemingly intractable problems? The market faces worrisome difficulties and uncertainties every day. There are geopolitical, political, fiscal, and economic risks of every kind. These risks are discounted by the stock market, and this is one of the reasons why the stock market has provided returns over time at a substantial premium over bonds. Currently, the U.S. economy is doing well. So are the new engines of global economic growth – China and India. The U.S. Department of Labor just “discovered” 800,000 jobs created over the past year, which had previously been uncounted. Yet the forward P/E on the S&P 500 Index Operating Earnings – 15.7 – is at a 7.6% discount to the market's average forward P/E ratio of 17 over the past 45 years. Clearly, if worst case scenarios materialize, the U.S. stock market will fall in the short term. But over the long term, quality growth stocks, such as the ones Bradley, Foster & Sargent, Inc. favors, have produced excellent returns, and we believe that the future will not be different than the past.