

Investment Perspective

Fourth Quarter 2006

“The market does not remember yesterday any better than it knows tomorrow.” -- [Undisclosed](#)

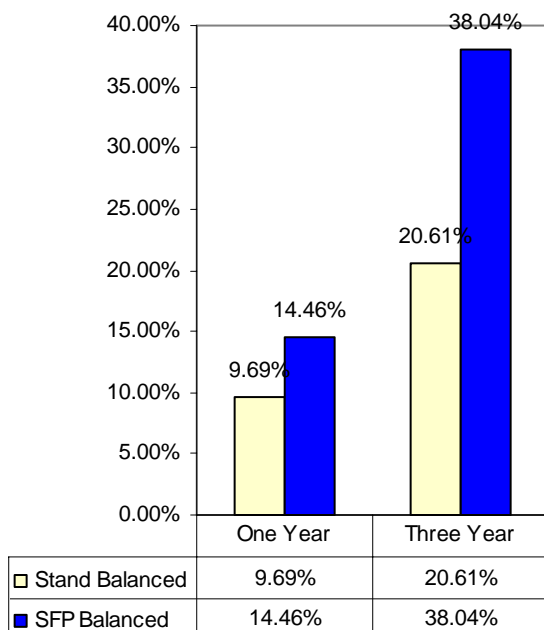
SFP Core Strategies*	Quarter 4	
	2006	One Year
US S&P 500 (Enhanced)	6.59%	15.03%
US Large Value	8.05%	20.18%
US Micro Cap	9.55%	16.16%
US Small Value	10.14%	21.55%
US Equity Real Estate	8.95%	35.26%
International Large Value	12.03%	34.15%
International Small Cap	12.62%	24.88%
International Small Value	13.53%	28.39%
Emerging Markets	17.23%	29.17%
Emerg Mkts Small Cap	20.98%	37.31%
Emerging Mkts Value	18.78%	37.93%
Ultra Short Fixed Income	1.28%	4.78%
Shrt/Inter Global Fixed Inc	1.02%	3.89%
SFP Model Portfolios		
SFP Income Portfolio	4.44%	10.57%
SFP Balanced Portfolio	6.31%	14.46%
Non SFP Std Balanced	4.09%	9.69%
SFP Aggressive Growth	9.88%	18.35%

Wow, what a quarter and what a year. It may have been stormy here in the Northwest late in 2006, but the sun was shining on the financial markets. We have only positive results to report both for the quarter and the year with all Skaggs Financial Planning, LLC strategies and model portfolios.

Overall, the U.S. stock market returned 13.18 percent in 2006 as measured by MSCI (15.8 percent for the S&P 500). On the fixed income side, returns were more muted, but still positive. The Lehman Aggregate Bond Index was up just over 4 percent for the year. The overseas markets had a similar performance to the U.S. and returned 13.5 percent as measured by MSCI in terms of the local currencies. Of course, we don't care about the returns in terms of the Euro or Yen - we care about returns in terms of the mighty Greenback. And 2006 saw the value of the US dollar decline. This boosted international returns to nearly 18 percent. That is one benefit of the dollar decline that could help offset those price increases at the local Wal-Mart.

Our model portfolio returns were simply outstanding. The SFP Balanced portfolio, with real life expenses and nearly half of the portfolio dedicated to ultra-safe bonds returned 14.46 percent for 2006. While this portfolio should prove to be much more conservative than MSCI's 100 percent stock index, it still provided a higher return and a return that was nearly equal to the 15.8 percent produced by the S&P 500 index.

Standard Balanced vs. SFP Balanced



On relative basis, our SFP Balanced Portfolio continues to outperform the Standard Balanced portfolio. The 14.46 percent return bested the Standard portfolio by 4.77 percent, a return nearly 50 percent higher for the year. And for the three-year period ending on December 31, 2006, the SFP Balanced portfolio's total return was 38.04 percent. That's about 17.43 percent higher than the Standard balanced portfolio, or an increase of around 85 percent. To be fair, the SFP Balanced portfolio was also more volatile – plain riskier. Fortunately, with only two of the last twelve quarters showing underperformance, almost all of that risk was to the upside. It would be naïve to believe we will always have the privilege of the upside volatility without any of the downside cost, but it sure has been nice.

How were these relative returns achieved? As you know, many experts have been calling for large growth stocks to outperform the stocks of smaller companies and more value-oriented companies. Well, we did not listen and once again our returns were enhanced by our exposure to smaller company stocks and value stocks. Stock performance outside of the United States, enhanced by the dollar's decline, and equity real estate, unlike residential real estate, also continued its bull run. Our strategy returned 35.26 percent! Please see the performance table and charts for all the numbers.

But I understand the thinking of the experts making their predictions. U.S. value and small stocks have outperformed their growth counter parts for so long, you would think that growth is due to outperform. After all, as measured by the performance of our associated strategies, value has outperformed for seven years in a row and small has outperformed for the last eight years. In similar fashion, one should expect stock market returns over the next three years to be lower because of the strength over the last three years, right?

But actual history is not so clear. We looked at each three-year total returns starting each quarter, beginning in January 1940 through December of 2005. That is a total of 241 separate, three-year return periods. The average three-year return for the U.S. Market (CRSP 1 – 10) during this time was 43.4 percent. Speculating that the market might swing from good periods to bad, we then looked at returns for each three-year period that followed an above average proceeding three-year period. Put simply, if the three previous-year period was good, what happened during the next three years?

The answer was astonishingly similar. There were 116 of these periods, and the average return was 42 percent. A true student of statistics would not be surprised, since only a slight increase above average would qualify as a good period. But what if we only looked at three-year periods following very strong market performance; for instance, periods in which returns were double the average? Do the following periods experience negative returns? There were 28 qualifying periods that met this test and the average return was still 25.7 percent – not too bad.

IS GROWTH ALWAYS FOLLOWED BY A DROP?
This bit of conventional wisdom isn't always so.

- When we crunched three-year returns from 1940-2005, we found an average three-year return for the U.S. Market of 43.4 percent.
- When we looked at returns for the three-year period following an above-average three-year period, we found an average return of 42 percent.
- Even following periods in which returns were double the average, the average return was still 25.7 percent during the next period.

Conclusion: Staying the course is often the best plan. Conventional wisdom isn't necessarily the best guide.

Yes, returns tend to be lower after strong performance – there is some reversion to the mean as they say. And yes, we do need to regularly monitor and rebalance positions to make sure they are still appropriate for you. But changing your strategy just based on these past return swings is a mistake.

In fact, in our third quarter 2004 Investment Perspective newsletter, we warned about the sustainability of equity real estate returns which had been quite good. Still, we stayed disciplined, stuck with our strategy and left the position in the model portfolios. Since that time, it has returned 76.78 percent.

While not completely analogous, you can think of the market like a flipped coin. Each time it is flipped, there is a 50/50 chance of it coming up heads. The coin does not know when five heads has been flipped in a row and tails is now “due”. All flips are always 50/50. In the same way, the market does not care what the price or outlook for a stock was last week, last month, or last year, it only cares about the current price and outlook. And our outlook for the future is that capitalism will continue to work and capital markets will continue to provide positive long term returns.

Have a great and prosperous winter, and may spring soon arrive.

Warmest regards,

Brian J. Skaggs, CFP

The information in this newsletter should not be construed as investment advice. Investment advice is only given in the context of individualized interactions that ideally result in the development of a continually evolving financial plan. *Total returns as measured by the performance of associated DFA funds - advisor fees not included in strategy performance. Advisor fees are subtracted from model portfolio performance at 8.3 points per month. This information is believed to be reliable, but we do not guarantee the accuracy of the information. **Past performance is not an indication or guarantee of future performance.**