Sargent Bickham Lagudis

Market Commentary and Review

January 3, 2007

"I am not ashamed to admit I am ignorant of what I do not know"
- Cicero

Summary:

2006 turned out to be a good year in financial markets with returns of about 10% for balanced portfolios and higher for most equity indexes.

2007 begins with a slowing economy, but most of the positive trends remain – good corporate profit growth, reasonable valuations, strong employment growth, moderate inflation, and some cooling in energy prices.

No significant changes to our strategic allocation decisions, but some fine tuning to our Alternative Assets and Dividend Income strategies.

In This Letter

Dear Clients and Friends,

Year end newsletters reminisce about the year past and prognosticate about the year ahead. This one will do the same. The last work days of 2006 brought Colorado's second major snow storm in two weeks (an occurrence remembered by few). While the snow caused travel and other problems, it was stunningly beautiful and a wonderful reminder of how fortunate we are to live here.

Significant events in 2006 included the Israel/Hezbollah war in Lebanon, North Korea's nuclear test, the Republican loss of control in Congress, a spike in gasoline prices, the Iraq war, a controversial sale of U.S. ports to a Dubai company, and Dick Cheney's hunting accident. The economy posted its 5th year of growth, corporate profits were up, and inflation came down.

We completed our 18th year of service, striving each day to help you, our clients, achieve your financial goals with the best service possible. Cliché? Sure, but we applaud our staff and thank our clients for the opportunity.

In reaching those financial goals, 2006 turned out to be a very good year. Following are returns through December 31, 2006:

	2006	Last 3 Years Annualized	Last 5 Years Annualized
Large Cap (S&P 500)	15.9%	10.4%	5.9%
Large Cap (Dow Jones Industrials)	18.9%	8.2%	6.4%
Mid Cap (S&P 400)	10.0%	12.6%	10.4%
Small Cap (S&P 600)	15.1%	14.3%	12.1%
Nasdaq 100	7.2%	6.4%	1.7%
Foreign Stocks (EAFE)	25.8%	19.8%	14.9%
Bonds (Lehman Aggregate)	3.9%	3.3%	4.7%
REIT's (Vang. REIT Index)	35.1%	25.7%	22.9%
High Yield Bonds (Vang. High Yield)	7.6%	6.5%	7.7%
Commodities (Commodity Research Bureau Index)	13.5%	15.6%	15.5%
Alternative Assets Group (13 Fund Avg)	12.4%	8.6%	12.3%

So what explains the returns from 2006 and what do we expect for 2007?

2006 began with several major concerns:

1. Oil prices were high and had risen from $45 bbl at the beginning of 2005 to $65 bbl at the start of 2006. They continued to rise through July, and finally peaked above $75. When prices finally fell to almost $55 bbl, markets were relieved because of the lower inflation pressures and the additional discretionary income consumers would have as a result of lower fuel costs.
2. The Federal Reserve began raising interest rates in June of 2004 and raised rates 17 times until finally stopping June 29th at 5.25%. While there was much speculation on the final increase, the markets could not be sure until the June announcement. This added to the market's confidence.
3. For several years, pundits have speculated that corporate earnings would falter. 2006 again proved the pessimists wrong with a 14% gain in S&P 500 earnings.
4. Some investors argue market valuation remains higher than historical averages. We have believed for some time, however, that when taking interest rates and inflation into account the market was, and remains, undervalued by about 10%.
5. After several years of economic growth, concerns about a recession increased this year. The culprits were expected to be a bursting of the housing bubble, slower consumer spending, too much debt, etc. While the economy did slow to a 2% annual growth rate in the third quarter, there was no recession and inflation has receded.
6. Political and Geo-political risks: we began and end the year with many of the same problems. Iraq has deteriorated and Iran is building a nuclear bomb. While Republicans bemoan the result of the midterm election, nearly everyone agrees we need a different plan in Iraq. That seems more likely now and is hopefully a positive.

2007 begins with some of the same issues, but some have changed:

1. Oil prices remain high, but have stabilized.
2. The Federal Reserve quit raising rates last June, but it remains an open question about the next move. Some believe they might be forced to raise rates again. We believe this is unlikely but we don't rule it out.
3. We continue to believe in a soft-landing economic scenario (slowing but no recession). If this is true, there is likely to be a slowing in corporate profit growth, but we would not be surprised if profits didn't surprise on the upside once again.
4. There have been signs the worst of the housing slump is behind us, but this remains a risk we'll monitor.
5. The trade deficit has been a long-time concern of ours that has yet to cause any significant market implications. A sharply falling dollar or an increase in inflation are risks to 2007.
6. We don't expect major initiatives from Washington since there is only a slim Democratic majority and Bush has the veto. However, tax policy and more regulation are increased risks in 2007.

Strategic Allocation Decisions

We began reducing small and mid cap allocations in the middle of 2006, which turned out to be only partially correct. While for the year small caps and large caps had similar returns (mid caps lagged), the timing of our changes hurt us. Small caps corrected more during the May – July decline, and then rebounded more. We continue to believe in this change due to large caps having more attractive valuation and better growth prospects for 2007.

We expect fixed income returns to be modest, and we are underweighted. International assets remain attractive and we are maintaining approximately 20% of our equity allocation in mutual funds with foreign holdings.

We continue to expect our Alternative Assets Group to outperform bonds, and we are fully invested in equities according to client's targets.

Performance:

Our accounts performed well over the last 12 months. A representative sample of our balanced accounts returned 9% to 10% and equities returned about 15% *(everyone's account is different, so your portfolio may be higher or lower than these averages).* Admittedly, it has been a difficult year to keep up with index returns. According to Goldman Sachs, 85% of mutual funds have underperformed their benchmarks this year. This puts us in the uncomfortable and unusual situation of having helped our clients make attractive returns this year, but being disappointed on a relative basis.

Asset Class Recap

U.S. Stocks:

According to our multi-factor model the market is currently 10% undervalued. The P/E on 2006 estimated earnings is 15.8, and based on 2007 estimated earnings is 14.4. This is half the level from the last market peak in 2000. We consider valuations to be reasonable but expect neither multiple expansion or contraction in 2007.

Earnings outperformed expectations for 2006 growing 14% to 15% over 2005. For 2007 S&P earnings are projected to increase 6% to 10%. If true, this would be a significant drop from 2006 and the prior few years. If the economy does not fall into recession, we would not be surprised to see this estimate outperformed again.

U.S. corporations are in solid financial condition, and 2006 saw a record level of mergers and acquisitions. These trends are unlikely to change in the near future, and are positive for market performance.

Investment-Grade Bonds:

In May we predicted the peak in rates was near, and in fact they peaked within a few weeks at 5.25% (10 Year Treasury bond). Since then yields fell to 4.4% before rising back to 4.6% - 4.7% at year end. The total return of 3.9% for bonds this year is still not anything to get excited about and while returns over the next 12 months are likely to be at least equivalent to the 4%-5% or so bonds are paying, it should remain below the returns from other asset classes.

Dividend/Defensive Group:

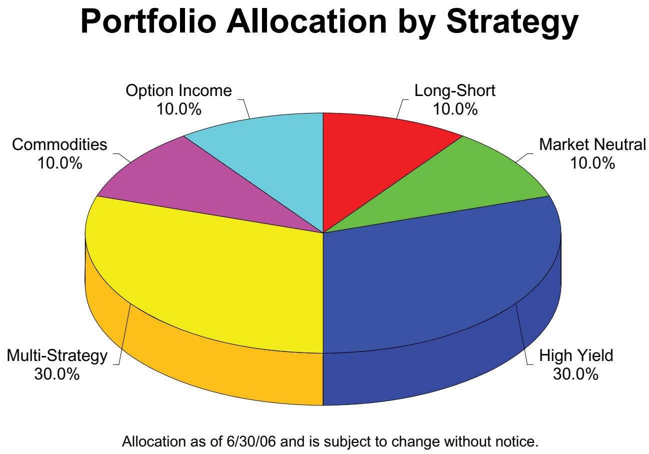
Our Dividend Income strategy has performed exceptionally well since we first rolled this out three or four years ago as an alternative to fixed income; however, we have had to re-evaluate the goals and objectives since that time. When first started, we were able to target a yield equal to or greater than 5 year bonds, which were only 2% to 3% in 2003. Today, yields have risen to 4% to 5% on bonds and have fallen on many stocks as a result of rising stock prices.

We continue to monitor a list of high quality stocks for selection, but have modified the criteria for inclusion slightly:

- Companies must first be of high quality defined by either an A- or better quality rating by S&P or a safety rating of 1-2 by Value Line.
- Companies must either have a yield greater than 1.5x the S&P 500, or must have a beta (risk rating) of 20% less than the S&P 500.
- Companies passing these two screens are then subject to the same quantitative, qualitative, and technical analysis used on all the companies we research.

Alternative Assets Group:

We have re-labeled the Low Volatility Group to be more consistent with the more broadly used term "alternative assets", and we have consolidated real estate and REITs into this category. Additionally, we have included gold into the list of approved investments, which will add additional volatility to the average, but historically has been an effective hedge against rising inflation, international crisis, and a falling dollar. The overall strategy is similar to that employed by hedge fund "fund of funds", but with lower fees, better visibility, better regulation, and hence less risk of fraud. The returns continue to be very attractive with a six year record averaging better than the S&P 500 with only a third or less of the risk. The 13 funds included have the characteristics on the following graph:



Real Estate:

We've nicknamed REITs the Energizer Bunny©. They just keep going and going. This is the third year of returns over 20%. Our valuation concerns remain, but we must admit our analysis may be flawed. By consolidating them into our alternative assets group we make them more or less a permanent part of the alternative assets allocation.

Model Equity:

Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.

It had to happen eventually, and it did. After three consecutive years of outperforming the S&P 500, our model equity underperformed in 2006. We have analyzed it from every angle imaginable and it comes down to three or four stocks that got clobbered. They were Chico's, United Health, Valero, and Qualcomm. We also re-learned a lesson about bad timing as we bought or sold too late. And finally, we were overweighted in healthcare, which turned out to be the worst performing sector. On a cumulative basis, the return is now equal with the S&P 500. Both are up 73% since 1/1/03**.**

Our current portfolio remains overweight healthcare and underweight technology. This is more due to a focus on our research strengths than a sector call. Other sectors are close to S&P 500 weightings.

Foreign Equities and Fixed Income:

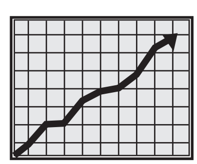
No changes to our views expressed previously: *"we continue to have over weighted positions in foreign equities and fixed income in our model portfolios, but we would not be surprised to see some moderation in relative performance. For the last several years foreign investments have significantly outperformed – emerging markets by a large margin. Some speculative characteristics are clearly forming, which usually leads to a nasty correction. However, with the U.S. dollar likely to be weak for some time to come, we believe international investments have attractive benefits."*

Company News:

2006 saw a few faces come and go. As previously reported Adam Halbridge left for graduate school in the spring, and in the early fall Louie McKee left to open a new gym in Golden. The new voice on the telephone is Larene Powell, and we welcomed Robin Catlin who is helping clients with financial planning matters. And, Chris and Laura Lagudis welcomed a new baby, Chloe, last July 4th.

2007 marks the 19th year the company has been in business – originally started in Mike Sargent's basement. We'd like to thank you for your confidence and trust, and if you know of anyone who might be interested in our services, please have them give us a call or check us out at www.sargentbickham.com . We have received all our clients through referrals, and would be proud to help your friends, family, or associates.

Many happy returns,



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