

# SHARPER ♦ GRANITE



*Optimal Portfolio Management*

**SPRING**  
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**R**ecall the frightening market drop last year when Japan fell 20%, Latin America fell 30%, and gold fell 22% from May 10th to June 13th?<sup>1</sup> After a long rest from that volatility the roller coaster resumed, this time even more violent for U.S. markets. Initiated by concern of a slowing Chinese economy, on February 27th the Dow fell 3.8%, the S&P 500 fell 3.5%, and the Nasdaq fell 4.1%. Then on March 14th the markets lurched down again as the Dow lost 2.1%. These were the two steepest one-day declines in the last four years.

In hindsight, no one should have been too surprised. China surged 130% last year and 13% in the week ahead of the February 27th plunge.<sup>2</sup> This rout shook investors from a cocoon of complacency, ending the longest streak ever for the Dow without a single-day 2% drop.<sup>2</sup>

These sharp drops cause many investors to pull out of the market at exactly the worst time. Consider that over the past ten years the average equity mutual fund earned 8.5% per year, but the average mutual fund *investor* made only 7.1%.<sup>3</sup> This is because investors tend to buy after markets have been rising and sell after markets fall. This is the opposite of “buy low and sell high” but it *is* where dominant greed and fear instincts guide many investors. Over the past ten years, investors as a whole have hurt their returns by 17% due to this behavior.

Long-term investors who stick with their strategies through the volatility win out over time. Sharper ♦ Granite client strategies are based on time horizon, risk tolerance, low cost and efficient taxes. With the tax deadline approaching, in this letter we review a few important tax rules that apply to several client investment strategies.

## Financial Markets Summary

Gyrations revisited the markets this quarter after a ghostly lack of volatility over the past seven months. The CBOE Volatility Index spiked to 20 in March after resting between 9 and 14 since July.<sup>4</sup>



But when the quarter ended, March went out like a lamb. The CBOE Volatility Index was back down to 13, China was back up, and the major U.S. indexes, along with oil prices, finished nearly flat for the quarter.<sup>4</sup> The S&P 500 Index returned 0.6% (stock price gain + dividends), while the Dow returned -0.3% (stock price gain + dividends). Meanwhile, the Lehman Aggregate Bond Index, which Sharper ♦ Granite uses as the benchmark for its taxable bond investment performance, returned 1.5% (bond price gain + interest payments), near its historical average.

The average of all Sharper ♦ Granite client portfolios gained 1.6% net of fees (6.4% annualized rate) this quarter and maintained a risk level 28% less than that of the S&P 500 Index. If normalized to the same risk level as the S&P 500, Sharper ♦ Granite client portfolios would have gained 1.7% (7.1% annualized rate).<sup>5</sup> Thus, the average of all Sharper ♦ Granite client portfolios beat the S&P 500 and the Dow on both an absolute and a risk-adjusted basis this quarter. In fact, 84% of all Sharper ♦ Granite client portfolios beat both the S&P 500 Index on a risk-adjusted basis. ●

## 3 Tax Reminders for Sharper ♦ Granite Clients

Each January unofficial Schedule D forms are sent by Sharper ♦ Granite to clients along with year-end statements. Keep them. These forms have all the information needed for capital gain preliminary tax preparation. By early February official 1099 forms are sent directly from TD Ameritrade. They show interest, dividend, and security sales information required for tax filing. Collect these forms, along with any K-1's from private equity investments and forward to your tax professional.

Do not hesitate to contact your Sharper ♦ Granite advisor for any questions regarding the information needed for your income tax filings. Or, have your tax accountant contact us directly.



### 1 Children's Accounts

If you are holding a UTMA/UGMA account for your children, remember that the first \$850 of capital gains is tax free each year. Strategically, you should be making sales each year that register approximately \$850 in capital gains in order to take advantage of this benefit. Over the course of 18 years this benefit could accumulate to as much as \$6,778 per child for California parents in the highest tax bracket.<sup>6</sup>

On the next \$850 of gains, children under 18 are taxed at their own rate (most likely 10%, and 5% for long-term capital gains). Unearned income over \$1,700 is then taxed at the parents' rate.

If your UTMA/UGMA accounts are being managed by Sharper ♦ Granite, your advisor is already factoring this advantage into your child's college strategy. If you have other UTMA/UGMA accounts, ask your Sharper ♦ Granite advisor how to optimally manage these accounts along with 529 Plans on an after-tax basis.

### 2007 Annual Contribution Limits

Age	Traditional or Roth IRA	401(k), 403(b), or 457	Gifts (529 plans)*
Under 50	\$4,000	\$15,500	\$12,000**
Over 50	\$5,000	\$20,500	\$12,000**

### 2 New Contribution Amounts

The 401(k) contribution limits were increased slightly for 2007. This chart shows 2007 contribution limits for IRA's, 401(k)'s and gifts (such as those to 529 Plans). For 2008 and beyond these amounts may be adjusted for inflation periodically.

\* Larger gifts are possible but eat into the \$1 million lifetime gifting exemption.

\*\* Amounts are person-to-person. For example, two parents may contribute \$24,000 per year to each child.

529 Plans also offer accelerated contributions of up to five years. For example, one parent could contribute 5 years of 529 gift as follows: 5 X \$12,000 = \$60,000 in Year 1; however, no additional contributions could be made in Years 2 – 5.

Your Sharper ♦ Granite advisor or your tax accountant can help determine your eligibility for a Traditional IRA tax deduction or a Roth IRA contribution. Remember that everyone is eligible for nondeductible Traditional IRA contribution.

### 3 Importance of IRA Tracking

Finally, keep track of which Traditional IRA contributions are tax deductible and which are not. This ensures that you will not pay tax again on the nondeductible contributions. File Tax Form 8606 to spell out which IRA contributions are nondeductible. One suggestion is to keep two Traditional IRA accounts – one holding tax deductible contributions and one holding nondeductible contributions.

Keeping these records takes on importance when you start making Traditional IRA withdrawals, mandatory by age 70 ½. You must make withdrawals in proportion to the values of your deductible and nondeductible contributions.<sup>7</sup> ●

**New checks and ATM debit cards are coming soon.** The post-merger integration of our two primary custodial banks, Ameritrade and TDWaterhouse continues. The new entity, TD Ameritrade, will send out replacement checks and ATM debit cards in the next week. The legacy checks will be accepted for processing up until May 8<sup>th</sup>, but please destroy the old checks when the new TD Ameritrade checks arrive.

TD Ameritrade is communicating directly with clients regarding this checking account changeover, but please contact your Sharper ♦ Granite advisor with any general questions regarding the merger.

## First Quarter 2007 Economy Review

The implosion of the sub-prime mortgage sector dominated economic headlines this quarter. Several “creative” mortgages were made during the housing boom frenzy to high risk borrowers. Many of these loans were tied to short-term interest rates which were historically low at the time. Then, after 17 consecutive Federal Reserve short-term rate increases, these loan payment amounts skyrocketed, and some of the borrowers are now defaulting. This can lead to a higher supply of homes on the market and more downward price pressure. This affects consumer spending in that people do not feel financially secure, knowing that their homes are worth less. Leery banks may also restrict lending for new home buyers, leading to less home-buying demand and again, lower prices.



While this was all expected (see “The Residential Real Estate Bubble”, *Summer 2006* at [www.sharpergranite.com](http://www.sharpergranite.com)), it requires monitoring to see how far the fire spreads throughout the residential housing market and the overall economy.

Since World War II, ten sharp declines in the housing market have hit the U.S. economy; eight were followed by recession. Additionally, since 1959, housing-start cycles have fallen an average of 51% peak to trough.<sup>8</sup> In six of the last seven cycles, when housing starts fell more than 25%, the economy went into recession.<sup>9</sup> Housing starts are currently down 30%.

However, looking at our leading economic indicators that follow we see that the economy is still expanding at a modest rate and is well situated in terms of interest rate and political cycles. Fears of the housing market leading to recession are well-balanced with concerns of too-hot global economic growth leading to inflation. This is good.

## Leading Economic Indicator Summary

↑ **Market Cycle:** The second quarter of each year is typically strong, historically averaging an annualized return of 10.9% with April tending to be the strongest month.<sup>10</sup> We are currently paused in the Fed rate-change cycle. Since 1989, the S&P 500 Index has risen an average of 10.1% during Fed rate pauses.<sup>11</sup>

This quarter volatility moved back into the market as several traditionally risky assets began acting risky again. But we also now sit with a slight perceived Fed bias toward lowering, rather than raising, rates. And the stock market leaps on every hint that a rate reduction may come. In fact, stock market returns since 1970 have averaged 18.5% in calendar years of declining interest rates but only 8.7% in years of increasing interest rates.<sup>12</sup>

While the market drop of February 27th rattled investors' view of the market cycle, it may not have been such a negative incident. Since 1974 there have been 27 days in which all three major stock market indices (Dow, S&P 500, and the Nasdaq) have declined 3% or more on a single day. On average all three indexes were up over 14% a year later.<sup>13</sup>

The only point currently working against the market cycle is that we have just completed four positive calendar years in a row, and five winning years in a row is rare. This market advance has continued longer without a 9% pullback than at any time in history.

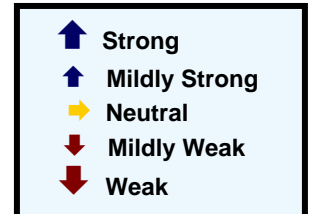
↑ **Political Cycle:** We are beginning the third year of President George W. Bush's second term. Traditionally, the third year in the presidential cycle is the strongest as elected officials typically try to boost the economy to improve chances of re-election. Since 1948, the third year of the presidential cycle has seen the S&P 500 Index post an average gain of 23.3% (21.9% with Republican presidents), far in excess of other years in the cycle.<sup>10</sup> Since 1960, every third year of a president's term has been positive, and all but one year has had a double-digit gain.<sup>14</sup>

Specifically looking at the third year of presidential cycles when the U.S. was at war, the stock market has also surged. The average gain of the S&P 500 Index has been 18.4%.<sup>10</sup>

↑ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy. It is a measure of all goods and services produced in the United States. 4Q06 GDP was revised to a 2.5% annualized rate following the 2.0% 3Q06 annualized rate.<sup>15</sup> The 4Q06 GDP report showed that overall demand rose 3.6%, with the difference being due to a decrease of inventories, which suggests a stronger economy than the 2.2% rate indicates.<sup>16</sup>

This current GDP growth rate is neither high enough to fuel inflation fears nor low enough to fuel recession fears. This represents the 21st consecutive quarter of expansion, or positive economic growth, since the official recession of 2001. GDP is expected to continue near 2.3% in 1Q07 and 2.4% in 2Q07, just keeping up with inflation.<sup>17, 18</sup>

Positive but low GDP growth may be the best result right now for the economy as higher growth rates could push inflation measures, which are currently at the upper boundary of acceptable levels (see "Inflation" below), high enough to force the Fed to tighten money supply.



- ↑ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, is hovering in the region of slow growth. This was the 13th consecutive quarter of expanding manufacturing activity despite the month of January which dipped into the range of slight contraction at its lowest reading in four years.<sup>20</sup>
- ➔ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, continues to advance at a rate in the upward range of that targeted by the FOMC. The twelve-month core CPI rate rose at a 2.6% rate in January and a 2.7% rate in February.<sup>21,22</sup>
- ↓ **Oil Price Containment:** After much gyrations primarily due to Iran's behavior, oil prices ended the quarter nearly flat (2.5% increase), but remained very high in historical terms.<sup>1</sup> Oil is a key input to so many business and consumer products. Its price movement can greatly affect consumers' ability to travel and purchase leisure-time products. It also impacts the profitability of corporations that produce plastic containers, fly airplanes, drive trains, build trucks, or manage hotels. Oil prices, while volatile, have such a strong influence on the overall economy that they must be watched closely.
- ↑ **Consumer Spending:** Consumer spending remained strong through the first quarter, led by solid gains in January retail sales. 1Q06 consumer spending was in the neighborhood of 3.5%, close to the pace for all of 2006.<sup>23</sup>
- In January the University of Michigan Consumer Confidence Survey jumped to its highest reading in three years.<sup>24</sup> Then in February the Conference Board's Index of Consumer Confidence rose to the highest level in over five years.<sup>18</sup> Consumer sentiment then fell sharply in March due to higher gasoline prices, falling home prices and the aforementioned stock market shocks.<sup>22, 25</sup>
- ↓ **Business Capital Spending:** Capital spending is a measure of how much companies spend on new buildings, machines and software. Decreases in capital spending usually coincide with recessions.
- Many capital spending indicators weakened this quarter. The 4Q06 GDP report mentioned above showed unexpected declines in new machinery, facilities, equipment and enterprise software. Growth in orders of non-defense capital goods (excluding aircraft) ran deeply negative in January and February.<sup>17, 18, 19</sup> The Purchasing Manager's Index continues to expand, but at a pace that has been declining since 1Q04.<sup>20</sup> Finally, business confidence, especially at small businesses, which tend to be early forecasters, is declining.<sup>26</sup>
- Many capital spending indicators turned decidedly negative this quarter, but corporate balance sheets, merger and acquisition activity, and the economy as a whole remain strong.
- ↑ **Investor Sentiment:** The UBS Index of Investor Optimism also trended lower this quarter.<sup>27</sup> The bearish sentiment in these measures is considered a bullish leading indicator for the stock market as it indicates that investors may have cash on the sidelines representing potential energy for the stock market.
- Analyst ratings typically trail market realities. This quarter, "buy" ratings as a percentage of all stock recommendation sunk to its lowest level since 1997.<sup>28</sup>
- ↓ **Corporate Earnings:** At the start of the year, 1Q07 S&P 500 company profits were anticipated to be 8.7% over a year ago. Now, those estimates are down to 4%.<sup>29</sup> This will end a record streak of 18 consecutive quarters of double-digit growth.

- ↓ **Insider Trading:** Significant insider stock buying implies that managers have positive information about their company's outlook. Insider buying spiked nicely in early March, just when the markets were being shaken. This is a good indicator of business confidence. The 30-day moving average of insider buying is at its highest point since September, 2006.<sup>30</sup>
- ↑ **Investor Cash Potential:** Private equity continues its buying spree, using low-priced capital from around the world. Estimates claim that these firms are wielding \$1 to \$2 trillion in combined buying power (cash plus leverage), enough to privatize 5 to 10% of the U.S. stock market.<sup>2</sup> The difference between cost of capital and return on equity is currently so large that it is attracting myriad private investors.<sup>2</sup>
- ↑ **Merger and Acquisition Activity:** 2006 was the strongest merger and acquisition year to date by dollar volume. There were 16 U.S. and 13 international mega-deals of over \$14 billion and 55 total deals of over \$10 billion,<sup>31</sup> with buyers paying higher-than-usual price-to-sales ratios than in the past five years.<sup>32, 33</sup> This high level of activity continued throughout 1Q07. ●

Questions?

Contact us at:

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#### Notes and Acknowledgements:

1. Morgan Stanley Capital Index Japan (EWJ), S&P Latin America 40 (ILF), streetTRACKS Gold (GLD), Barclays Global Investors Oil (OIL)
2. Cover Story, *BusinessWeek*, March 12, 2007
3. Morningstar as reported by "Funds that Mint Money", *Fortune*, December 25, 2006
4. CBOE as reported by *Barron's*, March 26, 2007
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6. Assumptions: 35% Federal marginal tax rate and 9.3% California marginal tax rate. Calculation:  $\$850 \times (35\% + 9.3\%) \times 18 \text{ Years} = \$6,778$
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10. *Stocks for the Long Run*, Jeremy J. Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University
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