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THERE'S SOMETHING GOING ON OUT THERE

If you are a fan of classic movies, you are certain to recall the "Jungle Movie" genre, recently rehashed in the clunker "King Kong". This category includes the original King Kong, the Tarzan series and their derivatives, and, for those who really appreciate the green cheese of cinema, "The Creature of The Black Lagoon". In most of these films, the square jawed hero, resplendent in safari attire, gazes out into the inky nighttime rain forest and intones, "There's something going on out there." This is almost always a signal for a large spear to appear in a native servant's chest, as if by magic, and we may almost always be assured that the skewered servant will fall a.) off the boat into the water, gasping, b.) off a handy nearby precipice, screaming, or c.) onto the hero, mouthing silently.

Why is this relevant? Check out the stock market. There's something going on out there.

Recently, tech monopolist Microsoft (symbol MSFT) conducted a Dutch Auction repurchase of its own shares. This buy-back is inside information at its best.

The big cheeses at MSFT, who own vast quantities of shares, are betting their careers and their own wallets that at the prices listed in the auction, the stock is a buy. They are also saying that at current prices, the stock is a better acquisition than any other smaller company they can find out there.

On the other hand, if the stock was a shrieking bargain, you would see these same executives mortgaging their kidneys to buy the stock, and this isn't happening. With a current p/e of 19, this stock appears to be simply attractive, but not compelling.

However, since the executives are inside the corporation and we all hope they know more about the company than we do, we have to conclude that they think the stock is cheap at these prices. They are telling us that this stock, at least, is worth owning.

Left to my own counsel, I am more comfortable buying a mutual fund than an individual stock. There is simply more diversification and better access to information when a good mutual fund is your investment vehicle of choice. Here's where the next surprise arrives at the campfire: check out the graph of the S&P 500 over the past three months (**GRAPH 1**). It is demonstrating surprising gains relative to the growth mutual funds around it.

Growth managers tend to be rational. The S&P 500 tends to be irrational. Right now irrational speculation is beating rational investing. My guess is that we are looking at a small blip of irrational buying via program trading and brainless indexing, which may indicate a coming market-wide trend.

So why are they doing this? And, once again, where is that spear-thrower hiding?

We reviewed a selection of concentrated Dow Jones Stock Indices. Each index contains a weighted average of the stocks of its chosen economic sector. We were interested in the "p/e's" of these indices, in other words, their "price earnings ratios". A price earnings ratio is the stock's price divided by its earnings. For example, if a stock has a p/e of 16, it means you will pay \$16 for a dollar's worth of earnings.

Undervalued stocks, which nobody loves, tend to have low p/e's. Stocks which everybody wants to buy tend to develop pricier p/e's. In other words, the p/e is a measure of relative value. What interests us now is that p/e's are also an indicator of investor sentiment.

The Dow Jones U.S. Real Estate Holdings and Development Index has a p/e of 4.17. That says to me that investors expect the housing market to continue to decline fairly dramatically.

The Banks Index has a p/e of 14.41. Investors are cautious about financials in expectation of future rising rates. But this moderate number also tells us that investors don't see the ceiling caving in on the banking sector. They must now perceive that rising interest rates are NOT a big problem.

On the other hand, the Mortgage Finance Index gets a p/e of 10.69. The consensus is that the boom times are gently ending in the mortgage sector.

The Oil & Gas Producer's Index has a p/e of 7.92. Oil stocks traditionally have a lower p/e because they are so tidal. But still, this is a low number. The investment world expects oil prices to decline!

And finally, the Apparel Retailer's Index is at 20.46, and the Durable Household Products Index p/e is 17.96.

Combined with the Microsoft buy-back, this all seems to indicate that the investors' consensus is as follows:

- Oil prices will moderately decline.
- Interest rates will go up, but not much.
- Residential real estate will get the spear. Whether it goes screaming off a cliff or gasping into the river remains unknown.
- Banks will muddle by.
- We will have a mild, barely noticeable slowdown.
- Consumers will return to the frontlines of consumption early, and purchases of everything from washing machines to cosmetics will continue almost unchecked.

So there's the forecast according to the investing public. And now here's the hook: the consensus can be very accurate. It can also be extremely wrong. At the moment, the markets for larger stocks are teetering on the edge of a moderate blue-chip bubble. This may happen, in which case our asset allocation will change to include big cap equity and index funds. Then again, something—like oil prices which DO NOT go down—could easily derail this consensus scenario.

We're left back at the campfire, peering into the dark, muttering the only thing we really know to be true:

There's something going on out there. 🧐

GRAPH 1:

