

# STOCKS SOAR !

## 10% Bond Gain Locked In for 2007!

*With rising corporate profits seen around the globe, stocks posted the best 2<sup>nd</sup> quarter gains in several years. For the last 12 months, the broad stock market is up almost 20%! As previously forecast, interest rates climbed as bond prices dropped. In mid-June, we were able to take advantage of a spike in interest rates by selling our entire position of the Pro Funds Rising Rates Bond Fund, locking in a 10% gain in less than six months. (SEE BOND & CASH STRATEGY BELOW)*

### INVESTMENT REPORT

In spite of a June decline, stocks soared during the 2<sup>nd</sup> quarter, adding to 1<sup>st</sup> quarter gains. Tepid housing reports, oil uncertainties, mid-East turmoil, rising interest rates, sub-prime mortgage concerns etc., etc., etc., were unable to derail global corporate profits. Most world-wide indices closed the quarter near record highs. Rising interest rates drove bond prices down, with the Lehman Aggregate Bond Index up a paltry 1% YTD. One-year CD and money market rates remained near or above 5%, while inflation continued to be contained in the 2.5% range:

	<u>2<sup>nd</sup> Qtr 2007</u>	<u>YTD</u>	<u>5-Year Annualized</u>
<b>Dow 30</b>	<b>+9.0%</b>	<b>+8.8%</b>	<b>+10.2%</b>
<b>S&amp;P 500</b>	<b>+6.2%</b>	<b>+7.0%</b>	<b>+10.7%</b>
<b>Nasdaq</b>	<b>+7.5%</b>	<b>+7.8%</b>	<b>+12.2%</b>
<b>Russell 2000</b>	<b>+4.4%</b>	<b>+6.5%</b>	<b>+13.8%</b>
<b>Lehman Aggregate (Bonds)</b>	<b>-0.5%</b>	<b>+1.0%</b>	<b>+ 5.0%</b>

While U.S. stocks performed very well, many international markets rocketed upward in reaction to spectacular economic growth. The Europe Australia Far-East Index (EAFE) is up 9% YTD. Various Chinese stock indices are up from 15% to 90% so far this year, setting new records. In Europe, the Dow Jones Stoxx Index hit a six-and-a-half year high. European GDP growth rates doubled, which portends well for that major world sector. According to the Wall Street Journal, three out of four U.S. dollars invested last year were invested off shore. And yet, foreign stocks are still considered to be more undervalued than U.S. stocks!

## SAM OUTLOOK & STRATEGY

Economic growth and stock & bond performance for this year are quite close to our earlier forecasts. Thus, our outlook and strategy remains little changed. **However, we are raising our forecast for the broad U.S. stock market for 2007 from + 9.5% to at least +10.5%.** This prognostication may prove to be too conservative. Last quarter, we lowered our bond total return forecast (interest and bond appreciation) downward from 4% to 3.5%. We are again lowering our bond return forecast to 3% for 2007. Housing prices are likely to slide even further, slowing U.S. economic growth, but not derailing the current economic boom.

At this point, we see no negative factors on the horizon that could contribute to a prolonged, major stock market decline. Emotional market drops due to terrorist attacks, natural disasters, etc., are always very short term. We are clearly near the beginning of the second half of a long bull market cycle. Two of the most prominent factors that warn of a coming bear market are terrible economic fundamentals and investor euphoric sentiment- neither of these factors are present in the current environment.

**We are currently over-weighting stocks in:**

- **Large company stocks paying higher dividends**
- **International companies**
- **Asia**

**We are currently under-weighting stocks in:**

- **Domestic companies**
- **Small, growth oriented companies**
- **Most computer-oriented tech companies**

**BOND & CASH STRATEGY:** Our complete avoidance of bonds (except for the Rising Rates Bond Fund) has really paid off so far this year. Bonds have produced almost no gain for the year, while our investments in high-yield money market funds and 1-year CD's are currently yielding about 5%. The Rising Rates Bond Fund was sold when interest rates suddenly spiked in mid-June. **We locked in a +10% rate of return in less than 6 months. An abnormally large amount of money market cash was in our stock & bond accounts at the end of June (as reflected in your June Schwab statements) because of this sale.** As interest rates may experience a summer drop, we are holding this cash for buying back the Rising Rates Fund at an opportune time. Alternatively, we may invest this cash in stocks if there is a summer market correction and stocks decline. (BUY LOW; SELL HIGH).

***Thank You for Your Referrals!***

## *Q & A*

*With this quarterly report, we begin a new feature- We'll respond to your questions about investing. If you have a general investment or economic question, please email, snail-mail, or call us. We'll try to respond to as many questions as possible in future newsletters.*

RECENT PROFITS HAVE BEEN GREAT, BUT CAN WE DO ANYTHING ABOUT THE HIGH TAXES?

We try really hard to avoid large tax hits in our taxable accounts. For example, we try to capture gains at much lower capital gains rates rather than as ordinary income (which we did on the sale of the Rising Rates Fund). We also try to avoid selling, thus avoiding the recognition of gain for tax purposes. If we know that our client is going to be in a higher or lower tax bracket next year, we will either defer or accelerate taxable gains as appropriate.

However, we will not sacrifice performance, just to avoid taxes. Why? No one is even close to a 100% tax bracket, and suffering a major loss of profit can more than offset the tax hit. Our conversion to a equal-weighted S&P 500 index did trigger significant capital gains, but the performance of the equal-weighted index over time is more than 2% per year greater. Finally, some individual securities have more than doubled in a short period of time (e.g. Carnival). They become so over-valued that there is a great danger of losing profits. After we sold Carnival last year with almost a 100% profit, that stock plunged more than 25%.

YOU HAVE REPEATEDLY SAID THAT STOCK MARKET TIMING DOESN'T PRODUCE GREATER RETURNS OVER THE LONG RUN. SO, WHY DOES INTEREST RATE TIMING WORK?

Stocks have unlimited upside potential, but interest rates have a very limited range. Interest rates won't go below zero, but they can't rise much above the inflation rate. By carefully observing inflation and economic trends, we can "buy" when interest rates are unusually low, and sell when rates rise. This enables us to capture much higher rates of return in a portion of our cash or bond holdings than simply holding all the cash in CD's or money market funds for a long periods. Thus, there will be periods of time when we hold a significant amount of cash in money market funds- waiting for the next opportunity to invest. Interest rates rarely stay the same very long.

***WE INVITE YOU TO VISIT OUR NEW OFFICE:***

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