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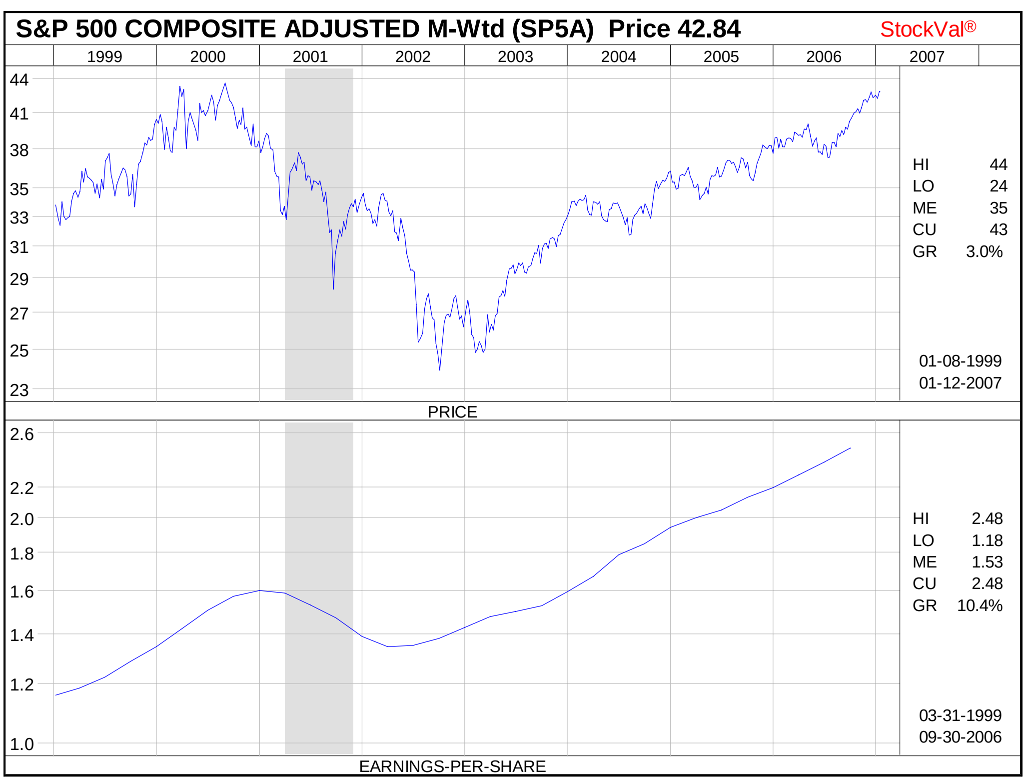
DECEMBER 2006

Market Commentary

The Equity markets in 2006 delivered their best performance since 2003 with the S&P 500 returning 15.8%, the Russell 2000 returning 18.4% and the MSCI EAFE returning 26.9%. Key themes that performed in 2003-2005 – value, small cap, emerging markets, and commodities -continued to deliver into the first half of 2006. However notable signs of a shift in market dynamics begin to emerge in the second half of the year. From a combination of increased production and investment, warm winter weather and moderation in consumption, energy prices fell dramatically from their highs. Crude prices in the first week of 2007 were back to their pre-Katrina levels of $55 / bbl. The same holds for the broad commodity indices. The Dow Jones – AIG Commodity Index suffered from losses in the second half of the year that brought its total 2006 return down to 1.7%. Among mega-cap stocks, quality performed well in 2006, with "A" rated stocks outperforming lower rated issues. However within the Russell 2000, A or A+ rated stocks returned around 11% compared to 24% for B- and 21% for C rated companies.

The S&P 500 ended 2006 within a few points of its December 1999 level of 1469. Operating earnings per share in 1999 were $50.96 while in 2006 they are estimated at $87. Had the S&P 500 maintained its 1999 P/E of 28, the index would be at 2436, about 70% higher than its current level. Thanks to post-Enron reforms, the reported S&P earnings are more conservative and reliable than they were 6 years ago. While 28 times earnings for the US market is a valuation we may never see again, 20 times earnings in a strong economic environment with low inflation and interest rates is not an unreasonable number. A 20 P/E equates to a 5% earnings yield that with the addition of 2.5% inflation and 2.0% real long term earnings growth supports 9.5% total returns over long periods of time. In an environment where small cap stocks are trading at 25 times earnings and large publicly traded Real Estate Investment Trusts are delivering 3% yields, the S&P 500 at 20 times earnings is not unattractive to investors.



The S&P 500 could well turn out to be the best investment opportunity of 2007. While valuations are at historical highs in small cap and emerging market stocks, the S&P 500 currently trades at about 18 times operating earnings if you remove the energy sector. Energy currently trades at 10 times earnings, lowering the overall S&P P/E ratio to 16. (This does not necessarily mean that energy stocks are cheap, as the earnings are volatile and the 2006 earnings reflect energy prices that were 20-40% above current levels.) Fund flow data and anecdotal evidence indicate that significant amounts of capital have exited large cap stocks in the past four years as allocations to foreign equity, emerging markets and alternatives have increased substantially. Disappointing performance in any of these areas could trigger substantial fund flows into large cap stocks. The combination of modest valuations, reasonable earnings growth and a lack of better opportunities could equate to a substantial inflow to blue chip names. If one starts at 18 times current operating earnings, assumes the 2007 consensus earnings growth estimates of 11.6% (ex-energy) are met, a dividend return of 2% and a multiple expansion to 20 times earnings in December 2007 then the S&P ex-energy delivers a 26% return in 2007*.

Risks to this scenario abound. Political instability surrounds the world's oil supplies, making event risk a primary concern. Recessionary risks are also present. The slowdown in housing and automobile manufacturing may be deeper and have a greater impact on the broad economy than the market is anticipating. Developing Asia, in particular China and India, have been, along with the US consumer, the primary engine of global economic growth. This engine faces real risks. Consumer spending in the US may fall off due to housing woes and over-indebted spenders. China and India both face serious internal political conflicts that may boil over and derail economic growth. Or more simply emerging Asia may just experience a classical real estate driven boom and bust. Given a rate of investment in China that makes Texas in the 1980's seem conservative, this may be the most likely scenario. A liquidity crisis in the financial market similar to 1998 is another real possibility. Evidence abounds of widespread speculation in derivatives on corporate credit, sub prime consumer credit (notably mortgages), commodities and other areas with fickle liquidity. A collapse in one area could set of a chain reaction of redemptions and funds scrambling to liquidate thinly traded securities. However, as the 28% performance of the S&P 500 in 1998 demonstrated, a liquidity crisis can actually be a boon for large cap stocks as they are perceived as a safe haven.

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Steve Browne,CFA
CIO
Paul Comstock Partners

We are pleased to see the strong recent performance of many investment strategies that have struggled over the previous few years and appreciate the patience of our clients with them. Conversely, several strategies that performed admirably in 2004 and 2005 struggled in 2006. Financial markets are cyclical and mean-reverting so more often than not, what is not working today may well work tomorrow. Proper diversification virtually guarantees that some investment strategies within a portfolio will be underperforming at any given point in time. Timing cycles with an acceptable success rate is impossible in our opinion. However, at a time when the cycle appears to be favoring high quality investments over those of low quality we believe it is prudent to listen to the market as the consequences for being wrong in overweighting high quality at reasonable valuations are relatively benign while the results of being wrong on a large bet on low quality can be disastrous.

*Source for earnings and valuation data: Standard & Poor's, StockVal

Questions? Contact Nancy Savoie at 713-554-0169.