Dear Investor, Q1, 2006

Attached is the first of what should become a quarterly news letter as yet untitled. I have yet to think about a regular format so initially it might be titled Pierre's random thoughts on the markets. In the future we will likely delve into domestic and world economies, politics as they affect markets, secular as well as cyclical trends, particular industries and companies and how they might be affected by all of the above.

Many people have become disenchanted with their actively managed mutual funds or their advisors' results that do not keep up with the S&P 500. A lot have decided that they are better off in a passively managed index fund such as the S&P 500. Index funds are a low cost way to be invested in the "market" as defined by the most popular large cap index. This first edition of our newsletter argues why a well diversified portfolio of stocks should contain more than just the S&P 500. By assembling a stock portfolio that includes large, small and mid capitalization stocks the portfolio should better withstand the markets ups and downs and theoretically achieve higher returns as well.

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Sincerely,

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Why owning the S&P 500 only may not be the best idea

Diversification: The key to successful portfolio management

The basic tenet of portfolio theory is that by diversifying assets held one reduces risk while also maximizing the return for that given level of risk. This is known as the theory of portfolio optimization or approaching the efficient frontier. The goal is to blend a number of non-correlated assets that accomplishes reducing the total risk of the portfolio while also maximizing return potential in relation to the risk taken. Large institutions diversify into many asset classes by holding not only stocks and bonds but foreign securities, real estate, natural resources, hedge funds, private equity etc. The goal is to put together uncorrelated assets to optimize the total. Individuals in most cases can not easily diversify their liquid assets to the extent of large institutions but many are already more diversified than they may realize. An individual's investments include not only stocks, bonds, mutual funds and cash but their home, vacation or rental properties, ownership in a business, life insurance policies, trusts, retirement accounts and even social security. Many of these provide future income even if not any liquidity of principal. Once these bigger picture asset allocations issues are understood then one can look at their more liquid assets available for investment in stocks, bonds or other relatively liquid investments.

Returns of Stocks and Bonds over the long term

Bonds can be great instruments to provide current income and can also reduce risk (portfolio fluctuation) but should not be thought of as an instrument that will increase one's wealth. Over the long term bonds have produced returns 3.5% per annum less than stocks. Over the last 50 years stocks have returned 11%*, Bonds 7.5%* and inflation has averaged 4%*. In terms of compounding, at 11% stocks double in value every 7 years while bonds take 11 years to double at 7.5%. This assumes that all income is reinvested and nothing is taken out of the account, no fees, no money for taxes or any withdrawals whatsoever. The power of compounding is even more magnified when looked at in terms of real purchasing power (pp) or net of inflation. In real terms (11%-4%) stocks take 11 years to double their (pp). Bonds (7.5%-4%) would take 21 years to double their (pp) and again both assume no withdrawals. In fact most bond accounts never grow at all in terms of real (pp) or even in nominal terms because typically the reason to be in bonds was to provide an income. That income, if in a taxable account, is taxed at ordinary income rates (up to 35%) as opposed to lower capital gains and dividend rates (both 15%). Between paying taxes and fees, never mind the effects of inflation, bonds actual net yield is considerably less than their stated coupon rate but this is not to say that bonds or other income oriented securities should not be important parts of a diversified investment portfolio. For those with income needs there are not only Treasuries and AAA rated Corporates but many alternatives such as lesser quality bonds, tax advantaged municipals, Agencies (some of which have novel structures like coupons adjusting higher over time), convertible bonds and convertible preferred stocks.

*Source: Value Line * 11% (actually 10.8%) is the total return of the Dow Jones Industrials, 7.5% for AAA rated corporate bonds and 4% the inflation rate over the 50 years ended 12/31/04.

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Time diversification and Reversion to the Mean a historical perspective

Once all the big picture asset allocation decisions are made then one needs to decide how to diversify the stock portfolio. The biggest and best reducer of risk is time. Over the long run we really do get reversion to the mean and that mean is about 11% on stocks, historically. Since the Great depression there had been only three back to back loss years 1929-30, 1940-41 & 1973-74 before our recent 2000-02 three year swoon. When you look at virtually any 10+ year period the market usually gets back to its double digit gains. Despite 2000-02 by 12/31/05 the 10 year annualized return was back to 9.1%. (See table 2 on the last page). The one huge exception was after the crash of 1929 when it took 25 years for the market (Dow Jones) to get back to its previous peak. After the choppy 1940's the market had a huge bull run throughout the 50's and 60's with only minor interruptions. The Dow hit 1,000 in 1966 and though it briefly touched above 1,000 a few times hence it did not pass it for good until 1982. This was a difficult period marked by high interest rates, energy prices and inflation and recessions in 1970, 74, 80, and 82. Ibbotson Associates had done a study to look at the worst performing periods for stocks in the past 30 years ended in 2000. The worst 5 year period ended in 1977, the worst 10 year in 1981, 15 year in 1987 and 20 year in 1990. Despite sub-par returns in the 5 and 10 year periods of the 1970's in the 15 years ended 1987 large caps had gotten back to virtually double digit returns (see table 4). This is amazing considering the brutal bear market of 73-74, three recessions and the crash of 1987 all occurred in this 15 year period. What is even more amazing is how small companies did in the same time period. They not only handily outperformed big caps over all the relevant periods but in the awful 5 year period ended in 1977 when the large companies were -.2% the small companies were achieving a long term like 10.8% and out performed the larger companies by 11% per annum.

Smid Caps, Another way to diversify from "the market"

In years gone by when most people talked about "the market" they were referring to the Dow Jones Industrials. The Dow Jones had been the most quoted average and was considered "the market" for most of the past century. In more recent years most professionals have switched to using the S&P 500 as the proxy for "the market". The S&P 500 is a far more diversified and representative index but it is still very biased toward the largest capitalization stocks. There are tens of thousands of publicly traded companies yet the S&P 500 components are worth over $11 trillion in market capitalization and make up 80% of the capitalization of the entire US market. By comparison the S&P Mid Cap 400 makes up only 7% and the S&P 600 Small Cap index only 3%. For a comparison of their respective yearly returns over the last 8 years please see (table 1). The Ibbotson study lumped both small and mid caps into the small company category. Some people have gone so far as to calling this huge pool of tens of thousands of companies Smid Caps. Historically smaller companies have out performed large companies by about 1.5-2% per annum over the long term. It has also been believed that smaller companies were far more volatile (risky) and that for many investors the added return was not enough to stomach all that risk. The last ten years have been some of the most volatile years ever and yet when you look at the standard deviations (table 3), which is the academic's way of measuring volatility or risk, over the period then the small and mid caps have been only ever so slightly more volatile than their big cap brethren.

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Small and Mid Caps can help on Defense as well as on Offense

It may be true that historically large capitalization stocks have been less volatile than smaller stocks but in the last decade or so their volatility seems to be converging. When you look at the year by year returns (table 1) one might conclude that the big caps were even more risky, especially if your definition of risk is how much can I lose (see last page for cumulative returns). The standard deviations (table 3) do not bear this out but do show that small and mid cap stocks have been only ever so slightly more volatile than large companies. One thing is for certain and that is that big and small do not always move together. Some years like 1998, 2000, 2001, 2004 & 2005 there are considerable variation between the different categories. We believe that diversifying between sizes of companies is just as important as diversifying between individual companies, different industries, parts of the economy, and styles although we diversify by all of the above as well.

The 30 year Ibbotson study (table 4) reinforces the theory that small company stocks either did better or at least recouped their losses and reverted to the mean faster than did large caps in these difficult and volatile times. We do not want to predict that as we look out over the next five or ten years that we will relive a period like that in the seventies but there may be some similarities. From 1982 to the present we have seen the biggest bull market in bonds this country has ever seen. Long rates have gone from 13% to 4%. We do not believe this sustainable. Going forward over the next few years we do not expect to go back to the 1970's situation with high single digit inflation and double digit interest rates but do believe both will creep up. When you assume a healthy economy not only here but around the world it should follow that both inflation and interest rates must rise some. We could see long rates in the 6% or 7% range in the next few years but this should not be enough to choke off growth of those companies who are not over leveraged and growing at above average rates. Inflation might average 3.5% to 4% but there are always some companies that can pass through prices accordingly. Strong and growing companies should have no problem in this environment but it may be much more difficult for the weaker or lesser growth companies.

The key will be to have top line growth so that you can spread your expenses over more units sold. Behemoths like GE, Coke and IBM have had stagnant top lines for years yet have managed to manufacture profits via accounting and cost cutting. In the new world of accounting responsibility and higher input prices no top line growth will relegate some of the former growth stars to the realm of value stocks. Value stocks are categorized with low PE's, high yields and likely low stock prices if they can not show growth. We have no problem with owning value companies if bought at low prices or multiples but many of the old growth companies will have a long way down before they'd be attractive value stocks. At LTBC we prefer companies that can show growth on both the top and bottom lines regardless of their market capitalization. There are still plenty of large caps with growth characteristics but there are many more small companies to choose from that have sustainable high growth rates. Holding a diversified portfolio which includes different sized companies we believe is the way to go.

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LTBC Capital Advisors approach or GARP (Growth at a Reasonable Price)

We at LTBC Capital Advisors manage individual portfolios using a disciplined bottom up fundamental analysis approach. Our approach identifies companies with solid earnings growth, underappreciated business models, or undervalued assets that have future potential regardless of market capitalization. These companies often trade at relatively low price to earnings multiples. They typically have either above average sustainable growth potential or trade at a considerable discount to their intrinsic value. These companies are often out of favor due to transitory events that mask the underlying fundamentals. Some may pay no dividends but many small and mid sized companies have long consistent histories of rising earnings and rising dividend payouts as well. We believe that a portfolio of 20 to 30 stocks can accomplish reasonable amount of diversification while also achieving meaningful positive attribution as well.

The choices of uncorrelated companies in different industries are only one of the ways to diversify a portfolio. We believe that growth stocks are great but good ones rarely come cheap. Value stocks almost always look cheap but all too often they stay that way. Many investors think you have to be in one camp or the other, we disagree. We believe that a well diversified portfolio should have some of each and what matters most is that every investment should fit the description of GARP or growth at a reasonable price.

Focusing on undiscovered growth potential

The trick in finding superior stocks is to find positive attributes in a company that either others do not see or are not wiling to pay for at present. In time you expect other investors will come to understand the positive attributes and be willing to pay for them in the future. At LTBC we look to buy value companies where there will be more growth than the price would indicate and growth companies where we see them continuing to grow at a higher rate and for a longer period than the price would indicate. So yes it is almost always about growth but at what price.

Diversification can also come from holding companies that move with the economic cycle and those that have less correlation with the cycle. Highly cyclical stocks can be tricky as to when to get in and out but can produce very high returns if timed appropriately. We typically only hold a relatively small portion, if any, of these highly volatile type situations and only when we believe an up cycle is in force or is about to be. We prefer to buy superior companies with sustainable competitive advantages and stay with them over the long haul. We are constantly updating projections for each individual company using a two to three year time horizon. Many mutual funds hold hundreds of stocks which surely reduce the risk of any one negatively affecting the whole but it also will not have much impact on the upside either. Although we strongly believe in diversification between various industries we do not believe in strictly sticking to industry averages as do many mutual funds. We prefer to over weight those companies and industries whose prospects are most attractive and underweight or not own at all those companies and industries whose prospects appear unattractive. Our goal is to identify companies with sustainable competitive advantages and stick with them over the long term.

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Index comparisons by company size

Table 1

Year by Year Returns for the last 8 Years

		1998	1999	2000	2001	2002	2003	2004	2005
Large Caps	S & P 500	28.58%	21.04%	-9.10%	-11.89%	-22.10%	28.69%	10.88%	4.91%
Mid Caps	S & P 400	19.12%	14.72%	17.50%	-0.61%	-14.52%	35.64%	16.50%	12.56%
Small Caps	S & P 600	-1.30%	12.40%	11.80%	6.54%	-14.63%	38.80%	22.65%	7.68%

Table 2

Annualized Returns are through 12/31/ 2005

		1 Year	3 Year	5 Year	7 Year	10 Year
Large Caps	S & P 500	4.89%	14.39%	0.54%	1.77%	9.07%
Mid Caps	S & P 400	12.55%	21.16%	8.61%	10.70%	14.36%
Small Caps	S & P 600	7.68%	22.39%	10.76%	11.14%	12.16%

Table 3

Standard Deviations for the periods ended 12/31/2005

		3 Year	5 Year	7 Year	10 Year
Large Caps	S & P 500	11.58%	18.17%	17.07%	17.49%
Mid Caps	S & P 400	13.05%	20.39%	20.31%	20.58%
Small Caps	S & P 600	14.97%	21.42%	19.79%	20.44%

30 year returns ended 12/31/2000 and the worst stretches within it (Source: Ibbotson Associates)

Table 4

	30 year annualized return ended 12/31/00	Worst stretch within * -- 5 Year	10 Year	15 Year	20 Year
Large Companies	13.2%	-0.2%	6.5%	9.9%	11.2%
Small Companies	14.7%	10.8%	17.3%	16.2%	13.3%
Intermediate Bonds	8.5%	6.4%	5.8%	9.2%	9.1%
Inflation	5.0%	7.9%	8.6%	6.9%	6.3%

* Through years-end 1977, 1981, 1987 1990 respectively.

FN = Returns LMS