



## A Brief on Investment Markets and Financial Planning Issues

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### Another Good Year!

In spite of a lot of gloom and doom news and more than enough worry, the investment markets scored another up year. By historical standards the US large cap market as represented by the S&P 500 experienced a fairly average 10.7% total return. International and small cap markets were above average. (See complete return analysis on page 4.)

Assuming you followed our advice, you should have experienced a decent year in your investment portfolios. And the more exposure you had to stocks, the better you should have done.

Below I offer my commentary on 2004 plus a look ahead to 2005 and beyond. Happy New Year!

**THIS ISSUE:**  
Looking Back and Ahead:  
A Q&A Commentary  
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Statistical Chart of Five-Year Returns

### Q&A Commentary on 2004 and 2005

#### A Self-Interview by J. Andre Weisbrod

#### How well did you anticipate and address the events and economic/market conditions in 2004?

The best way to address this is to review what I wrote to clients in mail and email STAAR reports last year.

**Jan. 2:** "If you are confident that technology will allow higher average growth over the next 10 to 20 years, then the S&P 500 is still undervalued. By this measure it would have to grow approximately 13% per year to reach the 8.5% trend line in five years.

If we use an 8% trend line, then the market is on the line now and is fairly valued to appreciate 8% per year (Price only, no dividends. Total Return is higher.)

**March 10:** "The next support level for the Dow is a little below 10,000. If it dipped to around 9,990, that would be a 7% correction.

To reach a 5% correction, the S&P500 would fall to around 1,100, the Russell 2000 to about 570, and the EAFE to near 1,430. The NASDAQ would need to fall below 1940 to hit a 10% correction.

At those levels I think I would definitely be a buyer unless something very serious has occurred."

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**STAAR Funds Spotlight**  
Stock Funds Score Stellar Performances

STAAR Funds Performance* (Read the Funds' prospectus for full information: 412-367-9076)	2004	3 Year Avg Ann Return	5 Year Avg Ann Return
International Fund	18.92%	10.32%	-1.57%
Smaller Company Stock Fund	12.65%	9.53%	6.01%
AltCat Fund	12.56%	6.76%	2.89%
Larger Company Stock Fund	10.62%	3.02%	-0.84%
General Bond Fund	0.51%	3.90%	5.68%
Short Term Bond Fund	-0.18%	4.64%	6.17%

Average of equal amount invested in each Fund at the beginning of each year **9.18%** **6.36%** **3.05%**

*Performance figures are total returns net of expenses, with dividends and capital gains reinvested.. Past performance is no guarantee of future results. Investment returns and principal values fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.*

**May 3:** "If the bull advance continues, I would expect the S&P 500 to reach about 1175 to 1200 on the next leg up. The DOW would reach the 10,900 to 11,000 range."

**July 1:** "Markets are not significantly overvalued against probable future earnings, but are high enough to lower return expectations and pay attention to risk management."

**Aug. 7:** "If the markets continue downward this week toward the next support levels, they could reach a point where they would be "oversold." Typically, when the stock market is being oversold, it ends with a significant broad-based drop at which point buyers step in and the market reverses upward. More often than not, this represents a significant buying opportunity.

I stand by my recent evaluations. While the economy is slowing, it should not slow enough to derail the growth trend that began in 2001."

**Dec. 1:** "...the bias is still on the up side. I would not be surprised to see a small downturn in the next week or two before the final year-end rally. "

Ok, let's look ahead to 2005...

#### On scale of 1-10 with 1 being a disastrous depression and 10 being the best possible economy, how would you rate the current U.S. economy and then the global economy?

I'd rate it a 6-7. Depending on your viewpoint, it could be a 3 or a 9. Your window is your own view. A boom is when you get a big bonus plus a raise. A good

economy is when you get a raise larger than inflation. A slow economy is when you get no raise or only an inflationary raise. A recession is when your neighbor is laid off. A depression is when you are laid off.

Here's what is good – high productivity and good corporate profits; low inflation and interest rates; technological advances on all levels; increasing jobs growth; high rates of entrepreneur/self-employment growth, global trade and growth giving US companies more opportunities abroad.

Here's what's bad – Growing deficits (especially Federal and Trade); irresponsible government; protectionist sentiments and International turmoil; people caught in tech-induced economy shifts; political polarization; terrorism; high increases in energy and resources costs, tsunami destruction.

Here are some double-edged swords that have both plusses and minuses depending on how they ultimately work their way out – Outsourcing; Iraq; falling dollar; China and Third-world growth; Republican majority.

#### ***How serious is the decline of the Dollar?***

I have thought all along that the dollar needed to find a better level among world currencies. The danger is if it drops too far too fast. That could cause a number of problems, including discouraging foreign investors in our financial markets. On the other hand, if it levels out and does not drop precipitously from here, then it will be good for our exports.

#### ***Is "outsourcing" a significant problem?***

If your job is the one outsourced, yes. But in the big picture, no. Remember that productivity and profits are good things and that labor must always be competitive.

If I go to the store and try to find a bargain, why shouldn't a company do the same? I find it interesting how some people whine about a company finding cheaper labor when they religiously shop for lower prices on the goods and services they buy for themselves.

I understand that the ebb and flow of commerce always presents elements of unfairness and immorality. I do not advocate an "anything goes" philosophy by any means. However, an honest business owner who "shops" for cheaper services to increase profits is no more immoral than any consumer choosing a lesser priced store at which to find food, furniture or entertainment.

Also, there is a flip side to this; many foreign companies have outsourced hundreds of thousands of jobs to the U.S. In the end, freer markets are better,

**The economy has been pretty good since 2001 and it should continue to grow in 2005.**

even though a certain amount of inequity and pain is inevitable along the way. People don't grow without difficulties; neither do economies.

#### ***What do you see happening on the inflation and interest rate fronts going forward?***

Barring a severe economic slowdown, both inflation and interest rates are almost sure to rise. The Federal Reserve has already set the course. If you assume long-term inflation to be around 3%, then short-term interest rates have to go above that in order for investors to have a real rate of return. And the longer the maturity, the higher the rates investors will demand for the relative risk. I see money market rates above 3% within 12 months and ten-year treasury rates up to around 5%, possibly a bit higher.

#### ***How significant a problem are the government deficits?***

As long as they do not exceed sustainable ratios for long periods of time, deficits are not alarming. In order to support increased debts, the total income (GDP) must rise at an equal or higher rate.

The deficits need to be watched carefully. Washington

needs to become more responsible fiscally. If the deficits expand faster than GDP it could become a significant problem.

**Whether deficits will be a big hurt depends on ratios of deficit growth vs. economic growth.**

#### ***Is Iraq a stimulus or a drag on the economy?***

It is both. What I say here is a dispassionate view of the economic big picture. I do not desire war and I am deeply concerned by the moral issues and human costs that can't be quantified in purely economic ways.

That said, wars have nearly always stimulated an economy... for the victor, that is. Some sectors boom during wartime. Some may be hurt. More demand for resources, food, materials, supplies, etc. are a positive force for companies that provide these. More sectors benefit than are hurt.

The downside is if you lose the war or if the costs create too much deficit spending or disrupt trade so that the economy gets unbalanced or, in the case of a loser of war, the economy is stripped and restructured in the image of the victor. But even that can be positive as

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Japan and Germany experienced after WWII.

### **What about energy prices?**

**Long term, energy prices will rise. It will make sense to invest in energy-related companies and sectors.**

What about them? They are currently finding a new level. We were spoiled by almost two decades where energy costs moved mostly sideways. I am not overly alarmed.

However, a major Middle East disaster or a

huge fall out with other producers could cause us significant problems. Our dependence on foreign energy is a long-term problem that has not been adequately addressed.

Look for oil to stay in the low \$40 range short-term, with some gyrations based on events in the Middle East. Regardless, prices are bound to edge up as China and other countries expand their demand at a fast pace.

### **Was the outcome of the November elections generally positive or negative for the economy?**

I think it is important to say that no matter who won, the stock market was going to go up. The market's biggest fear was that neither candidate would win decisively and the country would suffer a repeat of 2000. I am always amazed at how much credit people tend to give a candidate in having power to immediately affect an economy such as ours. The fact is that this is a battleship economy and it takes years of policy change and actions to turn it. What is done today is often not felt for years.

George Bush inherited an economy that was years in developing. Bill Clinton inherited an economy he had little to do with. Both affect the economy for positive and negative results, but those results are rarely seen immediately. Even actions designed to have a more immediate effect, such as the Bush tax cuts or dropping or raising short-term interest rates do not affect things much for many months or even a couple years.

That said, I think the Bush election is a little more positive than negative simply because his and the Republican philosophies and principles tend to favor economic growth more than the Kerry and Democratic forces do.

The problem is that neither party has a particularly stellar track record when it comes to fiscal responsibility and economic vision. So we shall see.

### **OK, where do you see the markets going in 2005?**

Here I am, dusting off my crystal ball. Or is that

an eight ball? Or just a goofball?

I once wrote in this space, "How many ways are there to say I don't know and still appear intelligent?" The best I can do is observe, use sound principles, remember the past and try to weigh the probabilities.

In the end, markets go up or down because a greater weight of buying or selling force occurs. And human beings making decisions based on thoughts and emotions cause such weight.

Both Bears and Bulls have rational and emotional reasons for their opinions. Many like to say they ignore their emotions, but in reality I think most of us always have a "feeling" element to our actions.

Bears think the stock markets are going to have tough sledding both near term and long term. They point out that PE ratios are again on the high side. They see a couple of years of good gains setting the stage for at least a healthy correction. If 1999 produced a huge "bubble" then we are seeing at least a modest bubble today.

Bears are concerned about government policies and large trade deficits creating a debt burden that will be hard to pay. They are concerned by poor ethics and practices in many businesses that risk long-term failure to make short-term profits. They are concerned about our energy dependence and a sense that many countries just don't like us and will work hard to beat us economically.

Bulls say that "the trend is your friend" and that the trend right now is inarguably upward on both a short-term and long-term basis. They argue that we are still in a major technological revolution and when such revolutions have happened in the past, a higher growth rate is sustainable for longer periods. They point out that not all company PE ratios are too high and that there is plenty of room for investors to "rotate" portfolios toward cheaper, more value-oriented companies. Bulls also point out that there is still a good bit of cash on the "sidelines" that can serve as investment fuel.

Bulls tend to embrace the global nature of this new economy and see growth pains rather than death throes. They will readily expect what they consider normal "corrections" of 5%, 10% or even 20% or more along the way. But they see ownership as the most likely road to wealth creation.

Where do I weigh in? I lean more toward the Bulls. I will not be surprised to see a correction of around 10% sometime in the first quarter. But I see an economy that is growing both here and abroad.

As long as the general trend is expanding, there will always be good opportunities to invest in good

**Crystal ball or Goofball?**

**The Election outcome was more positive than negative, but will Republicans lead responsibly and will Democrats cooperate responsibly?**

companies. Stock markets have always been roller coasters to varying degrees, and that will not end. But in an expanding economy, stocks tend to take three steps forward for every step backward.

If history is a guide, it shows us that on average the stock market loses money approximately 1 year out of every 3 or 4. Sometimes it is three years and one, sometimes ten years and then three. It is not regular or particularly predictable, but it does go up more than it goes down.

If I were to venture an educated guess as to where 2005 will end up, I would say the S&P 500 and the DOW could reasonably be expected to increase in price between 4% and 8% in 2005. With dividends, that would be in the 7%-10% total return range, a bit below average. I see interest rates rising, so bonds will be less likely to produce returns above inflation. International growth trends are strong and I won't be surprised to see foreign markets outperform U.S. markets.

My caveat is the unknown. Will terrorists be able to strike again in a major way? Will there be a nuclear confrontation in the Middle East or Far East? Will there be new scandals or some completely new

### Probable 2005?

- Higher interest rates. Short-term rates to 3%+. 10 year Treasury to 5%+.
- Continued Mid-East Problems
- Continued Global Growth
- Slowing Real Estate markets
- Modestly positive stock markets
- Foreign stock beat US again unless dollar reverses
- Correction of 5%-10% likely in 1<sup>st</sup> or 2<sup>nd</sup> quarter
- S&P500 Total Return 7%-10%
- Bond returns low, poss. Negative.

force that will derail economic growth beyond normal recession and growth cycles?

I don't know. But I can promise you that we will be watching the trends and if bad things happen we will try to make intelligent decisions and take action to minimize losses. We will try to ignore irrational fear and seek to weight portfolios to take advantage of trends and guard against risks.

### Wishful Thinking

Here are some things I wish I could see happen in 2005. (But I won't hold my breath.)

1. I'd like to see a TV "Reality" show that would bring out the best in people and not the worst.
2. I'd like to see more non-hyperbolic advertising.
3. I'd like to see lightening strike religious and ideological leaders who brainwash people into becoming suicide bombers and claim this somehow pleases God.

### What to Do Now

- \_\_\_ Call us to set up a meeting to review your plans.
- \_\_\_ Think about your situation and your objectives. Write down any issues or questions we should discuss.
- \_\_\_ Shoot the procrastination gremlin now.

**412-367-9076**

## A Statistical Review of the Past Five Years

(Ranked from best to worst 2004 Performance)

Benchmark Performance*	2004	2003	2002	2001	2000	3 Year Avg Ann Return	5 Year Avg Ann Return
EAFE International Index	20.25%	38.59%	-15.94%	-21.42%	-14.19%	11.89%	-1.13%
Wilshire SmallCap 1750 Index	18.40%	47.45%	-20.75%	-0.30%	-0.02%	11.43%	6.64%
Russell 2000 Small Co. Index	18.33%	47.25%	-20.48%	2.49%	-3.02%	11.48%	6.61%
MS Foreign Large Blend Funds	17.62%	33.31%	-16.81%	-21.81%	-15.96%	9.26%	-3.04%
MS World Stock Funds	15.19%	34.74%	-19.09%	-16.33%	-8.14%	7.89%	-0.71%
S&P 500 Stock Index	10.71%	28.67%	-22.09%	-11.88%	-9.10%	3.53%	-2.33%
NASDAQ	8.59%	50.50%	-31.50%	-21.10%	-39.30%	3.83%	-11.72%
Dow Jones Industrials	5.16%	28.28%	-15.01%	-5.44%	-4.85%	4.66%	0.62%
Lehman bros. Interm Gov't/Cred Index	4.19%	4.30%	9.82%	8.98%	10.10%	6.07%	7.44%
Lipper US Government Bond Fds.	3.35%	1.70%	10.00%	6.70%	11.90%	4.96%	6.66%
Inflation	3.30%	1.88%	2.38%	1.55%	3.39%	2.52%	2.50%
MS Short Term Bd Fds	1.55%	2.61%	5.48%	7.24%	7.75%	3.20%	4.90%
Lipper Money Market Funds	1.15%	0.61%	1.23%	3.58%	5.72%	1.00%	2.44%

\* These are preliminary and/or estimated numbers and are subject to revision. Indexes, except where marked with a "\*" are total returns. Non-fund benchmark

*indexes do not have expenses. Performance figures are total returns net of expenses, with dividends and capital gains reinvested. Indexes were quoted as published in various publications or sources, including the Wall St. Journal, Lehman Bros., Wilshire, Morningstar and other data sources.*