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The modest decline in the stock market averages in the first half of 2005 is no surprise. We entered the year believing valuations were near the high end of historical norms and the positive earnings surprises that drove the market averages upward in 2003 and 2004 would not be repeated. Nothing has changed to alter these beliefs. Our road map for the averages is unchanged.

The action of the bond market has been surprising. The Federal Reserve Board continues to raise short-term interest rates by ¼% at every meeting. Despite an increase in short rates from 1% to 3 ¼% in the last year, long-term rates have fallen. Treasury bonds due in 2031 yield 4.3% today compared to 5.3% a year ago. Ten-year Treasuries yield 4% today compared to 4.6% one year ago. Fed Chairman Alan Greenspan describes this as a "conundrum." Whatever the cause of this puzzlement, we see less reason than ever to favor long-term bonds over short-term cash and equivalents in balanced accounts.

## Bells Are Ringing

In our April letter, we expressed the view that house prices in most of the country were in line with incomes and interest rates. Chairman Greenspan recently expressed a similar view. While conceding that prices in some areas are "frothy," Greenspan said a nationwide real estate bubble is not in evidence.

Chairman Greenspan notwithstanding, our view has changed considerably. The "froth" is increasingly widespread. Behavior that characterizes a mania is becoming more pronounced. Call it froth or call it a bubble, we believe the end is near.

Here are a few indications that a late-stage mania is in progress. Any resemblance between these signs and those flashing during the Internet/Nifty 50 bubble of 1999-2000 is not coincidental.

Trees grow to the sky: Many real estate investors believe housing prices never decline. While a nationwide decline has not occurred since the Depression, local and regional declines have been commonplace. In Santa Cruz County alone, there have been two sizeable declines in the past twenty-five years. One decline ran from 1980-1983 and the other from 1990-1994.

Ignorance is bliss: In a cover story entitled "Real Estate Gold Rush," Fortune magazine profiled serial speculators who move from hot market to hot market. They fly into Phoenix or Austin, meet a real estate broker and buy four houses in a weekend. Some could not remember how many houses they own and knew little or nothing about the houses they were buying. All they know is that prices are going up.

Lax financing: Every bubble is aided and abetted by easy access to financing. In the Internet bubble, the financing was provided by venture capitalists, business incubators and besotted investors hurling money at everything from start-up companies to Initial Public Offerings. The co-conspirators in the housing bubble are mortgage lenders. Buyers who could not dream of paying current prices using traditional 20% down payments and amortizing mortgages are being shoe-horned into property with interest-only loans, option ARMs, no-down/low down loans, loans with negative amortization and/or loans made with no documentation. If this weren't enough, some banks are issuing letters of credit backing commitments to buy units in yet-to-be-constructed Florida condominiums. This harkens back to the Florida swamp boom of the 1920's when marshland would turn over multiple times at rising prices through the use of options or "binders."

Day trading is back: Transactions in the unbuilt condo units described above will soon be facilitated by a web enterprise called Condoflip.com. Condoflip is one among many websites bringing rapid fire trading to the traditionally illiquid, buy-and-hold real estate market.

Economic disconnect: Since residents in any geography can choose between renting and owning, housing prices generally bear some correlation to rental rates. In many areas, this connection has been broken. In San Francisco and other places, housing prices have surged while rents have declined. The cost of owning sometimes exceeds the cost of renting by 40% to 70%. In effect, the price/earnings ratio of residential real estate is stratospheric.

The Time magazine indicator: The popular press – particularly Time and Business Week – have an uncanny knack for publishing cover stories on investment booms and busts just as the trend is about to reverse. Jeff Bezos of Amazon.com was named Time's "Person of the Year" on December 27, 1999. Three months later, the Internet bubble burst. On September 14, 1998, just as the Dow Jones Industrial Average was hitting bottom following the Long Term Capital Management selling panic, Time's cover asked, "Is the Boom Over?" The Dow proceeded to rise 4200 points in the next 18 months. On June 7, 2005, Time magazine arrived in my mailbox with the cover story, "Home $weet Home. Why we're going gaga over real estate."

Who says they don't ring a bell at the top?

## Selling Out

We have responded to our increasing discomfort regarding the housing market by moving away from the line of fire. We have curtailed or eliminated exposure to companies involved in homebuilding, mortgage origination or mortgage guarantees. Our selling may be premature since manias can last longer than one expects. But we would rather be early than late since prices tend to fall more rapidly than they rise. In this, we heed the wisdom of renowned financier Bernard Baruch who once claimed, "I made my money by selling too soon."

## Things are Looking Up

Just as the bursting of the Internet/Nifty Fifty bubble did not torpedo the entire U.S. economy in 2000 – after all, we bought into our extremely profitable homebuilding position in 2000 – a bursting housing bubble will not necessarily sink the U.S. economy in 2005. Nevertheless, ripple effects remain a concern. Homeownership is more widespread than stock ownership. Cash-out refi's have provided an unknown portion of the oomph in consumer spending over the past few years. The wealth effect - where consumers feel richer and spend more when their assets are appreciating and feel poorer and spend less when they are not - could be significant. On the other hand, the damage might be confined to those most heavily involved – recent home buyers, imprudent lenders, real estate developers and get-rich-quick dreamers. This would be consistent with the limited collateral damage done by the unwinding of the U.S. bubble in 2000 or the Japanese bubble in 1989.

If the ripple effects are limited, the tide running against the stock market averages should ebb as 2006 approaches. Where the S&P 500 and Value Line Composite are trading at the upper end of their historical ranges based on 2005 earnings and inflation estimates, the S&P may be below its average historical valuation based on 2006 earnings estimates while the Value Line is close to expected value. These indices have gone nowhere since 1998 and 1997, respectively, so it will have taken the better part of a decade for earnings to catch up with prices.

For our holdings, the risk/reward equation is particularly favorable. We recently rolled our target prices forward to reflect 2006 expectations. Using the quantitative methodology described in our April 2004 letter, our stocks have average appreciation potential of 50% from current prices to their 2006 predicted median highs. Average downside risk from current prices to 2006 predicted median lows is 5%.

Before counting our chickens, several points should be made. Raw statistical data cannot be taken at face value. For some holdings, expected valuations must be adjusted downward because future earnings growth will be slower than past growth. For other holdings, higher valuations may be warranted.

Second, forecasting error increases as forecasting period lengthens. With reported earnings data for only one quarter of 2005, it is presumptuous to believe all our holdings will meet expectations for this year, let alone 2006. On the other hand, our forecasts are less prone to error than most since our holdings have very high earnings predictability.

Third, it is unrealistic to expect all our stocks to hit their median expected highs. It is even less realistic to expect them to hit their highs simultaneously.

Although we do not expect to make 50% over the next 18 months, we believe the likelihood of attractive returns is high.

## The Dark Side of the Force

Even when probabilities are favorable, bad things can happen to good investors. If a bursting housing bubble has a greater effect than we anticipate, a recession might follow. Unlike the capital investment recession that followed the Internet bubble, this would likely be a consumer spending recession. Consumer spending is believed to account for 2/3 of the U.S. economy.

Our portfolios would be insulated from, but not immune to, such a recession. Health care, insurance, data processing, natural gas, defense and industrial supplies account for 55% of our aggregate equity holdings. These industries have limited consumer sensitivity. The 10% of our holdings in automobile manufacturing and home improvement retailing would be the most affected if consumer spending drops off. The remainder would see varying but moderate effects.

On balance, we believe the attractive valuations, earnings predictability and sector weightings of our portfolios make negative outcomes unlikely measured from this point to the end of 2006. Still, risk is always present. We will be monitoring events and adjusting holdings as appropriate.