

April 2006 Commentary

First Quarter 2006 - Market Review

"If we don't change direction soon, we'll end up where we're going." Professor Irwin Corey

The first three months of 2006 started off quite strong for stocks, while other assets like commodities and bonds began to show some signs of weakness. The growing global economy is causing central banks around the world to raise interest rates and is creating trade tensions but is providing plenty of opportunity for companies to expand.

Continuing to lead the way were Real Estate Investment Trusts (REITs) and small company stocks, both of which delivered a good year's worth of return (more than 13%) in just a single quarter. Just how good has it been for REITs? After six straight years of positive returns, REITs rose another 14.7% in the first quarter. Since the beginning of January, 2000 REITs have appreciated by 247% while the S&P 500 Index is down 2.7%. Also, it's important to note that the return of the S&P 500 Index is actually helped by REIT returns as the Index now includes a small number of REITs.

Do the stellar historical returns of REITs make them attractive investments today? We don't know, except to say that the returns in the future are likely to be lower than the recent past. It is highly unlikely that the returns over the next three years will be 32% per year, the annualized return over the last three years. We act with discipline as we will rebalance portfolios back to their target allocations. As REITs appreciate, we sell some REIT investments and make purchases in other areas that have not done as well. This way if REITs continue to perform well, the portfolio benefits and if REITs experience a period of weak or even negative results, the portfolio won't be too adversely affected. If REITs really suffer a setback, we can take the opportunity to add to the position, bringing it back to our target. This way, we don't have to be smarter than the market or even right all the time to obtain good long-term results.

Asset Class Investment Returns - Before the Impact of Inflation

Investment Type	YTD	1 Year	3 Year	5 Year	10 Year
Equity Large Cap (S&P 500)	4.2%	11.7%	17.2%	4.0%	9.0%
Mid Cap (S&P 400)	7.6%	21.6%	26.0%	12.8%	14.5%
Small Cap (Russell 2000)	13.9%	25.9%	29.5%	12.6%	10.2%
International Equities (MSCI EAFE)	9.4%	21.3%	30.0%	9.1%	6.2%
Commodities (Dow Jones AIG)	-2.4%	5.7%	15.9%	11.8%	7.9%
Real Estate Investment Trusts (NAREIT)	14.7%	38.5%	32.1%	22.3%	15.8%
Bonds Gov't & Corporate Bonds (Lehman Gov/Credit)	-1.0%	2.0%	2.8%	5.5%	6.4%
Cash Cash (T-Bills)	1.0%	3.5%	2.0%	2.1%	3.6%
Inflation (CPI)	1.5%	3.4%	2.7%	2.5%	2.5%

Asset Class Investment Returns - After Inflation

Investment Type	YTD	1 Year	3 Year	5 Year	10 Year
Equity Large Cap (S&P 500)	2.7%	8.1%	14.1%	1.4%	6.3%
Mid Cap (S&P 400)	6.1%	17.6%	22.6%	10.0%	11.7%
Small Cap (Russell 2000)	12.4%	21.8%	26.0%	9.8%	7.5%
International Equities (MSCI EAFE)	7.9%	17.4%	26.6%	6.4%	3.6%
Commodities (Dow Jones AIG)	-3.9%	2.3%	12.8%	9.0%	5.3%
Real Estate Investment Trusts (NAREIT)	13.2%	34.0%	28.6%	19.3%	12.9%
Bonds Gov't & Corporate Bonds (Lehman Gov/Credit)	-2.5%	-1.3%	0.1%	2.9%	3.8%
Cash Cash (T-Bills)	-0.5%	0.1%	-0.7%	-0.4%	1.1%

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"If the facts don't fit the theory, change the facts." Albert Einstein

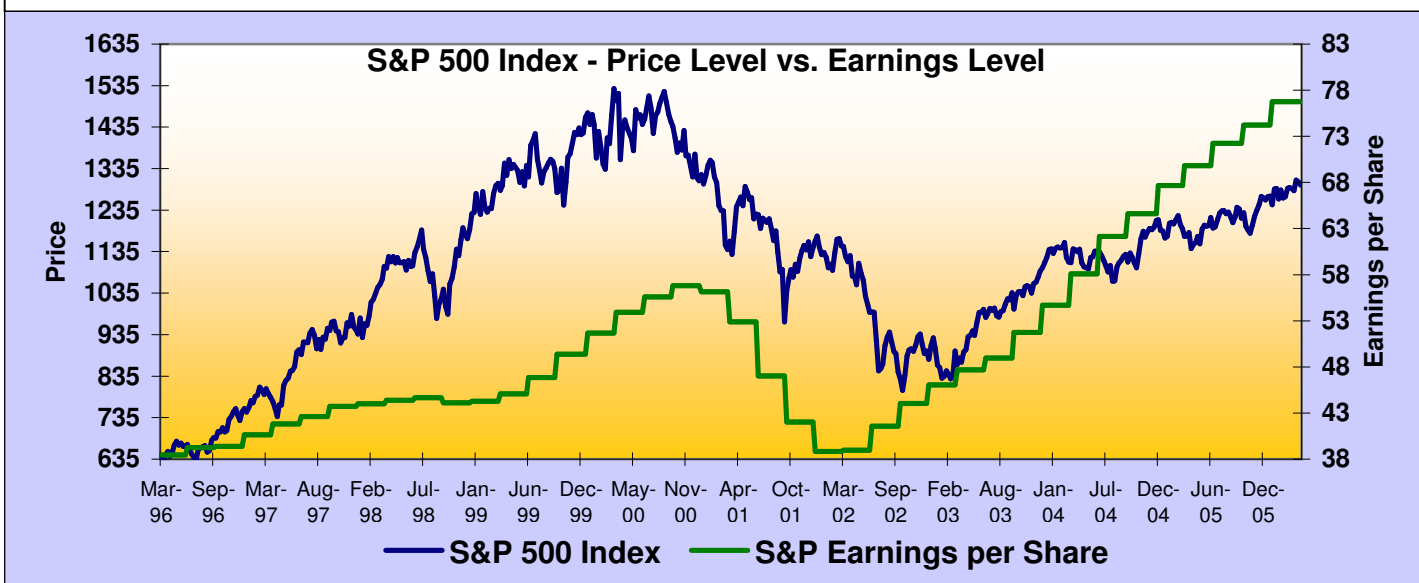
On the opposite side of the coin, the S&P 500 Index has experienced several years of disappointing results. Returns over the last five years have trailed the returns on bonds (4.0% vs. 5.5%). Investors with a bearish view on large company stocks often have some 'compelling' statistic to make their point. For example, recently a well respected mutual fund manager argued that "in 1999 to 2000, some were chasing illusory growth prospects; today we believe they are chasing unsustainable profit margins. Net U.S. corporate profits as a percent of GDP have been at a level not seen since 1929, and today are more than 30% above average." The implication here is that today is like 1929 and that we might be headed for a 30% fall.

In our view, while caution is always warranted, the problem with the manager's statement is that it's too simplistic and it doesn't take into account a changing world. At first blush, comparing corporate profits to GDP seems like a good idea, as the corporate sector can't gain too much share without workers and the government wanting more too, creating a battle that keeps profit margins in check. However, corporations are more global today than they were in 1929 and becoming even more so with each passing year. Comparing corporate profits (which include profits from international operations) to our nation's annual domestic economic output is truly comparing apples to oranges.

If it were possible to adjust for the international impact on profit margins as a share of GDP, the manager's conclusion might well be different. In our view, much of the economic data that we are presented with today suffers from this problem as it wasn't designed to measure today's global economy of free flowing ideas, trade and capital. The data, if not carefully examined, can lead to the wrong conclusions. And these days we have plenty of data, but perhaps not enough thoughtful analysis.

Coming back to large company stocks and the S&P 500 Index – we see opportunity in this area over the next several years. The principal reason is because of the weakness in large company share prices since 2000 while profit growth for the S&P 500 Index has well surpassed levels in 2000 (see chart below). Over long-periods of time stock prices do track the growth in earnings. The current disconnect between the two means that investors can get more 'value' today by investing in large company stocks than at any point over the last five years. We plan to capture that value by setting an allocation target, investing to it and rebalancing when appropriate.

"The cost of a thing is the amount of what I call life which is required to be exchanged for it, immediately or in the long run." Henry David Thoreau



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