

# October 2005 Commentary

## Third Quarter 2005 - Market Review

Considering all the events that occurred in the third quarter it is surprising that the equity markets were able to produce positive results. A terrorist attack in London, the Federal Reserve's continued rate-raising campaign, catastrophic hurricanes Katrina and Rita, surging oil and gasoline prices, and the bankruptcy filings of Northwest and Delta Airlines added to market volatility, but had little negative effect on stocks. On the other hand, the events were too great for bond investors to ignore as prices succumbed and posted losses for the quarter.

The table below displays the returns of several market benchmarks. Large company stocks rose 3.6% during the quarter and were up 2.8% year-to-date. Mid-caps, small-caps and REITs all rose more than 3.8% during the quarter, while international equities rose 10.4% and commodities rose 17.6%. Government and corporate bonds fell 1.0% during the quarter and municipal bonds lost 0.2%. Cash earned 0.8% in the third quarter.

Lately, a big area of concern for investors is inflation. Last quarter, inflation, as measured by CPI, rose 2.2% and is now up 4.7% over the last 12 months, to its highest level in 15 years. Fueling this increase is the massive run-up in the cost of energy, as the energy component of CPI is up 34.8% versus one year ago. In addition, higher energy prices are also filtering through to the transportation component, which is up 14.5% over the last 12 months. Many market observers are concerned that higher inflation may also spread to other areas. So far there is no evidence of a ripple effect and for now the "core rate" of inflation appears to be well contained. Stripping away the volatile food and energy parts of CPI shows that the "core rate" is up only 2.0% over the last 12 months. It is interesting to note that just over two years ago the concern was for deflation. In our May 2003 Commentary we noted that "Federal Reserve Chairman Alan Greenspan voiced his concern about the prospects for deflation."

**"An investment in knowledge always pays the best interest."** - Benjamin Franklin

### Investment Returns - Before the Impact of Inflation

Investment Type	3rd QTR	YTD	1 Year	3 Year	5 Year	10 Year
<b>Equity</b> Large Cap (S&P 500)	3.6%	2.8%	12.2%	16.7%	-1.5%	9.5%
Mid Cap ( S&P 400)	4.9%	8.9%	22.2%	22.1%	7.1%	14.1%
Small Cap (Russell 2000)	4.7%	3.4%	18.0%	24.1%	6.5%	9.4%
International Equities (MSCI EAFE)	10.4%	9.1%	25.8%	24.6%	3.2%	5.8%
Commodities (Dow Jones AIG)	17.6%	25.2%	19.6%	20.8%	13.3%	10.2%
Real Estate Investment Trusts (NAREIT)	3.8%	10.5%	27.3%	26.0%	19.6%	14.8%
<b>Bonds</b> Gov't & Corporate Bonds (Lehman Gov/Credit)	-1.0%	1.8%	2.6%	3.8%	7.2%	6.6%
<b>Cash</b> Cash (T-Bills)	0.8%	2.1%	2.6%	1.6%	2.3%	3.7%
Inflation (CPI)	2.2%	4.5%	4.7%	3.2%	2.8%	2.7%

### Investment Returns - After Inflation

Investment Type	YTD	1 Year	3 Year	5 Year	10 Year
<b>Equity</b> Large Cap (S&P 500)	1.4%	-1.7%	7.2%	13.1%	-4.1%
Mid Cap ( S&P 400)	2.7%	4.5%	16.7%	18.3%	4.2%
Small Cap (Russell 2000)	2.5%	-1.1%	12.7%	20.3%	3.6%
International Equities (MSCI EAFE)	8.2%	4.6%	20.2%	20.8%	0.4%
Commodities (Dow Jones AIG)	15.4%	20.7%	14.2%	17.1%	10.2%
Real Estate Investment Trusts (NAREIT)	1.6%	6.0%	21.6%	22.1%	16.4%
<b>Bonds</b> Gov't & Corporate Bonds (Lehman Gov/Credit)	-3.2%	-2.7%	-2.0%	0.6%	4.3%
<b>Cash</b> Cash (T-Bills)	-1.4%	-2.4%	-2.0%	-1.5%	-0.5%

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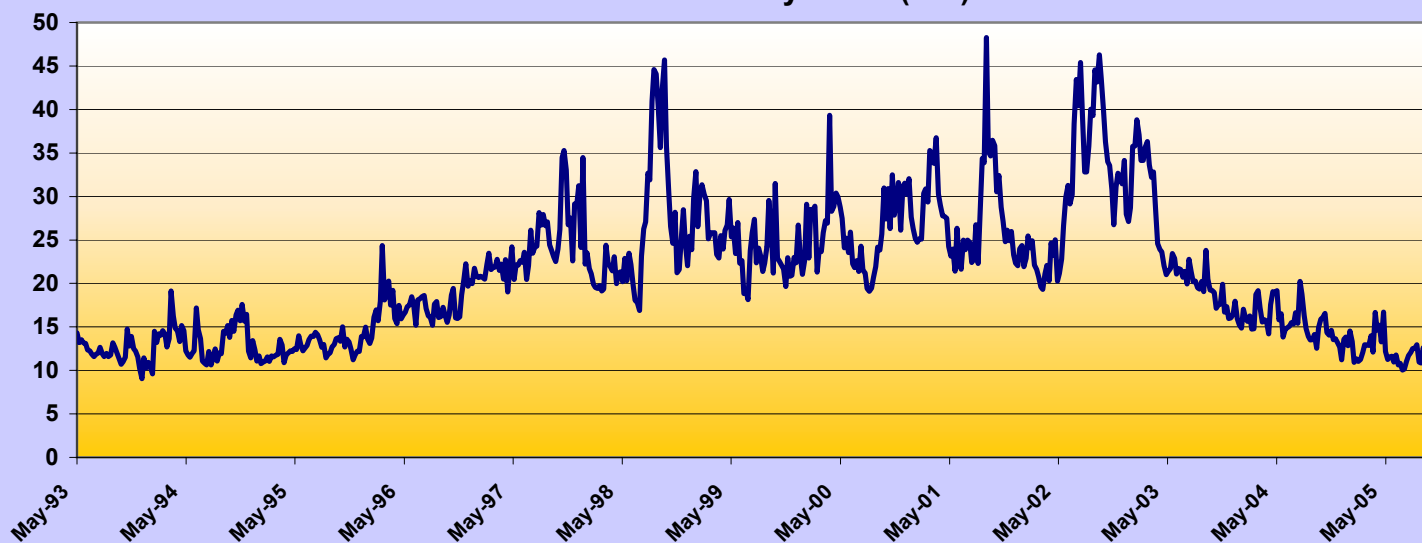
In last month's Commentary we discussed the topic "Financial Preparedness when Disaster Strikes." Our discussion focused on some things that you can do to prepare in advance for a disaster. It is also important that your investment portfolio is prepared and that you are psychologically ready to handle a financial market crisis. Turmoil in the financial markets should be expected and is not necessarily a bad thing, if you are positioned for it. That said, there appears to be quite a bit of complacency in the markets today.

The chart below shows the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which shows the market's expectation of future volatility. The VIX is a widely used measure of market risk. The first VIX, introduced by the CBOE in 1993, was a weighted measure of the implied volatility of eight S&P 100 at-the-money put and call options. Ten years later, it expanded to use options based on a broader index, the S&P 500, which allows for a more accurate view of investors' expectations of future market volatility. VIX values greater than 30 are generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets. The index is often referred to as the "investor fear gauge". Today the VIX is at about 15 after sinking down to about 10 this summer.

Financial market crises can come in several forms. There are events like political turmoil, terrorist attacks, natural disasters, frauds and bankruptcies that can cause short-term disruptions. Then there are other disruptive forces caused by surging inflation, recessions, and wars that may have a longer lasting impact. At Madison, we construct portfolios with all these types of events in mind, but with an understanding that the risks from these events cannot be avoided. For instance, those investors who are adding money to their portfolios should welcome downturns in the markets as opportunities to buy investments more cheaply, just like anyone would welcome a sale at the supermarket.

We construct all-weather portfolios. We allocate our clients' investment dollars to asset classes (stocks, bonds, cash, real estate, commodities, etc) that have different performance characteristics. For example, stocks, commodities, real estate and inflation-indexed bonds may perform better during inflationary periods. In recessions bonds can perform well, while cash and gold are better during short-term crises of confidence. Cash, while the model of stability, is no solution over the long run, once you figure in inflation and taxes. Investing is characterized by uncertainty and broad diversification is your best defense. The winds that can push your portfolio up or down on daily basis should not affect your ability to get a sound night's sleep. If they do, please give us a call.

**CBOE Market Volatility Index (VIX)**



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