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July 2006

Valuation, Valuation, Valuation

Are we right? Or, are we wrong?

For the past two years, we have been saying that high quality stocks were undervalued and due for a strong rally. With the S&P 500 index producing only 5.5% annual price growth during that time, have we got it wrong? We don't think so. Come along with us while we show you how we determine the underlying values for the market.

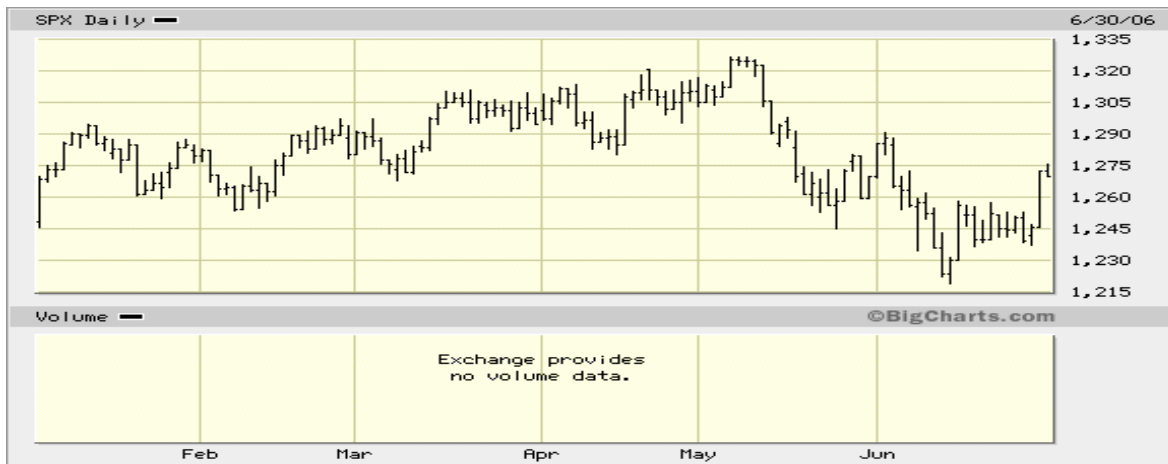
The way we see it, corporate dividend and earnings growth over the past 24 months justify much higher prices for blue chip stocks. The reasons for the poor relative performance of high quality stocks versus their strong fundamentals have been many, some of which are obvious and some not. Terrorism, uncertainties surrounding the war in Iraq, geopolitical tensions, rising interest rates, and the spike in oil prices have all combined to act as a drag on stock prices, but, in our judgment, the seventeen consecutive rate hikes by the Federal Reserve's Federal Open Market Committee (FOMC) are the main reason for the weak markets. While we have been making this argument for a long time, we think there is now proof.

Chart I shows the S&P 500 Index since the first of the year. On January 3rd of this year, the FOMC released the minutes of its December meeting. In those minutes, there was a clear indication that the rate hikes were nearing an end.

"The Committee agreed that several changes in the wording of the announcement to be released after today's meeting would be appropriate. . . . **given the information now in hand, the number of additional firming steps required probably would not be large.**"

Chart I shows that upon seeing the new "softer" language in the Fed's minutes on January 3rd, the S&P 500 spiked higher and continued to move higher until the middle of May.

Chart I
S&P 500 Index - Year to Date



It was at this time that Maria Bartiromo, a newscaster for CNBC, asked new Fed Chairman Ben Bernanke if the market “had it right.” He said no, and over the next 30 days, the S&P 500 erased all of the gains for the year and then some. The Dow Jones Industrial Average (DJIA) made the same round trip, starting the year at 10700 and rising to 11700 in May before retracing almost all of the year’s gains by the middle of June. Chart I shows that the S&P abruptly made another change of direction on June 29. Again, this spike of nearly 2% (20 points in the S&P and 200 points in the DJIA) occurred as a result of another modest softening in the Fed’s language that accompanied its most recent rate hike.

Whether we have seen the last rate hike or not, in our opinion, is not as important as Wall Street seems to think. We are confident that the rate hikes will stop in 2006, and when they do, there is every reason to believe that blue chip stocks will push higher.

Almost all of the companies we follow had outstanding dividend and earnings growth in 2004 and 2005, and first quarter 2006 results were very strong as well. As we write this letter, second quarter results are being released, and again the numbers look good. We do not think Wall Street traders can ignore the wide gap that has opened between prices and values much longer. In the remainder of this letter, we will look at three valuation models we use for clues as to how wide the valuation gap might be.

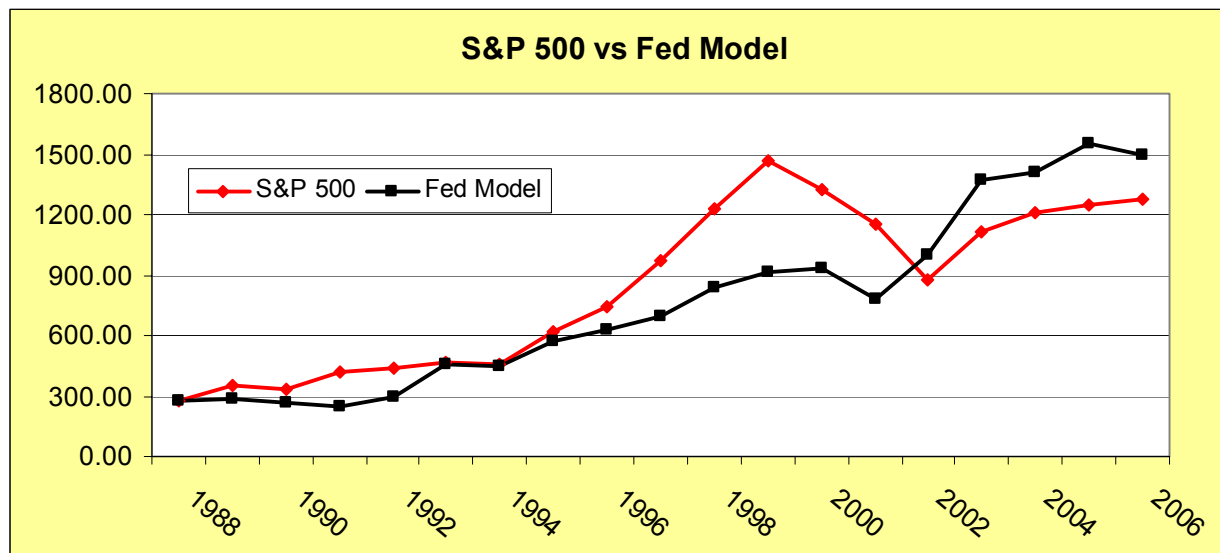
Fed Model vs S&P 500

The “Fed Model,” a very simple approach, is widely quoted on Wall Street and in the financial press. It first became popular after a December 5, 1997 speech by then Fed Chairman, Alan Greenspan, to the American Enterprise Institute in which he uttered the famous words “irrational exuberance.” Ed Yardeni, former strategist for Prudential Securities, popularized the term “Fed Model” in a number of speeches and research reports he made analyzing Mr. Greenspan’s comments. While the Fed does not endorse the model, their researchers have published studies that show the model’s correlation with the stock market indices.

To compute the Fed Model valuation, all you need are two pieces of data, the most recent 12 months earnings and the current yield on the 10-year US Treasury bond. The earnings are then divided by the bond yield to arrive at an indicated fair-value price. If the resulting figure is higher than the current

market price, the market is said to be undervalued, and if the calculated value is less than the market, the market is considered overvalued. The earnings for the S&P 500 Index over the past 12 months are approximately \$78. The yield on the 10-year Treasury bond is currently about 5.20%. Dividing \$78 by 5.20% equals 1500, which is nearly 20% more than the current price of the S&P 500. Chart I shows the historical relationship between the S&P 500 and its predicted value using the Fed Model methodology since 1988.

Chart II



The Fed Model works because money cannot sit idle – it must go somewhere. It will, sooner or later, be invested where the probable returns for the perceived risk are most attractive. The theoretical return for owning a company (stock) is its total profits divided by its price. On Wall Street, this is called the Earnings Yield. The return for owning a bond is the interest paid to the bondholder divided by the bond price, resulting in the Interest Yield. The Fed Model very simply compares the current Earnings Yield on stocks to the current Interest Yield on bonds. If, based upon earnings, stocks are more attractively priced at any point in time, money will move to stocks. If the Interest Yield on bonds is more attractive than the Earnings Yield, money will move to bonds. To simplify the process of determining the better value, the Fed Model produces a fair, or predicted, value for stocks given current earnings and prevailing interest rates.

The chart above shows that the S&P 500 (red line) and the model's predicted value (black line) traveled together from the late 1980s to the mid 1990s. At that point, the S&P 500 exploded higher while the predicted value rose at a much slower rate. By the start of 2000, the S&P 500 was near 1500 while the predicted value of the Fed Model stood at only 900, nearly 40% lower. The remarkable thing about the Fed Model, and the reason that it still has followers today, is that by the end of 2002, the S&P did, indeed, fall all the way back below its predicted value of 900.

Since 2002, the Fed Model's predicted value, spurred by strong earnings growth, has moved sharply higher and today stands at 1500, nearly 20% above the current level of the S&P 500.

Fed Model vs Dow Jones Industrial Average

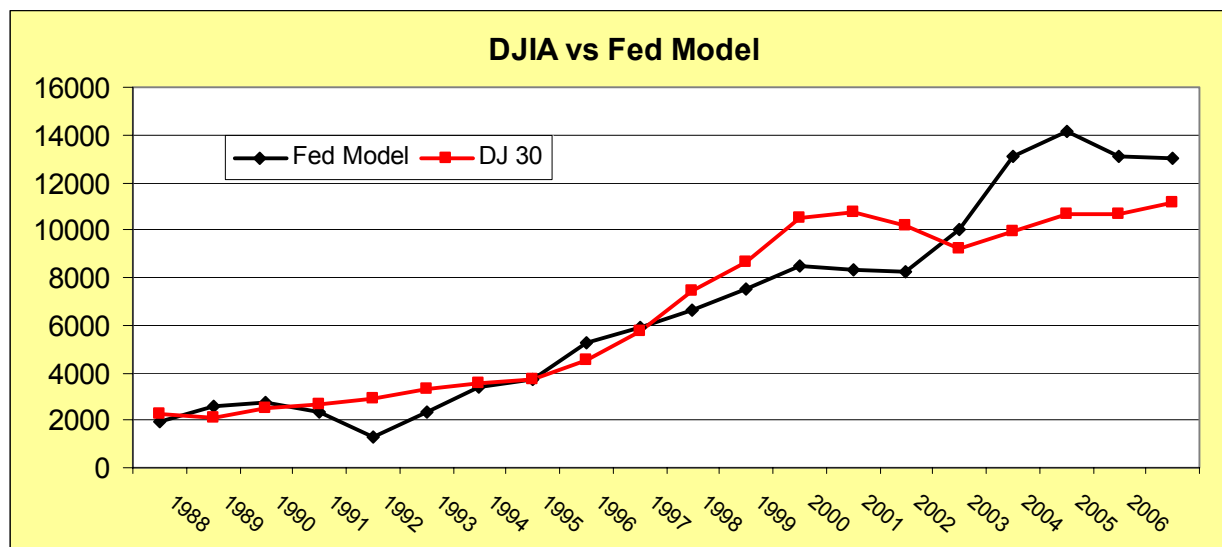
We also apply the Fed Model formula to the DJIA. We have found that the correlation between the DJIA and its predicted value using the model is tighter than that of the S&P's. Statisticians use a measure called R^2 to mathematically determine how closely one set of data fits with another. Said another way,

R^2 is a statistical measure of predictive ability, where 1.00 indicates a perfect fit. The R^2 of the Fed model for the S&P 500 is about 0.60. This means that over the last 17 years, the model has been able to explain roughly 60% of the movements of the S&P 500 on an annual basis. The R^2 of the DJIA compared with its predicted value using the Fed Model methodology is over 0.80. This simply means that there is a much tighter correlation between the DJIA and its predicted value than the S&P 500's.

We believe the tighter fit of the DJIA compared to the S&P 500 is contained in one word: technology. Tech stocks make up a smaller proportion of the DJIA than they make up of the S&P 500 Index. Since tech stocks are very volatile (think: unpredictable), this means that the DJIA is a less volatile index than the S&P 500, and this translates into the DJIA making softer turns compared to the movements of the S&P 500.

Chart II shows the Fed Model compared to the Dow Jones Industrial Average.

Chart III



The chart shows the tighter fit between the DJIA and the Fed Model, as compared to the S&P 500. The chart shows a more modest overvaluation in 1999-2002 and more gradual correction compared to that of the S&P 500. The predicted value of the DJIA is now near 13000 or about 15% above the current price of the DJIA, based on trailing 12-month earnings.

Donaldson Capital Management's Dividend Correlation Model

Donaldson Capital Management has a proprietary model called the Dividend Correlation Model (DCM). The DCM model uses the historical growth of the DJIA's dividends and earnings and, like the Fed Model, factors in interest rates on 10-year Treasury bonds.

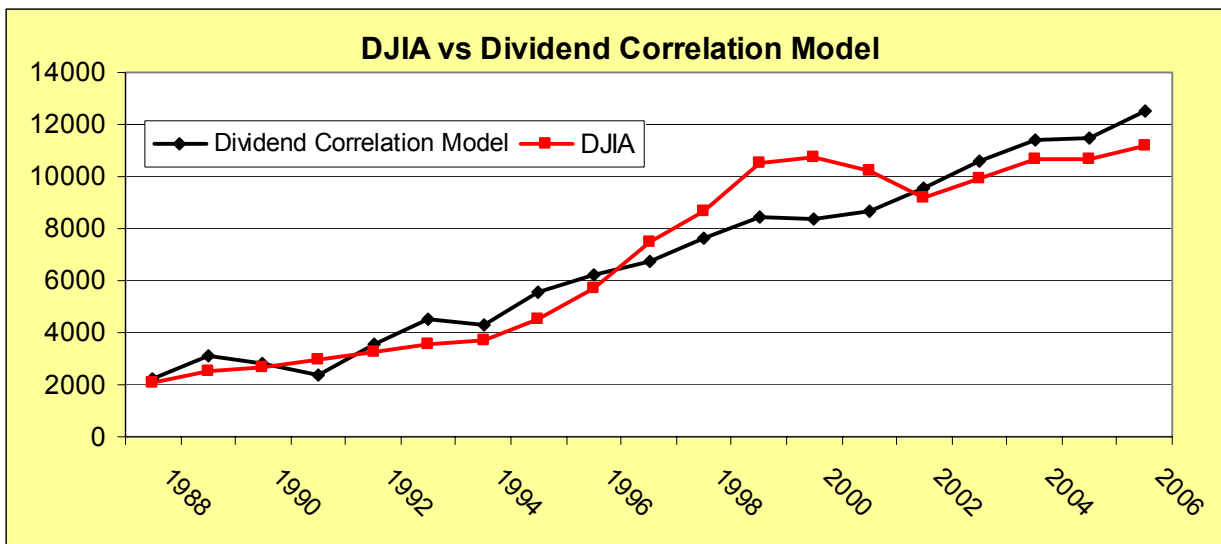
You could have guessed that dividends would figure into our thinking sooner or later. Here is a little secret that we learned along the way. The investment world follows earnings and only earnings. If a company misses its quarterly earnings by a penny, its stock will likely fall sharply. This is not news. But what is news to most people is that, particularly for the DJIA, our dividend correlation model has proved to be a better predictor of value than any earnings model we have seen. The reason for this is simple: Because dividends are set by the board of directors of the company, they are much less volatile than earnings. The annual volatility of operating earnings for the DJIA is over three times that of dividends. In

short, earnings are all over the road for the 30 companies in the Dow, while dividends drive between the lines very nicely.

We use both dividends and earnings in our Dividend Correlation Model, but we give more weight to dividends for the reasons we just mentioned. We use earnings kind of like a weather vane, to tell us the direction of the economic winds. This is important because dividends are so stable that they can sometimes completely ignore a downturn in the economy. The evidence of this is the recent bear market. According to Value-Line, from 2000 through 2002, the total annual dividends of the DJIA went up every year, while earnings fell two of the three years.

Chart III shows the Donaldson Capital Management Dividend Correlation Model compared to the DJIA.

Chart IV



This model has the highest correlation to the actual annual price movements of the DJIA of all the models and is the one we rely upon the most. It has an R^2 of 0.92, which means on average it has explained 92% of the annual changes in the DJIA. It has done a good job over the years in measuring the underlying or intrinsic value of the DJIA. Notice that in the period from 1992 to 1997, the model was consistently showing that DJIA prices were undervalued. Beginning in 1994 the DJIA made a sharp acceleration toward the value line, bringing values and prices into equilibrium by 1997. From that point until 1999, the DJIA continued its accelerated trend until it was significantly overvalued. Again, prices began to correct back toward the value line, reaching equilibrium in 2002.

In the last 18 years, the DJIA and its predicted value, as measured by our DCM model, have spent very little time precisely at equilibrium. The chart clearly shows that the DJIA has swung back and forth across the value line. The key idea here is that value has grown in a reasonably steady trend. In each case of overvaluation or undervaluation, it has been the DJIA that has corrected back to the value line, not the other way around. Our dividend correlation model now estimates that the fair value of the DJIA is near 13000, about 15% higher than the current price. We use the same DCM to value each of our companies in your portfolios. As of the end of June, we calculate that our average stock is about 15% undervalued, about the same as the indices.

The DJIA is now in its fourth year of undervaluation. If history is any guide, the valuation gap should start to close soon. The laundry list of worries we mentioned earlier will still confront us for a long time to come. However, we believe that when the Fed does go to the sidelines, blue chip stocks will have a solid

rally. We do not know when that time will come, but the market appears to be signaling that that time may be near. When that time comes, blue chip stocks have a lot of catching up to do.

We began by asking whether our take on the market was right or wrong. As you can see, several measures show that the market spends precious little time at equilibrium with its fair value. In fact, the market can stay overvalued or undervalued relative to its earnings and dividends for extended periods of time, but eventually returns. As we write this, the best of our models shows the market for blue chip stocks entering its fifth year of being undervalued, the Fed indicating they may be near the end of raising interest rates, and the DJIA is rallying above 11,000. Now if we could only get Ben Bernanke to whisper to Maria Bartiromo that the market has “got it right” this time.

Blessings,

Greg Donaldson Mike Hull