Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

July 2007

"Sitting Tight in a Bull Market"

> After spending many years in Wall Street..., I want to tell you this: *It was never my thinking that made the big money for me. It was always my sitting. Got that? My sitting tight.* It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time... And their experience invariably matched mine – that is, they made no real money out of it. *Those who can both be right and sit tight are uncommon. I found it one of the hardest things to learn.*
>
> Edwin Lefevre, *Reminiscences of a Stock Operator*, 1923

The current U.S. bull market started in March, 2003, several weeks before the commencement of the war in Iraq. Over the past 4 years+, the S&P 500 Index has doubled. Recently, as various stock market indexes have hit new highs, some investors have become anxious that this bull market may be near its peak. They ask themselves if it is time to take some profits. This anxiety is stoked by breathless financial newscasters and pundits, informing them nightly that such and such index is near or at an all-time high. These supposed experts then recite a list of problems and risks that the market faces, implying that a sell-off might be imminent, and that a prudent investor should exit the stock market. There are, indeed, problems to be overcome. But there are always hurdles which every market must conquer. What is important is for investors in this bull market to follow the advice in the paragraph above written by the legendary stock trader Jesse Livermore. Livermore, whose pen name was Edwin Lefevre, was a brilliant self-taught trader. With modest financial resources, he used his remarkable trading skills to amass $3 million in 1907 by the age of 30. Many of the rules that stock and commodity traders currently follow were first articulated in his book, *Reminiscences of a Stock Operator*.

What are the hurdles which the stock market must overcome if it is to climb higher? They include a slowdown in the economy, higher interest rates and energy prices, weakness in the housing market, and the sub-prime mortgage mess. And there could also be a random, exogenous event that negatively impacts the U.S. markets. But, before we examine these risks, some perspective is needed. Yes, the S&P 500 Index closed at 1548 on July 12, 2007, which was the highest close ever recorded. What most pundits neglect to mention, however, is that the S&P 500 Index traded at 1553 in *March, 2000*. In other words, the S&P 500 is at the same level that it was at more than seven years ago. If an investor had invested in an S&P 500 Index fund in March, 2000 and re-invested all the dividends during this period, the average annual return on the investment would have been 1.7%. It is true that the S&P 500 Index has doubled since the triple bottom at 775 in 2002-2003, but this was after the S&P 500 declined 50% during the 2000-2002 bear market. The technology laden NASDAQ Composite declined over 78% during this period and at 2702 remains 46% below its March 2000 peak of 5027. Thus, despite the strong stock market this year, the average annual returns from U.S. equities during the first 7½ years of this decade are the worst since the decade of the 1930's – the Depression years. Finally, large cap U.S. stocks appear reasonably valued based upon a number historical metrics, as we examine on page 4.

The Risk of a Credit Meltdown

While the current mid-cycle U.S. economic slowdown and the weakness in the housing market are well reported in the media, the risks in the U.S. bond market are less well known. The chart on the next page was presented in an excellent Wall Street Journal article written recently by Steven Rattner, managing principal of the Quadrangle Group LLC. This chart shows the additional yield above U.S. Treasury bonds that lower rated, riskier bonds pay investors.

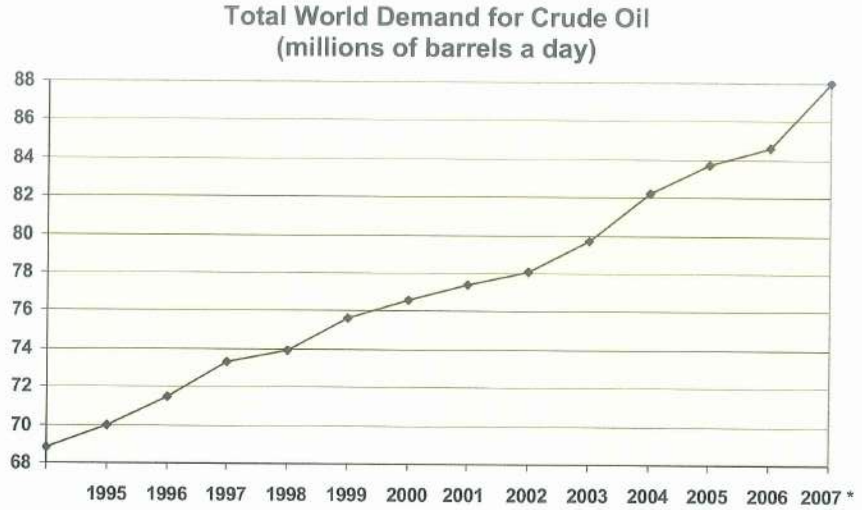
Spread Between Lower Credit Bonds & U.S. Treasuries
1987-2007 (in basis points)

Source: JP Morgan

High levels of worldwide liquidity have led to a situation where investors are willing to receive a very modest premium for investing in the riskiest kinds of bonds. During the past two recessions, investors received spreads of 10% over U.S. Treasury yields when they invested in lower credit bonds. In other words, if the 10 year U.S. Treasury note yielded 5%, high yield bonds had a cash yield of over 15%. The average spread over the past 20 years has been 5.4%. Currently risk premiums are the lowest in history – approximately 2.6%. With investors willing to buy bonds with such low yields, private equity investors have availed themselves of enormous amounts of credit. According to Rattner, $300 billion was borrowed in 2005, and leveraged loans jumped to $500 billion in 2006. The pace of 2007 is on track to exceed this number. With institutional investors' seemingly unending appetite for lower credit bonds, private equity players are able to structure their deals with debt/equity ratios of 5:1 or more. The recent buy-out of First Data is typical: $5 billion of equity is invested accompanied by $24 billion of debt. The first hint of trouble in the bond market came this winter as sub-prime mortgages began to experience high delinquency rates. According to Inside Mortgage Finance, $2.3 trillion of sub-prime mortgages were taken out by borrowers between 2002 and 2006. Some analysts believe that 10-15% of these loans may become delinquent. Most of these sub-prime mortgages were bundled into CDOs (collateralized debt obligations) and sold by investment banks in tranches with differing credit risks and pricing to pension and hedge funds, insurance companies and other institutional investors. As the delinquencies in the CDOs spread this winter, two Bear Stearns hedge funds needed to be rescued. They now control $20 billion in equity and borrowed capital – after a series of fire sales of mortgage assets and numerous margin calls for additional cash or collateral could not be met. In early July, Moody's and Standard & Poor's downgraded billions of dollars of sub-prime loans. It is too early to tell how far the damage will spread – especially if liquidity dries up, which would cause some bond prices to plunge and collateral calls to impact negatively various key financial players. If there is any positive news here, it seems to be that the large financial intermediaries – the largest U.S. banks and investment houses – do not hold a disproportionate amount of this paper, but it is rather institutional investors who might be left holding the bag. The systemic risk as exemplified by the collapse of Long Term Capital Management in 1998 may be re-visited when the final chapter of this junk bond asset bubble is written.

Energy Prices

Prices at the gas pump hover around $3.00 a gallon again in most states. This reflects the fact that crude oil prices are near their all-time high at approximately $73 per barrel. Prices are high not because of a conspiracy by large oil companies or a political power game by OPEC but because of the demand and supply trends for oil globally. The chart on the opposite page shows the steady growth of world demand for oil over the past 13 years.

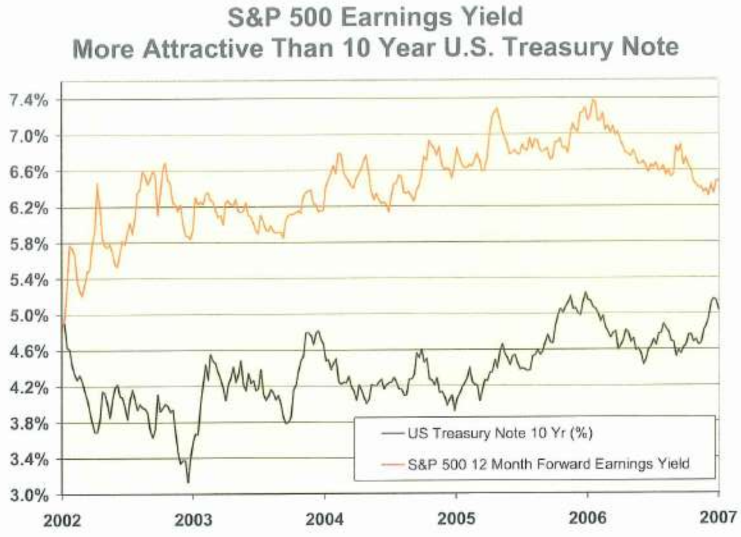


Source: International Energy Agency
* IEA 2007 Forecast

World demand for oil has increased by almost 20 million barrels a day over the past 13 years. Importantly, demand for oil did not drop during the period of economic weakness in the developed countries in 2000-2002 but continued its steady climb. This occurred largely because of the increase in energy demand from India and especially China as their economic growth accelerated. During this period, China went from being a net exporter of oil to being an importer. On the supply side of the energy equation, a fierce controversy rages over whether global oil production has already peaked or will soon peak at 87-88 million barrels a day. This "Peak Oil" theory was advanced by M. King Hubbert some years ago, and continues to attract support from reputable economists and oil analysts. The "Peak Oil" school of supply holds that oil production in a number of the world's major oil fields is now on the decline (North Sea, Mexico, Alaska North Slope, perhaps even some of the Saudi fields), and the newer fields will not be able to increase production faster than the depletion taking place in these other fields. Moreover, access to oil in these new fields is difficult and therefore more costly to produce. Other analysts debunk the "Peak Oil" theory but acknowledge that most of the "easy oil" has been lifted, and the deposits such as the oil sands in Canada, the huge deep water find in the Gulf of Mexico and the Siberian reserves will keep oil production climbing but at higher prices. On balance, it is likely, we believe, that the free market pricing mechanism will match demand and supply but only by means of increasingly higher fossil fuel prices. These higher prices will drive stronger conservation policies by governments and the private sector and will encourage larger amounts of capital to be invested in traditional fossil fuel as well as in alternative energy. Thus, it is likely that higher energy prices are here to stay, as long as the developing countries continue their rapid economic growth. And higher prices may dampen consumer demand in the U.S. in a modest way, requiring a very careful approach when investing in the retail and consumer discretionary sectors.

Why the Stock Market Still Looks Attractive

Despite the modest economic slowdown the U.S. economy is experiencing, weakness in the housing and mortgage markets, and higher energy prices, we believe that the U.S. stock market can continue its positive performance for some time. Economic growth in the U.S. is re-accelerating, and inflation, as measured by the PCE (the Fed's key indicator of inflation), was 1.9% in June – the lowest year-over-year rate in 3 years. Economic growth internationally is strong, led by China and India, which continue their remarkable growth trajectory. The international arena now has a major impact on U.S. companies. Approximately 50% of revenues from companies in the S&P 500 come from abroad. In terms of valuation, stocks in the U.S. continue to be more attractive than bonds. A useful way to measure their relative attractiveness is to compare the yield of the 10 year U.S. Treasury Note with the earnings yield of the S&P 500 Index (the earnings yield is calculated by taking the inverse of the P/E ratio i.e. earnings divided by price), as shown on the chart on the next page. This was a favorite analytical tool of former Fed Chairman Alan Greenspan.



Source: StockVal

The S&P 500's P/E ratio on forward operating earnings at the end of the 2nd quarter was 16 – an earnings yield of 6.25% – approximately 25% more attractive than the bond yield. We believe that funds at the margin will continue to flow into stocks rather than bonds until the returns are closer to equilibrium. And even with the recent run-up of the market, the S&P 500's P/E ratio of 16.6 is still below its average of 17 over the past 45 years.

The Black Swan

Nassim Taleb has recently written a book, *The Black Swan*, about random events and their effect on history and the markets. He calls such a random event the "black swan." This image comes from a treatise by Scots philosopher David Hume in 1739 commenting on a statement written by John Stuart Mill: "No amount of observations of white swans can allow the inference that all swans are white, but the observation of a single black swan is sufficient to refute that conclusion." Indeed, when Australia was later discovered, the explorers found black swans. The black swan image is relevant to the stock market because no amount of analyzing the typical market behavior, statistical risk and probability, and the historical averages can prepare the investor for the truly random event – such as the crash of 1987 when stocks dropped 25% in two days, the "ten sigma" event (1 in 10 billion probability) when Long Term Capital Management imploded in 1998, or the events of 9/11.

How do we at Bradley, Foster & Sargent, Inc. deal with the possibility of the black swan event occurring tomorrow? We seek to control the risk of a random event in five ways: First, we work with our clients to find the proper asset allocation for their own special circumstances. Next, we invest in equities for the long haul and tell our clients that one should not buy stocks unless one's time horizon is at least 5 years and preferably 10. Then, we concentrate primarily on high quality equities with low debt, good cash flow and strong brands so that a sudden exogenous shock can be overcome. The shares of such companies tend to be relatively liquid and can usually be sold even in an irrational market (although not a 9/11 event when the market may close for a week or more). We also encourage our clients not to buy stocks using leverage (margin). Finally, our investment approach is to use broad and strategic diversification when constructing a portfolio.

In summary, absent the appearance of a black swan, we see no reason why the stock market cannot continue its upward trajectory well into 2008 and beyond. The last two bull markets lasted for 8 and 9 years respectively. We urge investors to follow the advice of Jesse Livermore: "Sit tight in a bull market."

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