Quarter Notes

FIRESTONE CAPITAL MANAGEMENT, INC.

JACK M. FIRESTONE, CFP
CAROL G. KAUFMAN, CFP
www.firestonecapital.com

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Market Summary

For the third quarter, the major market indices posted modest positive gains. The Dow rose 2.9%, the S&P 500 gained 3.1% and the Russell 2000 was up 4.4%.

Year to date, however, the Dow is still negative by 2% , the S&P 500 has gained a meager 1.4% and the Russell 2000 is up 2.5 %.

International stocks as measured by the MSEAFE have risen more than 6% year to date.

Bonds fell as the yield on the 10 year Treasury rose to 4.33% from 3.92%.

1500 San Remo Ave.
Coral Gables, FL 33146
Tel: 305-669-2119
Fax: 305-669-1976
jack@firestonecapital.com
carolk@firestonecapital.com

Markets Up Despite Hurricanes, Energy and Interest Rates

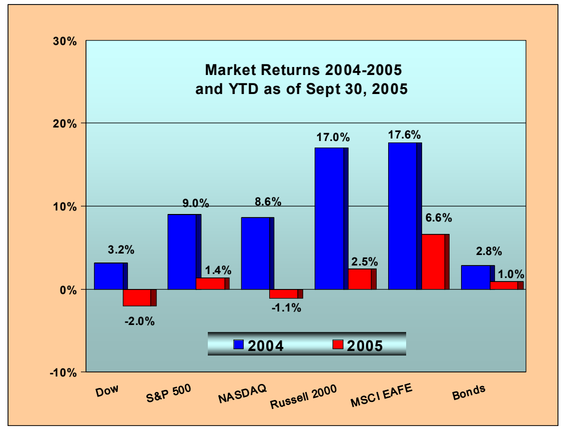
Given the magnitude of the destruction wrought by Hurricanes Katrina and Rita, we realize that our clients worry about the potential economic and investment impact. The Gulf Coast's important role in oil refining and shipping will obviously have some economic impact, but it is hard to say how much. Short to intermediate-term risks that could threaten the stock market include a reduction in energy infrastructure—oil refining capacity, drilling and natural gas. Higher energy prices would be harmful to the global economy.

Some economic effects of the hurricanes have been observed. Consumer prices jumped in August due to higher energy costs; September employment is likely to show a drop of 200 to 300 thousand jobs; and the Fed expects industrial production to fall .3%. Uninsured losses and a drop in income resulting from job losses could still hurt consumer spending.

However, Congress has already passed the first $62 billion of a possible $200 billion economic stimulus package that will offset some or possibly all of the economic impact. Once rebuilding begins, housing starts could rise by 150 thousand units. Jobs for the reconstruction should help offset those lost and Federal assistance could replace much of the loss of consumer income. So, as bad as the situation appears, at this point we believe it is unlikely that the economic consequences will go beyond a temporary slowdown.

So far, our outlook is that the economic risks are not so negative that it makes sense for us to become more defensive at this time. Recession seems unlikely. From a multi-year standpoint, we believe that the hurricanes will have little impact on the markets. Nothing has changed to the extent that we would change our equity market exposure and we will continue to rely on our fund managers for making the adjustments at a stock-picking level. Judging by the muted stock market reaction, investors are not overreacting.

Because rational investing always assumes uncertainty, we rely on diversification to provide shorter-term portfolio protection against unforeseen events. These events are a good example of why we diversify.



Alternative Assets

Over these last two years, the US economy has shown no clear signs of either strength or weakness. The traditional markets of stocks and bonds have struggled to produce meaningful returns. Wall Street professionals have been actively seeking nontraditional holdings to further diversify portfolios and enhance returns. Common buzzwords for these nontraditional investments have been *alternative* and/or *uncorrelated* assets.

One of the basic principles of asset allocation is that better diversification is achieved by holding uncorrelated investments. Uncorrelated assets are generally defined as nontraditional assets that have a weak connection with the performance of the major global stock and bond markets. Examples of these assets include:

- Precious metals: gold, silver, platinum, palladium
- Industrial metals: aluminum, titanium, copper, steel
- Commodities: oil, sugar, coffee, orange juice, coal
- Currencies: Dollar (US), Yen (Japan), Euro (Europe), Yuan (China), Pound-sterling (UK), etc.
- Timber and lumber
- Hedge funds and specialty mutual funds: merger funds, distressed debt, market neutral funds, long/short funds, etc.

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Emerging Markets

Many investors have avoided emerging market stocks fearing that they are too volatile. Some of these investors might be remembering the sobering losses of 1998, which were caused by Russia's default on outstanding loans. Since that time, significant global changes have affected the emerging markets. Prior to 2002, most of the emerging market currencies were pegged to the currencies of the developed world. They did this in an attempt to keep their currencies stable despite inflationary pressures of growth. Currency pegs artificially held in place tend to end violently when market forces cause them to rupture.

Today, very few countries have pegged currencies. Even China, under pressure from the US, has recently loosened its fixed rate to the US dollar. In addition, the export trade surpluses of the emerging countries have significantly reduced the undervaluation that existed 5 years ago. We believe the asset class is still attractive. Given the expected growth rates and stronger financial health of these countries, we continue to use some emerging market investments in our clients' portfolios as part of an overall international allocation.

Fed Raises Rates Twice in 3rd Quarter

The Federal Reserve increased rates twice in the last quarter moving Fed Funds rate to 3.75%. This is the 11th consecutive rise taking the rate from 1% to 3.75% during this tightening cycle. The Fed Funds rate is the interest rate which commercial banks pay the Federal Reserve Bank to borrow funds. Changes in the Fed Funds rate reverberate through our economic system because banks lend money at a profit over their cost. So as the cost of money increases to banks, they charge more to their borrowers.

The Fed's posture is similar to 1994 when it rapidly raised rates to ward off inflationary pressures. But unlike 1994, long term interest rates have actually declined in the face of increasing short term rates. This is unusual. Long term interest rates normally provide a premium over short term rates because lenders have to be compensated to take the risk of locking up their capital for a longer time period. The primary risk is inflation: dollars paid back in the future will have less purchasing power than dollars have today. In this cycle, inflation is expected to be tame for the foreseeable future. One reason is the ample opportunity to increase production of goods because of increasing worldwide capacity.

Even with the rise in energy costs, inflation is not expected to increase significantly. Statistically, energy costs represent about 5% of corporate costs, versus labor costs which represent 75%. With the abundant worldwide pool of labor and the increased ability of businesses to utilize efficient labor pools in various parts of the world, the increased energy costs are not expected to fuel major increases in the rate of inflation.

That said, we still have structural risks that could fuel an interest rate rise: the war in Iraq; the current account and Federal budget deficits; and US consumers who continue to spend beyond their means. In the best case, these inbalances could resolve gradually as other countries increase their wealth and consumption.

How does this analysis apply to investment decisions?

1. Keep a short term bias in fixed income investments for now. We are not being well compensated for extending maturities.

2. Be prepared to revert to an intermediate term bond portfolio when the Fed stops tightening, probably .50% to .75% increase from present levels.

3. Expect the GDP growth to slow. The desire to slow growth to sustainable levels (and to reduce speculation which drives up asset valuations) is the reason the Fed raises interest rates. With slower GDP growth comes slower growth in corporate earnings.

4. Maintain an exposure to international investments and alternative assets to diversify risk.

Despite a potential "pop" in the equity markets to celebrate the end of the Fed's tightening cycle, we will probably see modest domestic equity market returns as earnings growth moderates.

Alternative Assets

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Commodity movements are determined strictly by global supply and demand and are quite independent of stock and bond valuations. Price movements in raw materials can directly affect performance of specific stocks, but it is a one way street. Rarely is the market price of a raw material reliant on the performance of a stock. For example, if the price of timber rises due to increased global demand, then the stock price of paper manufacturers may fall as their profitability declines due to higher raw material costs. Meanwhile, aluminum prices react to entirely different market forces and perform independently of timber, sugar, gold, stock indexes, bond indexes, etc.

Hedge funds have been the fastest growing segment in the alternative category now controlling more than one trillion dollars of investable assets. Hedge fund managers reduce correlation to stock and bond exposure using complicated strategies involving leverage, futures, swaps, options, forwards, and shorts along with other strategies. In the past, hedge funds required $1-5 million dollar minimums and provided very little liquidity. However given the recent popularity, access to hedge funds has eased and is often available for as little as $10,000. The flood of new hedge fund offerings has diluted their effectiveness and their ability to find the good managers. Today, inexperience, high fees, and hot money are major cautions when considering a hedge fund investment. (For more detail about hedge funds, please refer to our QuarterNotes article in April 2004.)

How are clients benefitting? As these new investments have become available, we have been seeking out the most appropriate investments and slowly positioning some of the alternative assets in the tactical sector of our portfolios. Although very beneficial to diversification, these assets are notorious for high volatility and risk. Therefore we are cautious to overweight these positions.