INVESTMENT LETTER
A PUBLICATION OF CALDWELL TRUST COMPANY

MARKET SNAPSHOT: SEPTEMBER 30, 2006 DJIA: 11,679.07 NASDAQ: 2,258.43 S&P 500: 1,335.85 10 YEAR TREASURY NOTE: 4.63%

FIVE FACTORS

The past two months in these Letters we discussed long term stock and bond market trends and reasons why the 10-15 year period from the late 1960s until into the early 1980s should be viewed by investors as clearly an aberration for investors in both.

Now that both stocks and interest rates are pretty much back on a track that is historically more normal, this month we think it appropriate to delve a little deeper into factors that are at play today that were not so during the earlier "normal" period prior to the 10-15 year inflationary debacle. We will try to keep this as simple as possible, yet cover some pretty "heavy" stuff. We do this because what we are alleging is monumental in importance to investors.

Factor #1 — You have read past Letters in which we discuss what we refer to as the amalgamation of vast pools of wealth in the hands of funds, pensions, etc., under the management of professionals who all pretty much have the same access to financial and economic information and pretty much employ similar models to determine stock valuations. The point we want to emphasize here is that in aggregate these pros now control/own over two thirds of the outstanding shares of all major public companies and have a big influence over those who manage the companies they control. Management at companies that fail to produce acceptable returns for stockholders are now at risk of being replaced.

Factor #2 — Technology has made all things financial transparent for easy analysis to the n^{th} degree. And, sophisticated analysts do exactly that, then act quickly and in massive dollar amounts 24/7 due to the integration of all major financial centers around the world.

Factor #3 — The access these managers of big pools of money have to instant information and electronic tools has produced huge profit opportunities for acting on split-second decisions to capitalize on even the tiniest differentials in currency and securities pricing in new and old world financial centers. "Derivatives" became the word commonly associated with enormous "risk management" and other profit-seeking activities, the rise in the usage of "hedge funds" being one of the outcomes. After WWII, financial markets viewed short selling and buying puts and calls as an "exotic" activity best left to speculators and day traders. Today, all managers engage indirectly or directly in such activities, knowingly or unknowingly.

Factor #4 — Indexing is extensive and is now fully ingrained in financial markets, even though still poorly understood. This practice, too, came as a result of enabling technological advances and because of wealth pooling that produced mediocre performance results below that reported for the major stock market indexes. Once indexing techniques became readily and easily available, the practice spread quickly and widely into market sectors and other areas.

Factor #5 — Currency stabilization finally won over other monetary theories after the disastrous experiences world monetary regulators suffered due to high inflation a few decades ago. It was a long time coming, but here again the information revolution, as a result of technological advances, obviated the follies of the past. Today, central bankers work together closely to avoid the pitfalls of the past. And, as we have repeated ad nauseam, classical inflation is probably now all but impossible in an environment that virtually prohibits manipulation of currency exchange rates to any nation's advantage. Fluctuations in the prices of goods and services are not inflation but <u>normal</u> economic forces at work. Inflation is an <u>abnormal</u> decline in the purchasing power of a paper currency. The two are vastly different.

We submit that these five main factors—and there are more—have radi-

PUBLISHER
Roland G. Caldwell, rgc@ctrust.com

CONTACTS
R. G. "Kelly" Caldwell, Jr., kelly@ctrust.com
H. Lee Thacker, Jr., thacker@ctrust.com
Jan Miller, jan@ctrust.com
Phone: 800-338-9476
Internet: www.ctrust.com

THIS ISSUE:
Volume XXXII, Issue 9
September, 2006

cally changed conventional wisdom regarding the risks, and therefore the attraction, of different types of financial instruments commonly purchased and owned by all investors. Fiduciaries like Caldwell Trust Company, as investors on behalf of others, are no exception and are not immune from understanding and acknowledging that the sea-change going on around us impacts us at an even higher level than is so for an investor who acts for himself alone.

Human nature being what it is, it is also true that people are correctly cautious and rightfully wary of change. Accordingly, it is important that all understand clearly that moving forward must always be a deliberate and carefully thought out process. But failing to recognize that changes are underway all around us ignores the fact that financial markets tend to move ahead whether any of us like it or not. This would be unwise.

Some examples of specific issues requiring specific responses include, among others:

a. If inflation is really a thing of the past, are investors justified in continuing to be worried about a return of high interest rates by investing all fixed income monies short term?
b. If the risk of price changes in bonds could result in no, or low, real annual returns in the event of any rise in rates ahead, can bonds be justified investments when the historical and expected returns from stocks have been, and are currently, about double current interest rates?
c. If the controlling ownership of the stocks of most major public companies is in strong hands, which is highly unlikely to change absent some calamitous event, and with companies now actively supporting the share price of their own stock by huge buy-back plans when its share price gets out of line with its financials, wherefrom will come a major decline in share prices ahead?
d. If company profitability is now managed to a fine degree percentage-wise as to the rate of return on invested capital, and we all know immediately when expectations for any company are not being met, wherefrom are likely to come the surprises that alarm investors?
e. If indexing removes the need to worry about the results of any specific company, and the market returns become increasingly dependent upon macro factors such as tax and interest rates, consumer and business spending, monetary policy changes, federal fiscal spending trends, etc., and if these macro factors are and have been performing well and seem likely to continue, are equity return rates at present high levels still justified? (*Note: If not, stock prices should be substantially higher than at present.)*
f. If stocks on average, especially indexed portfolios, seem likely over time to generate fairly predictable total returns much greater than the going rate of interest on bonds, what is the rational sponse that investors should be considering seriously?

CONCLUSION: The answers to these and other questions are ones that will have to be addressed by anyone who invests. Ignorance of changes will not be found to have been acceptable behavior when questions are asked in future years. Moving slowly and soundly is always the best defense. But failing to seek answers is no defense. Today, financial numbers are known, analyzed, and returns calculated to a high degree of accuracy, especially in respect to an index of stocks versus a specific company. The War on Terror has no such certainty. But, America, its systems, its history, and its prospects are pretty clearly defined and proven. Risk is inherent in life itself. Determining probable and possible risk parameters in the financial world, however, have never been more obvious than today. Again, the rewards will go to those who identify the risks of changes, and then make a determination to act on the merits of taking the risk in exchange for premium results.

Roland

NOTE: *Looking for a good way to give to charities of your choice, but do it anonymously? Ask us about* **Foundation Trust***, Caldwell Trust Company's very own Foundation, that was set up solely as a way to help us and clients help those less fortunate. Call 941-493-3600 for information.*

Venice
201 Center Road, Suite 2, Venice, Florida 34285
Voice: 941-493-3600 Fax: 941-496-4660
Toll Free: 800-338-9476 Web: http://www.ctrust.com

Sarasota
8592 Potter Park Drive, Suite 150, Sarasota, Florida 34238
Voice: 941-926-9336 Fax: 941-926-9335
Toll Free: 877-926-9336

Punta Gorda
133 West Marion Avenue, Punta Gorda, Florida 33950
Voice: 941-505-8500
Fax: 941-525-8501