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Vacation to Libya?

Alumni attending a recent Hamilton College gathering were encouraged to consider school-sponsored tours of exotic countries such as Vietnam, Cambodia and Russia. Imagine how incredible it would have been for the title of an investment newsletter headline in 1972 to have read "Vacation to Saigon and Hanoi," during the seemingly endless Vietnam conflict. While enough comparisons between parts of the Middle East and Vietnam already take place in media and political circles, we want to point out that long-term investors are generally rewarded for focusing on mega-trends, no matter how horrific current events can be.

A look at what recently happened in Libya elicits hope in the midst of despair in the Middle East. Once perhaps the most rogue place on Earth, sanctions were lifted on Libya in 2003. Soon after, Mo-hamar Quadafi and his son abandoned a massive stockpile of weapons of mass destruction. While it is unlikely that Libya will soon be anywhere near a perfect country, it has turned over tons of dangerous substances and is seeking assistance in improving the productivity of their energy industry and, ultimately, bettering the lives of its citizens.

The current war in Iraq is intractable at best, and thus the worrisome threat to stable global energy supplies continues. As we have documented in previous newsletters, we feel strongly that, over the long run, growth in China, India, Russia and Latin America will provide more benefits to humanity's standard of living and well being than the carnage Al Qaeda may inflict.

In the face of our long-term optimism, to what do we attribute the recent turbulence in the market? Well, the caveat-free answer is that rising interest rates are bad for stocks in the short run. Further thoughts are summarized as follows:

1. INTEREST RATES ARE RETURNING TO NORMAL LEVELS

After the 9-11 calamity, the Federal Reserve, with global cooperation, allowed interest rates to drop to historically low levels. Low rates served to keep the global economy growing during difficult times, but also provided financial fuel for speculators in real estate, junk bonds, emerging markets and commodities like gold and copper. As confidence in sustained global growth sets in, interest rates are being allowed to rise to more normal levels. In the process, some speculators have been stung and the economy will likely slow.

2. THE WORLD HAS BEEN GROWING FASTER THAN THE UNITED STATES

The United States has been growing, on average, 2%-4% per year. Recently, places like China, India, Russia and Latin America have been growing 5%-10%. Our unfettered consumerism at home has generated enormous export opportunities for other countries and now the world's economies are more connected than ever. Higher interest rates will serve to slow the American consumer and thus temper global growth. Ideally, the slack created by a slowing American consumer will be absorbed by greater infrastructure spending in the rest of the world. There are no guarantees, however.

3. THE BERNANKE EFFECT

Along with normal pressures from market uncertainty, investors are still not familiar with Federal Reserve Chairman Bernanke's style. Much as he may have been warned by his tightlipped predecessor, Mr. Greenspan, Mr. Bernanke is learning the hard way that global markets "hang" on every word a Fed Chairman utters. Surely, Mr. Bernanke will learn to better manage the press and Wall Street.

We have been active in response to the evolving investment environment. As interest rates have risen, we have scaled into longer-dated bonds that currently yield in the 5%-6% range, or around twice the rates seen just one year ago. Within our Quality Core portfolio of 40 names, we have been trimming our energy and natural resources investments to reposition into companies that may fare relatively better as growth slows. Although we are carrying above-average levels of cash in client portfolios at this time, we have also made selected investments in satellite navigation and high-tech

defense/surveillance concerns as well as the global wireless industry, among others.

In addition, we have developed a portfolio of individually purchased companies consisting of larger "value" holdings. This portfolio, sports a healthy 3%-3.5% current dividend rate, as compared to 1.6% on our Quality Core portfolio, and is designed to offer diversification and current income.

In summary, higher interest rates come as no surprise, but leave us unimpressed with prospects for the U.S. consumer. A healthy global "pause to refresh" reflected by slower growth is probably the best possible outcome. Countries like China and India are trying to limit their growth to levels below 10% per year, just as Mr. Bernanke chimes in by "tapping the economic brakes" here at home.

Although future investment performance can never be guaranteed, somewhat higher interest rates and slower growth could be good for traditional blue chips, some of which have not traded at such attractive valuations for more than ten years. Scroll to the end of this newsletter on our Web Site at www.investstrategic.com to see our latest purchases and sales for 2006.

While you won't see this writer touring Libya anytime soon, let's not forget to celebrate the fact that Vietnam and Prague are on your travel agent's current "hot list" right now. Wouldn't it be nice to say the same for Baghdad someday?

Your comments and questions are always welcomed.

Important Disclosure: "It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities discussed in this newsletter."

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