Volume 4 / Issue 1 / Third Quarter 2006

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The Properly Diversified Portfolio

by L. Daniel Akers Jr., CPA, CFP

Review and Outlook

Since Altavista was founded in 2003, we have been stressing the meaningful diversification of portfolios. "Diversification" is one of those words that, if repeated too often, ceases to have meaning. Let's revisit key principles of investment management at Altavista, such as diversification and quality, and put them in the context of the market realities of 2006.

More Than Eggs and Baskets

Advisors often say that diversification means not putting all of your eggs in one basket. To follow this analogy, one must know what kinds of baskets are available and useful for the storage of his or her eggs.

Twenty years ago, a diversified portfolio meant buying at least 20 different blue-chip stocks and putting a little away in investment-grade bonds. The only time a portfolio manager read about overseas markets was to plan his golf trip to St. Andrews after receiving his bonus. That worked for a long time. Not only did U.S.

(continued on page 3)

What Does "Quality" Mean in Stock Selection?

by Kyle R. Boyd

Currently, the stock market is trading at a reasonable 16 times this year's earnings. However, due to increasing interest rates and profits at peak levels (likely to fall, in our view) we do not see the broad market as particularly compelling, at this moment. The market is sensitive to changes in direction of things like profits and inflation as the 5% market decline in May testifies. According to our disciplines, within such a market we seek to emphasize areas that are attractively priced. In the current environment, we believe that the most compelling value within the broad market is not a sector or industry group, but companies with desirable financial characteristics or "quality," as our clients have often heard us describe them.

In short, quality companies are those in a strong financial position due to (1) less debt than the average company, (2) steadier earnings, and (3) shareholder-

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HigherView quarterly

ALTAVISTA
Wealth Management, Inc.

The Altavista Wealth Management Group >
L to R, above: Dan Akers, Kyle Boyd, Greg Jones
L to R, below: Barbara Orr, Christine Nelson

News In Brief

Dan Akers, Managing Principal, has been asked to serve on Schwab's Institutional Services Regional Advisory Board for 2006-2007.

Altavista has earned a coveted spot in Wealth Manager Magazine's *annual ranking of America's 500 top Wealth Managers for the third year in a row. Since its founding, Altavista has placed in the top third of this survey every year, the only North Carolina based firm to do so.*

WHY DIVERSIFY?
Asset Class Performance Over the Last 25 Years (1981— 2005)

	Times Delivered Best Return	Times Delivered Worst Return	Compound Annual Return	Volatility (Std. Dev. of one-yr. Returns)
Large Caps (S&P 500)	5	7	12.7%	16.00
Small-Caps (Ibbotson/Russell 2000)	3	5	11.1%	18.01
Foreign Stocks (MSCI EAFE)	9	9	10.8%	22.63
REITs (NAREIT Equity Index)	8	4	13.4%	14.83
Diversified Equity Portfolio	0	0	12.4%	15.52

Doing Well By Doing Good — Socially Responsible Investing

by Greg Jones

Increasingly we are being asked by a small-but-growing number of clients to invest money according to their deeply held beliefs and values. To some, this means avoiding the traditional "sin" stocks in the tobacco, alcohol and gaming industries. To others, it means avoiding companies whose profits and policies depend upon and hurt the environment, such as certain oil and mining companies. Some clients want to look affirmatively for companies that are responsive to concerns about social justice, affirmative action, and the exploitation of child labor.

One option is to buy mutual funds that invest in a socially responsible manner. An option that we are excited about at Altavista is to invest in a list of companies that has been evaluated by a consultant specializing in the screening of stocks from the perspective of the socially responsible investor. Altavista has formed a relationship with the leading consultant in this field. Through their proprietary database we can produce a list of companies that possess the investment characteristics that we believe are desirable, and match this list with the social concerns enumerated by our clients. The consultant will then tell us these companies meet the requirements set by our client. Clients for whom this is a priority will have the assurance that their money is invested in alignment with their principles.

Last year a diversified strategy worked well with foreign shares, real estate, and smaller stocks all doing better than the S&P 500.

Times are Bright for Dividends

One of the advantages of holding high-quality, dividend-paying stocks is a rising stream of dividends.

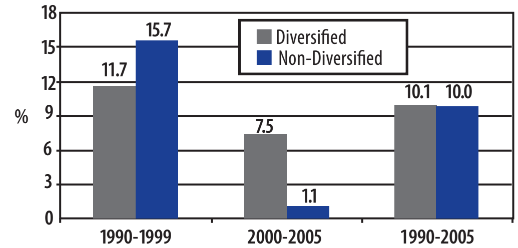
Company	Indicated Dividend Per Share	Approximate Dividend Yield at Current Market Price	Dividend Growth Since 2002
Conoco-Phillips	$1.96	4.1%	180%
General Electric	$1.00	3.0%	151%
Intel	$0.40	2.0%	400%
PepsiCo	$1.04	1.8%	76%
Johnson & Johnson	$1.32	2.2%	66%
Sigma-Aldrich	$1.04	1.3%	147%
Wal-Mart Stores	$0.67	1.4%	139%

The table above illustrates this aspect of investing. This list of high-quality dividend-paying stocks is paying 4.1% to 1.3% in annual dividends. More strikingly, each of them has raised this dividend anywhere from 66% to 400% since 2002. Each of them has the financial capacity to continue to raise their dividend. This group also exhibits good earnings growth potential.

We believe that high-quality companies will continue to increase their payout to shareholders. The percentage of profits paid to shareholders is low by historical standards.

If you buy stocks when they are cheap, it generally doesn't matter how skilled you are at picking stocks, since a rising tide will lift all boats. If you cannot buy the broad stock market when it is on sale, then you must be very careful to choose those equities within the market that are priced rationally.

Performance of Diversified and Non-Diversified Portfolios



Diversifying away from a traditional 75% S&P 500 / 25% LB Agg. portfolio was costly in the 1990s, but has paid handsomely in the 2000s.

Diversified *(continued from page 1)*

stocks make up the majority of the world's equity market, it also provided stellar returns. From 1982 through 2005, the U.S. stock market returned an average of 10.2% after inflation, well above the long-term trend of about 6.2% since 1926.

Success during this extraordinary period has sown the seeds of mediocrity for the broad U.S. market going forward. You see, U.S. stocks started this extraordinary period of performance from a very low price by any measure. One of our favorite measures is Tobin's Q, which values the stock market as a multiple of its underlying replacement value, one of the most conservative measures of the stock market's price. The chart below (courtesy of BCA Research) shows that in 1982, the stock market was trading at less than its replacement cost. In fact, you could have bought all of the plant, equipment, intellectual property, and proprietary knowledge possessed by all of the companies in the S&P 500 at a 50% discount just by buying all of the stock at market prices on the NYSE.

At the height of the bubble in 2000, by contrast, the stock market valued these same possessions at nearly twice their replacement cost.

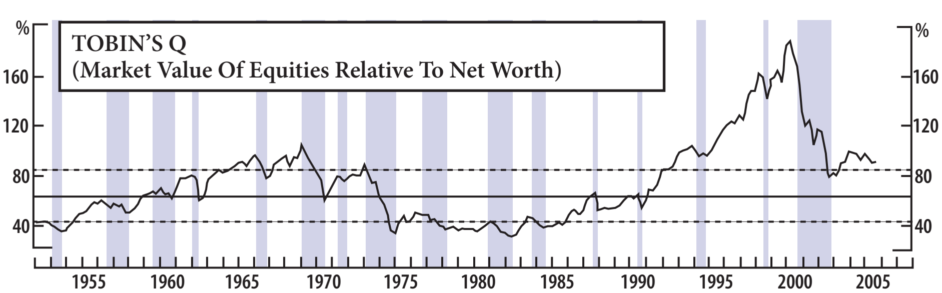
In other words, most of the S&P's striking 10.2% annual return after inflation was not the stock-picking skill of our intrepid golfer, or earnings, or the improving fundamental performance of American business — it was the effect of the entire market going from being on sale to being sold at premium prices.

If you buy stocks *when they are cheap*, it generally doesn't matter how skilled you are at picking stocks, since a rising tide will lift all boats. If you cannot buy the broad stock market when it is on sale, then you must be very careful to choose those equities within the market that are priced rationally. More importantly, you must take great care to not purchase securities that are grossly overpriced amid a frothy environment (remember JDS Uniphase?). It is also important to look further afield to other asset classes (small stocks, REITs, foreign shares, timber) that are attractively priced relative to their prospects.

Paying a reasonable price at all times is at the heart of meaningful diversification.

Has The Strategy Worked?

The past 16 years of investment experience bear this out. The consulting firm Hammond & Associates did a comparison of the portfolio probably favored by that hypothetical golfing portfolio manager in 1990, a mix of 75% S&P 500 stock index and 25% Lehman Aggregate Bond index.



They compared it with a meaningfully diversified portfolio that divided the stock portion of the portfolio among large and small U.S. stocks, foreign shares and real-estate investment trusts. The bond portion was divided among U.S. government and corporate instruments, as well as developed and emerging foreign debt. The results are shown in the chart above.

It would have been lonely holding the quirky diversified portfolio during the bubble-era 90s, when the simple strategy would have raced ahead as stock market valuations raced ahead. The current environment (2000-2005) has provided sweet consolation, with the diversified portfolio putting in a respectable 7.5% annually, well ahead of the 1.1% annual return of the simple strategy. During the entire period from 1990 to 2005, which encompasses the golden age of the U.S. stock market, the diversified portfolio won the performance derby by a nose, returning 10.1% to the traditional portfolio's 10.0%.

We believe that the current investment outlook requires a broad net.

The properly diversified portfolio is never the highest performer in any one year. Faddish bets on one idea of the moment or another win the sprint (tech stocks in 1999, Japanese stocks in 1988 and 2005, Biotech in 1988). But a discipline that invests systematically in attractively valued assets, harvesting profits in those investments that have become full grown to invest in newly emerging opportunities, is one that wins over a distance. It has the added virtue of allowing the owner of such a portfolio to sleep soundly at night, whatever the day's business news might be. It is just such a strategy that we pursue on behalf of the clients and families we serve.

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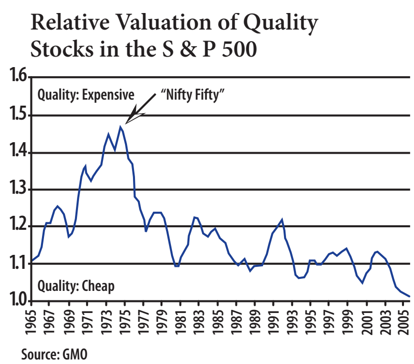
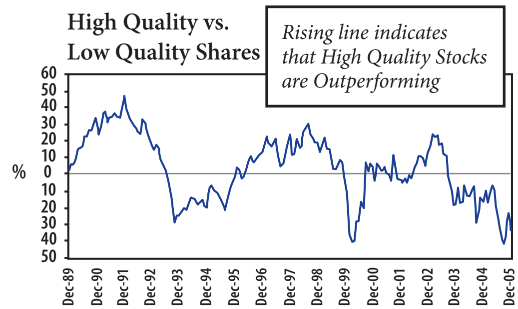
Quality *(continued from page 1)*

friendly policies with regard to dividends and share repurchases. Stocks widely held by our clients that exhibit favorable quality characteristics include General Electric, Johnson & Johnson, Intel, Sigma Aldrich, Sysco, Automatic Data Processing, Pfizer, Gannett, Wal-Mart and others.

Because of these virtues, stocks with these characteristics have generally traded at an almost 20% premium to the broad market. Currently, this tier of stocks trades right at the market multiple, as the chart below from our friends at Grantham, Mayo & Van Otterloo illustrates. The second chart (to the right) illustrates that lower-quality stocks have been out-performing higher-quality stocks since the market lows of 2002. We believe that this trend is set to reverse, as indeed it has begun to in the first quarter of 2006.





In our view, the current environment presents an opportunity to establish positions in superior companies selling at "normal" prices, consistent with our preference for paying reasonable prices for desirable securities.

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