

J.W. Burns & Company

Investment Counsel

Quarterly Update and 2007 Market Outlook

The Third Year's The Charm

Dear Clients and Friends,

The year 2006 was a solid year for equity markets worldwide, continuing a 3-year trend of the stock market generating the full year's return almost exclusively in the fourth quarter! Indeed, 2006 could be called the tale of two years – with a very poor start followed by a powerful finish.¹ Notably, the high quality, global powerhouses that make up the bulk of your portfolio came back with a vengeance in the fourth quarter, and began to exert leadership in the financial markets – a leadership that, as I write this in mid-January, is continuing.

Throughout our 2006 client communications, we presented our view that the overall U.S. economy – while fundamentally very solid – would enter a period of slower or more normal GDP growth rates. In our view, both the U.S. housing market and increased use of leverage over the last few years would lead to a healthy slowdown in consumer spending. This is actually what the Federal Reserve was seeking to achieve with the slow and steady climb in interest rates. We referred to this as a normal mid-cycle slowdown, and believed that this would be a catalyst for stronger stock market performance. That played out in late 2006 and remains one of



**“Let’s leave it at this:
In good time, good
things happen to
cheap stocks.”**

**James Grant, Editor,
Grant’s Financial
Newsletter**

many reasons for our bullish view towards the financial markets in 2007, and your stocks in particular.

Indeed, our outlook for stocks in 2007 is decidedly bullish. Going into the new year, the investment focus at J.W. Burns & Company remains on high quality growth equities and selected international stocks. We believe the economic environment of the slowing economy, lower oil prices, benign Federal Reserve interest rate policy and lowered inflation expectation sets the stage for another very good year in the equity markets. With this backdrop of a healthy, yet moderating economy, ***our view is that quality growth stocks will significantly outperform cyclical and small cap equities.***

We also believe that developed international stocks will outperform the emerging markets in a moderating global economy, although we remain convinced that one particular emerging country – China – will continue to play an ever increasing role in the world. As such, our research continues to seek companies – both in the U.S. and internationally – that

directly benefit from China’s explosive growth. It should be noted that a high percentage of your current portfolio – companies such as Walt Disney, General Electric, Fed Ex – are global leaders already powerfully positioned in China/Asia and will benefit for years to come.

The recent highs reached for the Dow Jones Industrial Average notwithstanding, we believe a broad bull market has yet

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to materialize. On an inflation adjusted basis, the stock market remains well below the highs reached in early 2000. In our view, stocks overall and especially the premium, low risk equities we have positioned in your portfolio, are an outstanding bargain relative to real estate, bonds, hedge funds, and the like. In the immediate aftermath of 9/11, when the Global Central Banks aggressively lowered interest rates to provide protection against severe economic fallout, the world has been awash with liquidity. Instead of investing in traditional blue chip stocks, investors focused on increasingly exotic investments – such as hedge funds, private equity, aggressive small and micro-cap stocks, real estate, timber and art – pushing many of these asset class prices up to extreme levels.² This has come at the expense of traditional Blue Chip equities such as the stocks in your portfolio that are durable, growth-oriented, and cheap. *As we have mentioned in previous client communications, the price/earnings ratio of your portfolio is very inexpensive relative to the S&P 500.* Historically, your stocks have sold at a significant premium! Good things happen to cheap stocks, as James Grant likes to say, and we are indeed expecting good things to happen to your portfolio.

Along with the high quality and inexpensive earnings streams, there are other reasons we are bullish heading into 2007. Certainly 17 interest rate increases since mid-2004 have dampened investors’ appetite for equities. At the time of this writing, it appears that we are nearing the end of the Federal Reserves tightening cycle. This would be a major positive for stocks, and certainly played a part in the market rally in the fourth quarter. Corporate earnings and balance sheets remain strong, inflation – aided in no small part by falling oil prices – remains benign, merger and acquisition activity is very robust (2007 is expected to be a big year for M&A activity, historically a very bullish sign) and corporate share repurchases continue to boom. Political

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posturing and media hype notwithstanding, a slim majority for either the Republican or Democratic Party usually translates in nothing getting done in terms of serious legislation – bullish for stocks.

Another factor, although not much talked about in the financial media, is that we are in the third year of a Presidential election cycle. Historically, this has been the best year for equities with an average return of 18% for the S&P 500 since 1945. For the first, second, and fourth years of a presidency, the S&P 500 has posted average gains of only 2.35%, 2.4%, and 8.6%, respectively.³ The chart below shows the year by year results through the presidential election cycles in a shorter time frame, but the trend remains. Let’s take a look:

Average Annual S&P 500 Change: 1962 - 2006

Term	1st Year	2nd Year	3rd Year	4th Year
'61-'64	23.1 %	-11.8 %	18.9 %	13.0 %
'65-'68	9.1	-13.1	20.1	7.7
'69-'72	-11.4	0.1	10.8	15.6
'73-'76	-17.4	-29.7	31.5	19.1
'77-'80	-11.5	1.1	12.3	25.8
'81-'84	-9.7	14.8	17.3	1.4
'85-'88	26.3	14.6	2.0	12.4
'89-'92	27.3	-6.6	26.3	4.5
'93-'96	7.1	-1.5	34.1	20.3
'97-'00	31.0	26.7	19.5	-10.1
'01-'04	-13.0	-23.4	26.4	9.0
'05-'08	3.0			
Average	5.5 %	-2.6 %	19.9 %	10.8 %

Source: Birinyi Associates

The third year tends to be strong for a number of reasons, but certainly both political parties are heading into the political election cycle and, again, not much gets done. Benign political activity tends to be very, very good for stocks, as politicians don’t get in there and “muck everything up.”

A Word About Risk:

There are certainly risks; there are no guarantees with stocks, as in life. Our biggest concern at J.W. Burns & Company would be that Central Banks globally raise interest rates and financial liquidity dries up, as happened in the May-June market correction; I believe this is quite unlikely, but one never knows. The real risks are usually the ones no one is thinking about. A financial crisis such as the 1998 melt-down of the hedge fund Long-Term Capital Management or the 1997 – 1998 Asian currency crisis comes to mind. In this regard, we can only report to you, our clients, that not only are your quality growth stocks cheap, they are also a potent hedge against risk. High quality, low debt, durable companies such as the equities in your portfolio tend to hold up significantly better than the broad market in tough times. In fact, it has been said by someone on Wall Street that when times get bad, buy stocks of things people can eat, drink and smoke! Your portfolio is full of powerful global franchise businesses with superior business models. These are companies that literally can prosper in tough times. Yes, we have an eye on risk and believe your portfolio is built to withstand shocks.

It seems over the last few years, most investors have forgotten about risk. As I mentioned in the opening, more and more exotic investments continue to entice investors. Recently *Fortune* magazine came out with their 2007 Investor's Guide, and interviewed five well-known strategists. I'm never at a loss for words, but, in this case – well, I'll let them say it.

-“It's that risky things have become extremely expensive . . . junky companies have done better than high-quality companies; junky bonds have done better than

high-quality bonds.”

- *Jeremy Grantham, Chairman at GMO*

-“The relationship between equity-market volatility and the performance of quality stocks is amazing. Lower quality stocks do exceptionally well when volatility is down, and high-quality stocks do exceptionally well when volatility goes up . . . I don't think it's going to be a good bet over the next year, year and a half, to say that volatility is going to continue to go down.”-

- *Rich Bernstein, Chief Investment Strategist at Merrill Lynch*

-“Companies with high return on equity and return on capital and strong balance sheets are trading at nine or ten times cash flow. This is where people should be looking to put money.”- *Dave Herro, Portfolio Manager at Oakmark*

Well said . . . well said, indeed.

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Bullish for stocks.”**

Going Global:

In 2007, we do not contemplate major changes but a “tweaking” and further continuation of our quality and international emphasis. Over the last few years, J.W. Burns & Company has broadened its investment platform to give a more diversified approach, especially regarding international equities. Yes, the theme of global growth continues to dominate our thinking and discussions! Investment ideas that we may initiate a position or continue to add to include Barclays, Monsanto (soft commodities feeding the world), EAFE (ishares international fund), China Mo-

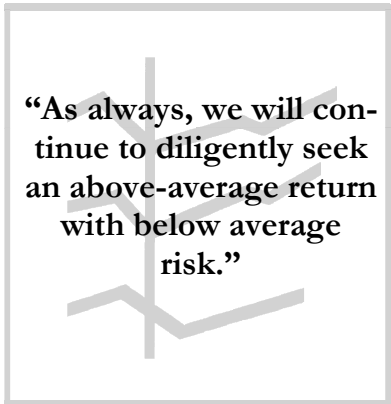
ble, Powershares Golden Dragon ETF (a basket of Chinese and U.S. stocks which benefit from China's expanding economy), Allied Irish Banks, and unique for us, we are very interested in international real estate. The international real estate market is just beginning to come into its own and is very inexpensive relative to U.S. real estate. There are a few mutual funds that seek high quality, lower risk Real Estate Investment Trusts (REITs) in international markets that are significantly uncorrelated with the U.S. real estate market. We believe this is potentially a high return area and we will continue to do research here.

¹Harry Segalas, W.P. Stewart

²Jeremy Grantham, Chairman at GMO, October 2006

³Sam Stovall, Chief Investment Strategist at Standard & Poor's

In the end, a company's earnings growth and financial strength will determine the stock's price performance. We believe your portfolio is positioned in the world's premier growth companies and we expect strong returns in 2007. *As always, we will continue to diligently seek an above-average return with below-average risk.*



Thank you for the confidence you have placed in us, and please call us with any questions or concerns.

Best wishes,

James C. Burns, CFA
President