EARL M. FOSTER ASSOCIATES
INVESTMENT MANAGEMENT

NEWSLETTER

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STOCKS VERSUS BONDS FOR 2005

A Risk-Return Comparison

Stocks ended the quarter with a 2% decline after trading in a "seesaw" pattern for most of the last three months. Investors reacted to positive news on the economy, offset from time to time with negative news on the Federal deficit, the expanding trade deficit, the deterioration in the value of the dollar, and record crude oil prices.

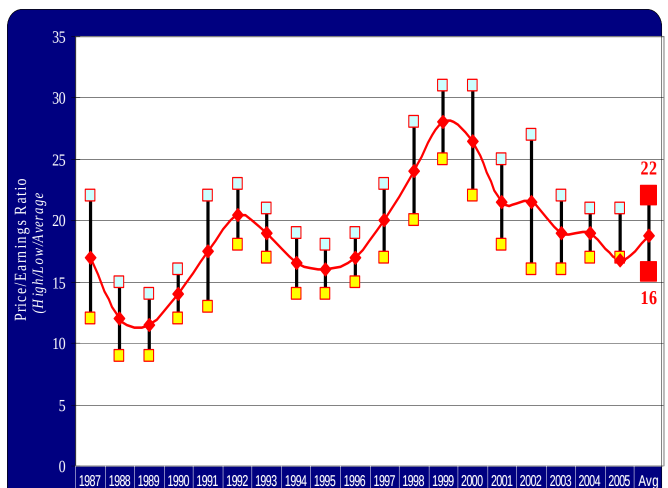
Bonds also had marginal to negative returns across most maturities as interest rates moved higher. The rise in interest rates began in February as crude oil prices once again exceeded $50 a barrel. Since then, the 10-Year U.S. Treasury yield increased from less than 4.0% to as high as 4.6% driven by inflation concerns and more hawkish remarks by Federal Reserve Chairman Alan Greenspan.

With interest rates rising and the economy facing a number of crosscurrents, how will stock performance compare to bonds?

Chart I illustrates the range of price-earnings ratio for the Standard & Poor's Index since 1987. During this time, the highs averaged 22, the lows averaged 16, and the mid-point averaged 19 (last column in Chart I). The upward progression in the ratio since 1987 culminated in the 1998-2000 bubble. However, that aberration reversed with the subsequent "bear" market. Currently, the Standard & Poor's Index is selling at 17 times projected earnings for 2005, close to the average low. Thus, today's stock market appears attractively valued relative to our recent history.

Corporate earnings are expected to increase in the 6% - 7% range over the next several years. If price-earnings ratios remain stable, stock prices should rise in parallel with earnings. With dividend yields of approximately 2%, stocks are expected to generate an 8% - 9% annual return over the next several years.

CHART I
Standard & Poor's Index
Price/Earnings Ratio
1987-Current



	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Avg
High	22	15	14	16	22	23	21	19	18	19	23	28	31	31	25	27	22	21	21	22
Low	12	9	9	12	13	18	17	14	14	15	17	20	25	22	18	16	16	17	17	16
Avg	17	12	12	14	18	21	19	17	16	17	20	24	28	27	22	22	19	19	17	19

Chart II shows the secular decline in interest rates over the last 20 years in which the 10-year U.S. Treasury yield fell from 11.9% to as low as 3.3% in 2003. While the decline occurred in waves that were partially reversed, bonds experienced neither the speculation nor the severe bear market that occurred in stocks during this period.

CHART II
Ten Year Treasury Yield

1985-Current

Even though the 10-year U.S. Treasury yield already advanced more than one percent from its 2003 trough, its yield is still close to the 20 year low. With the economic expansion continuing, inflation pressures building, and capacity utilization rates rising, the Federal Reserve is likely to raise short-term interest rates further. Thus, the 10-year U.S. Treasury yield could exceed the 5% level in the not too distant future.

Small changes in interest rates can materially impact investment returns for bonds. For each 0.25% increase in the 10-year U.S. Treasury yield, its market price would decline by about 2%. In other words, an increase in yield from the current level of 4.5% to 5.0% (one-half of a percent) results in a bond price decline that would offset most of the year's interest earned. The net return would be a marginal 1%. Interest rate increases beyond that would result in negative bond returns. On a longer term basis, a rise in the 10-year U.S. Treasury yield to its 20 year average of 6.7% over the next three years would also result in negative bond returns. Interest earned would be insufficient to offset the erosion in market value. Therefore, near-term risk in bonds is significant.

INVESTMENT STRATEGY

On this basis, investment strategy for the near-term focuses on stocks, at least for the next several quarters and until interest rates rise sufficiently to improve their risk return prospects for bonds.

Diversification within the stock component should reflect underlying business conditions. Below are six broad investment sectors and the rationale for under-weighting and over-weighting each:

- **Consumer ↓under-weight –** High energy prices and rising interest rates should curb consumer spending for the balance of the year.
- **Finance ↓under-weight –** Most companies in this sector will be burdened by rising interest rates. Finance stocks may become more attractive later in the year when interest rates are higher than they are now.
- **Utilities ↓under-weight –** They will be exposed to rising interest rates and may have some "friction" in passing along higher fuel costs.
- **Healthcare ↑over-weight –** This sector under-performed the stock market since the recovery began in the fall of 2002. Many companies in this area are now at unusually attractive valuations.
- **Capital ↑over-weight –** Companies in the industrials, manufacturing, and materials sector should experience strong earnings growth as the economic expansion continues. However, attention should be paid to individual valuations as some have already discounted stronger earnings this year and next.
- **Technology ↑over-weight –** Technology spending is likely to be at the forefront of the expansion in the capital sector. Many of these companies have yet to recover from their 2000 – 2003 bear market valuations in spite of rising earnings.

TABLE I
MARKET PERFORMANCE COMPARISON
(Including Interest and Dividend Income)
*Year to Date**

MARKET INDEX	*12/31/04*	*03/31/05*	*Return*
Standard & Poor's 500	1,212	1,181	-2.2%
Dow Jones Average	10,783	10,504	-2.1%
NASDAQ	2,175	1,999	-8.1%
EAFE Index	1,515	1,504	-0.8%
3 Mth U.S. Treasury Bill	2.2%	2.7%	0.5%
10-Yr U.S. Treasury Bond	4.2%	4.5%	-1.0%
10-Yr AAA. Tax-Exempt	3.6%	3.9%	-1.5%

*Estimate