



TABR Capital Management, LLC  
500 N. State College Blvd., Suite 1320  
Orange, CA 92868

Tel 714 704-9180  
Toll Free 800 220-8219  
Fax 714 937-1886  
www.tabr.net

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TO: All clients and interested parties

FROM: Bob Kargenian

This quarter, we're examining inflation, valuations as a forecasting tool, the power of sectors, 2008's biggest surprise, perspective and of course, performance. We also have an announcement regarding our website and client data access.

### **Inflation**

Back in early 2006, a New York Times writer penned a column entitled "**Inflation Not a Problem (as long as you don't eat or drive).**" This was a not so subtle swipe at the absurdness of some government statistics, most notably the Consumer Price Index (CPI).

Everyone in the "real" world inherently knows that the cost of running one's household tends to go up virtually every year, some areas more than others. Our medical premiums for TABR's group plan have risen 11% annually the past two years. Gasoline in many areas of the country is now over \$3.80 per gallon, an increase of 30-35% over last year.

A couple of weeks ago just prior to Thanksgiving, the LA Times ran a story showing that the average cost of a normal home-prepared Thanksgiving dinner had increased 11% over 2006. There are many simple reference points that we can look at to see how prices increase over time.

Remember when a postage stamp cost 15 cents in the 1980's? Today, that same stamp, delivering the same service, is 41 cents. My box seats at Angels Stadium were \$8.50 in 1985 and are now \$49—that's a compound inflation rate of 8.3%. The list goes on, and we'll examine one on the next page, but according to Ibbotson & Associates, from 1926 to 2004, the CPI has compounded at 3% per annum. Since 1970, it has been running 3.5%.

We've been using the 3.5% number in all retirement planning projections, but a number of observers feel the CPI understates actual inflation. This would not be surprising, since it is in the best interests of the government to keep the number low, since Social Security benefit payments are indexed to inflation. The higher inflation is, the more the deficit grows with this entitlement program.

Though food is just one item in running a household, a local event last year gave me the idea to focus on this topic. Perhaps my favorite breakfast joint anywhere is the Original Pancake House in Yorba Linda. They are not as numerous or well known as IHOP, but

they are so much better. I've found them in Dallas, Ft. Lauderdale and Kirkland, WA to name a few places. Last October, the local owner, Ron Voll, celebrated his retirement and the 50<sup>th</sup> anniversary of his restaurants in Anaheim and Yorba Linda by rolling back the prices to 1957, for one day only. Below I've reproduced a portion of the menu.

**Delicate French Pancakes**  
with Triple Sec Suzette Topping  
**90¢**

**BARNEY'S Banana Pancakes**  
with Tropical Syrup  
**90¢**

**Blueberry Pancakes**  
Served with Fresh Blueberry Compote  
**90¢**

**LARGE German Pancake**  
Served with Lemon and Powdered Sugar  
**1.25**

**Buttermilk Pancakes**  
Whipped Butter, Hot Syrup  
**50¢**

**Hawaiian Pancakes**  
with Pineapple and Tropical Syrup  
**90¢**

Nebraska Corn Cakes .55

Yeasty Buckwheat Pancakes Whipped Butter, Hot Syrup . . . **50¢**

Cottage Cheese Pancakes .65

**Pancake House Specialties**

**The Two by Four . . . . .75**  
Two Fried Eggs and Four Pancakes

**Three Little Pigs in Blankets . . . . .75**

**Junior Plate (for Children Under 12) .65**  
3 Buttermilk Pancakes, 2 Strips of Bacon, Sausage or 1 Egg, Whipped Butter and Hot Syrup, Includes Drink

**Dollar Pancakes**

**10 Dollar Cakes . . . . .65**

**12 Dollar Cakes . . . . .75**

**18 Dollar Cakes . . . . .90**  
Served with Whipped Butter and Hot Syrup

**Juices and Fruits**

Orange Juice . . .25 Large .45  
Grapefruit Juice .20 Large .35  
Tomato Juice . . .15 Large .25  
Apple Juice . . .25 Large .45  
Pineapple Juice .25 Large .45  
Canned Peach Halves . . . . .35  
Santa Clara Prunes . . . . .30  
Sliced Bananas and Cream . . .50  
Canned Grapefruit Sections .35  
Apple Sauce . . . . .30  
Sliced Canned Pineapple . . .35  
Fresh Berries in Season . . . . .50

**Breakfast Cereals**

Oatmeal . . . . .35  
Assorted Dry Cereals . . . . .35

**Our Pancakes Are Made From Fresh Ing**  
We Regret that we cannot be

**NO Substitutions • NO To**

On a recent visit, I jotted down the CURRENT price of a variety of entrees, ranging from buttermilk pancakes or ham and eggs to coffee, orange juice or a side of bacon or ham. The table on page 3 shows the price from 50 years ago compared to today, and the applicable inflation rate.

<b>Entrée/Item</b>	<b>1957</b>	<b>2007</b>	<b>Inflation Rate</b>
French Pancakes	\$0.90	\$6.40	4.0
Blueberry Pancakes	\$0.90	\$6.10	3.9
Buttermilk Pancakes	\$0.50	\$4.95	4.7
10 Dollar Cakes	\$0.65	\$4.75	4.1
Ham & Eggs	\$1.25	\$7.25	3.6
Golden Brown Waffle	\$0.50	\$4.90	4.7
Side Bacon	\$0.45	\$3.40	4.1
Side Ham	\$0.65	\$4.15	3.8
Orange Juice(large)	\$0.45	\$3.20	4.0
Coffee	\$0.10	\$2.00	6.2

The average of the 10 items was 4.31%, with coffee significantly above the others (hey—Starbucks must know what they are doing). Relating back to the 3.5% number cited earlier, another way to look at things would be to compare a \$100,000 income today to 20 years from now. To equate to the same number with 3.5% inflation, the income must double to \$200,000. This also means our purchasing power is declining by 50% every 20 years.

This is not on topic, but is still quite relevant, in that inflation is why in our opinion it is critical to keep a representative portion of equities in one's allocation at all times, not just in the accumulation stage. Retirements are lasting 20 and 30 years, and historically stocks are about the only asset class that has significantly outpaced inflation over time.

### **Valuation as a Forecasting Tool**

It is pretty common for clients to ask or wonder “what do you think about the next year or the current environment?” I’ve been doing this job since 1982, and I’m convinced more than ever that forecasting is pretty much impossible, and therefore a useless exercise. But that doesn’t stop a lot of people from doing it—especially because most people will forget what they said.

Instead, I’ve found through extensive research that by examining past sets of data, stocks (and other markets) produce above average returns in certain environments and below average returns in other environments. As a result, we adjust market exposure based on the environment, using various risk models. But, we are not forecasting.

You can, however, make some educated guesses about the future using certain indicators or principles. It goes without saying that the price you pay for something has a huge impact on your future return. Would you rather buy Microsoft at \$25 or \$50? Or invest in bonds yielding 7% or 4%?

A common valuation indicator that many people use is the Price/Earnings ratio (P/E). This is derived by taking the stock price and dividing by the trailing 12 months of earnings (trailing P/E). For an index, such as the S&P 500, you take the price of the index and divide by the total earnings of all the stocks in the index. In general, higher P/E's imply higher risk, and lower P/E's imply lower risk, but not always.

Below is a table created by Ed Easterling of **Crestmont Research**. Easterling is the author of Unexpected Returns ([www.crestmontresearch.com](http://www.crestmontresearch.com)). He took the trailing P/E of the S&P 500 each year back to 1919, broke them into deciles and then calculated the forward 20-year compound returns from each starting period.

20 Year Periods Ending 1919 - 2006 (88 periods)					
DECILE	NET TOTAL RETURNS BY DECILE RANGE		S&P500 DECILE AVG	AVG BEGIN P/E	AVG END P/E
	FROM	TO			
1	1.2%	4.5%	3.2%	19	9
2	4.5%	5.2%	4.9%	18	9
3	5.2%	5.4%	5.3%	12	12
4	5.4%	5.8%	5.6%	14	12
5	5.9%	7.2%	6.7%	14	14
6	7.2%	8.8%	8.4%	16	18
7	9.0%	9.3%	9.3%	15	19
8	9.4%	10.8%	10.4%	11	20
9	11.0%	11.9%	11.7%	12	22
10	11.9%	15.0%	13.4%	10	29

These returns, by the way, include dividends. You can see that when P/E's begin at about 10, future returns have averaged 13.4%. You have to go back to the early 1980's to see a market when P/E ratios were below 10. Stocks followed with 20-year returns near 16% per annum. In contrast, when P/E's begin at 19 or above (the first decile), future 20-year returns have averaged just 3.2%. At the end of 1999, P/E's were near 30, and here, 8 years later, returns have averaged under 2% (see later All About Perspectives). So you can see, there is some predictive value with this.

Where do valuations stand today? According to **Ned Davis Research**, the S&P 500 trailing price/reported(GAAP) earnings ratio is currently at 18.2, while the S&P 500 trailing 4q price/operating earnings ratio is 17.3. That puts us in the 2<sup>nd</sup> decile, where 20-year returns have averaged 4.9%. For what it's worth, that is right there with the 5% range John Hussman is expecting over the next 7 years, and whom I've mentioned before ([www.hussmanfunds.com](http://www.hussmanfunds.com)).

The above may not sound very appealing, but it's based on sound research, not the BS that Wall Street spits out or the uninformed gossip from your friends and neighbors. The bottom line is, with interest rates below 4% and real estate more over-valued than ever

before, active management in the stock market is likely to be quite important for the next 10 years or more.

**The Power of Sector Investing**

In last November’s newsletter, I outlined a sector strategy that we were implementing at the turn of the year in all actively managed portfolios (typically 5% in moderate risk accounts). It is a momentum-based approach using the Fidelity Select sector funds, and had a hypothetical track record of 20.9% compound returns vs. 10.54% for the S&P 500 for the 16 year period ending 2005.

For the first 11 months of 2007, the strategy is living up to its billing, up just over 20% vs the S&P 500 at +5.6%. It is tempting to ratchet up the exposure because it feels good, just as one would be inclined to pull back on a strategy that was not doing so well(see wrap accounts/performance). I do think it will be beneficial to increase exposure, but we’re likely to do it on a more gradual basis. This is a fully invested strategy that can be volatile on the downside, so we take the position that it is best to add after a substantial drawdown.

In any case, I’ve borrowed the chart below and the accompanying text from **Dorsey Wright & Associates**, and I appreciate their permission to reproduce it.

**Hypothetical Performance of 4 Different Investors**

Year End	Buy & Hold Strategy	Perfect Market Timing	Buying the Best Performing Sector	Buying the Worst Performing Sector
<b>Beginning</b>	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
1990	\$ 9,344	\$ 12,253	\$ 11,271	\$ 5,499
1991	\$ 11,802	\$ 17,334	\$ 18,135	\$ 5,560
1992	\$ 12,329	\$ 19,694	\$ 22,435	\$ 4,676
1993	\$ 13,199	\$ 22,256	\$ 27,604	\$ 4,334
1994	\$ 12,996	\$ 26,028	\$ 33,864	\$ 3,567
1995	\$ 17,429	\$ 35,092	\$ 51,487	\$ 3,978
1996	\$ 20,960	\$ 45,198	\$ 69,935	\$ 3,859
1997	\$ 27,460	\$ 67,962	\$ 105,078	\$ 4,215
1998	\$ 34,783	\$ 103,921	\$ 282,008	\$ 3,151
1999	\$ 41,575	\$ 140,880	\$ 753,836	\$ 2,605
2000	\$ 37,359	\$ 168,486	\$ 1,176,587	\$ 885
2001	\$ 32,487	\$ 208,068	\$ 1,315,424	\$ 404
2002	\$ 24,896	\$ 248,911	\$ 1,363,173	\$ 248
2003	\$ 31,463	\$ 333,023	\$ 2,058,938	\$ 266
2004	\$ 34,293	\$ 388,507	\$ 2,726,652	\$ 270
2005	\$ 35,322	\$ 440,290	\$ 3,656,168	\$ 260
<b>2006</b>	<b>\$ 40,133</b>	<b>\$ 516,329</b>	<b>\$ 5,002,734</b>	<b>\$ 278</b>

Source: Sector performance based upon Dow Jones sectors

“In this look back at the markets, we have four investors, each of whom has a different series of outcomes based upon how they invest. The first investor is who we’ll term, “the buy and holder.” He just buys the S&P 500 and rides it up and rides it down, making no movements at all in the portfolio. Our second investor is only invested during those months that the S&P 500 has an up month. So for instance, in 2006, there was only one down month (May, down 3.09%), so he would have had the returns of the S&P 500 for each month except May. Or said another way, he was able to perfectly time the market. Our last two investors were sector investors. The third investor was smart enough to know every year what the best performing sector for the year was going to be and invested 100% in that sector. The fourth investor was an unfortunate fellow who perhaps was following the sage advice of magazine covers but he bought the worst performing sector every year.

As you might imagine, each of the investors had dramatically different results from their initial investment of \$10,000 in 1990. Mr. Buy and Hold currently shows a portfolio value of \$40,133. Mr. Perfect Market Timer has a portfolio value of \$516,329. Mr. Perfect Sector Timer though has seen his portfolio swell to just over \$5 million while Mr. Poor Sector Timer’s portfolio is now only \$278! We are not trying to say that anyone can perfectly time the market or should put all their eggs into one basket every year but rather this is a powerful illustration of just how important incorporating a sector rotation plan can be into your overall portfolio strategy.”

I couldn’t agree more. This momentum-based approach is also behind the strategy used in our largest core equity position in all accounts, FundX Upgrader.

**2008’s Biggest Surprise**

Well, at the risk of sounding hypocritical, I’m going to make a forecast. The U.S. Dollar is going to make a major reversal to the upside against foreign currencies in 2008.

My reasoning is based on overwhelmingly negative sentiment (a six-year downtrend will do that) and investor behavior. Remember the DALBAR study I mentioned in a previous issue that showed that the average return of an investor in equity funds for the 20-year period ending 2005 was about 3.7%, yet the average return of the funds they invested in was about 10.7%? I think we may be about to see a similar situation in regards to international equity funds.

First, the facts. The U.S. Dollar Index has declined since early 2002 from the 120 level to 76, a drop of 36%. This has helped international equity funds substantially outperform domestic U.S. equities during this time. See below.

Fund	Total Gain	Compound Return
Vanguard Total International Fund	190.6%	24.2%
Vanguard Total Stock Index Fund	89.6%	13.9%

The above numbers are for the period 12/31/2002 to 12/04/2007. As a result, Americans’ appetite for foreign investments is at exceptional levels. According to the Investment Company Institute trade group, more than 95% of net inflows of money into stock funds

has gone to internationally focused funds this year. Five years ago, that number was less than 10%. I can't be certain this will end badly, but I sure don't like the odds. This just seems like the technology and real estate manias all over again. I will say that the relative strength measure comparing the two funds above is still solidly in favor of International (it switched 12/07/2004). But that's not my point.

### **All About Perspective**

Even with this year's volatility and the first 10% correction since 2002, stock investors have enjoyed fruitful times these past five years. See the numbers below.

	<b>S&amp;P 500</b>		<b>S&amp;P 500</b>	<b>CAG*</b>
12/31/2002	880	12/05/2007	1484	13.2%
10/09/2002	777	12/05/2007	1484	15.4%

\*compound annual gain with approximate 2% dividend reinvested

When we are interviewing prospective clients, then, why do we ask them how they've done over the last 8 years? Because it matters.

12/31/1999	1469	12/05/2007	1484	2.1%
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It does an investor absolutely no good to make money in a bull market, only to give much of it back in a bear market. Returns are important, but so is the amount of risk taken to achieve those returns. Besides helping clients meet their individual goals, our investment management goal at TABR in most situations is to beat a passive benchmark, with less risk, over a full market cycle. With stocks sitting about 5% below their highs set in early October, we may have now seen a complete down/up cycle—peaking in March 2000, bottoming in October 2002 and perhaps topping in October 2007.

### **Performance**

Below is the performance, net of management fees, of six real-time portfolios we are tracking. These represent a majority of the strategies we are using in client accounts, but not all. The differences are mainly attributed to risk (example—moderate allocation versus conservative allocation or aggressive) and account size. The numbers are for the first nine months of 2007, through September 30, except for the Bond account.

<b>Type of Account/Strategy</b>	<b>YTD</b>	<b>Benchmark</b>
TABR IRA (Moderate Risk)	+7.54%	+7.46*
TABR Stock Wrap Account	+7.02%	+9.12%**
TABR OEX Relative Strength	+12.57%	+ 9.60% (S&P 100)
TABR D.A.L.I. Account	+9.98%	+7.46%*
TABR Passive Allocation	+11.00%	+7.46%*
TABR Bond Account	+2.78%	+3.75%***
Vanguard Total Stock Index		+ 9.12%
Vanguard Total International Stock Index		+ 14.54%
Vanguard Total Bond Index		+ 2.93%

\*consists of 45% Vanguard Total Stock Index, 15% Vanguard Total International Stock Index and 40% Vanguard Total Bond Index

\*\*Vanguard Total Stock Index

\*\*\*Vanguard Total Bond Index, period only for 6/30/07 to 9/30/07

**Returns shown are net of management fees, and include reinvested dividends**

With the exception of the Stock Wrap account, we have been beating the appropriate benchmark in every category for the year to date (note—the Bond account is only 3 months old). The OEX, D.A.L.I and Passive Allocation accounts are all fully invested, relying entirely on selection and relative strength, while the IRA and Stock Wrap accounts use our risk models to manage risk. Through September 30, the approximate equity exposure in these actively managed allocations was 72%, and this had dropped to 68% through December 4.

Just a short note on the Stock Wrap accounts. They've struggled since the end of the third quarter, up just 1.26% through December 4 versus +4.8% for the benchmark. Though we have taken quite a bit less risk, the main "hurt" has been the performance of the stocks selected using the Joel Greenblatt return on capital formulas. Through November 30, the average performance of the 20 stocks in the portfolio using this screen was -6.75%, compared to the average performance of the 20 stocks using our Value Line criteria was +6.9%. The 20 stocks using the Zweig formulas are doing OK as well.

I bring this up not because 11 months is meaningful—it's emphatically not. It is human nature to not be happy when everything is not going right. I still believe, though, that it is better to use 3 screens that have proven themselves over time, instead of one (Value Line was my original idea). And this brings me to what Greenblatt wrote in chapter 8 of his book, "The Little Book That Beats The Market."

First, the magic formula often doesn't work for several years in a row. Most investors won't (or can't) stick with a strategy that hasn't worked for several years in a row. For the magic formula to work, you must believe that it will work and maintain a long-term investment horizon. We'll expand our thoughts on our Wrap Account strategy in the next issue, due out in late January or early February. I'll also be detailing more information on our Passive Allocation strategy, which has been doing quite well in both real time as well as back-testing. It has been living up to the "More Risk, More Return," moniker I've given it, but its all about expectations and understanding what you'll have to endure.

### **Administrative News**

We've done an about face with our website, and are in the process of changing our web host, with a significant redesign. Our expectation is to make the changeover sometime in January. We'll also be unveiling what we think is a better and improved format for client data access. As we get closer to the date, a separate letter will go out with the details.

I'd like to express my gratitude to all of you who entrust your assets and financial lives to us at TABR. We are not TABR without you. Here's wishing you a Merry Christmas and a terrific holiday season.

Best regards,



Bob Kargenian, CMT  
President

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Comparison of the TABR Model Portfolios to the Vanguard Total Stock Index Fund, the Vanguard Total International Stock Fund and the Vanguard Total Bond Index Fund (the "Vanguard Funds") is for comparative purposes only and the volatility of the Vanguard Funds used for comparison may be materially different from the volatility of the TABR Model Portfolios due to varying degrees of diversification and/or other factors.

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