

NBZ Quarterly Review

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4th Quarter 2006

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Tale of the Tape

The downturn that I expected in the fall never materialized. Instead, the S&P 500 shot up 16% from its low in July and never looked back. 2006 marked the fourth consecutive year of positive returns for the broad US markets. Since 1926, the market has advanced for four straight years only 16 times. The following year was positive 11 times and negative 5 times.

For the year, value stocks once again outpaced growth stocks and small stocks returned slightly more than large stocks. Bond returns trailed far behind the stock indexes. Certain prognosticators predicted this turn of events, but I was not one of them. See my predictions for 2007 to see what might not happen this year.

Don't miss our feature article that highlights several investments that could boost your income. At least one of those investments should be in everyone's portfolio.

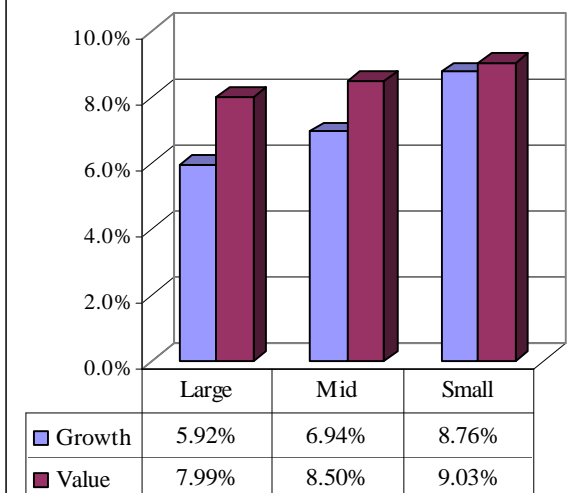
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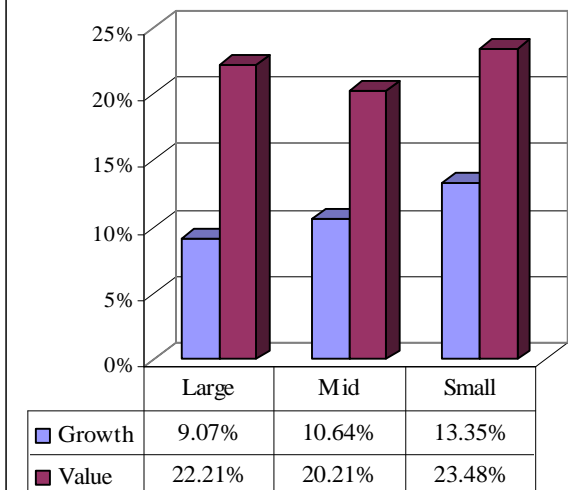
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4th Quarter 2006



January to December 2006



<u>Index</u>	<u>Type</u>	<u>Q4 Return</u>	<u>YTD</u>
New York Stock Exchange	Broad market	7.90	17.87
S&P 500	500 large US companies	6.70	15.80
Dow 30 Industrials	Industrial blue chips	6.71	16.29
Nasdaq Composite	Index with large tech exposure	6.94	9.52
Russell 2000	Small company stocks	8.90	18.35
Morgan Stanley EAFE	International stocks	10.40	26.86
Lehman Govt / Corp Bond	Intermediate term bonds	1.03	3.78

Searching For Yield

Most of us have the financial goal/dream of accumulating enough savings during our working years so that we can live off the income of those investments during retirement and not touch the principal. While we're accumulating our nest egg we seek total return (income plus appreciation). Once in retirement, we plan to focus mainly on income producing investments. We look back fondly on the time when CDs yielded 10%+ and money market accounts paid 15%. Today's 5% CD rates seem paltry in comparison. What's an income seeker to do?

While the yields of many income producing instruments are much lower today than 20 years ago, the number and type of income producing investments have mushroomed. This article will explore some of the new investment choices available. First, let's review some timeless truths about income investing:

1. In general, the amount of income you receive is related to the amount of risk you are taking or the time frame of the investment.
2. Income can take many forms including taxable interest, tax-free interest, ordinary dividends, preferred dividends, option premiums, rents, royalties, short-term capital gains, etc.
3. In a retirement account, the tax treatment of the investment is not important. In a taxable account, you have to be aware of the tax treatment and compare investments using after-tax returns. For example, if you're in the 35% tax bracket, a corporate bond yielding 5% will result in less after-tax income than a mutual fund yielding 4% in qualified dividends or a 3.5% tax free bond. The interest from the corporate bond will be taxed at 35% and the dividends will be taxed at 15%. The after-tax yields of the three investments are: corporate bond—3.25%, mutual fund—3.4% and tax free bond—3.5%.

A Great Parking Place

If you keep a large balance in a checking account or bank savings account, you could be losing hundreds of dollars a year in unpaid interest. Several new internet banks offer FDIC insured accounts with yields up to 5.22%. You link your checking account with the internet savings account and transfer funds to and from the savings account with the click of a mouse. Some of the best rates are available at Amboy Direct, BankUnited, iGobanking.com, and WTDirect. Go to bankrate.com for a complete listing of these internet banks and rates.

Risk: low Yield: above most money market yields

Don't let Rising Rates Get You Down

Bank loan funds are a small subset of bond mutual funds. Instead of holding corporate or government bonds, they purchase loans from banks. These loans are fully secured and many times are from publicly traded companies like Blockbuster, Charter Communications and Georgia Pacific. The interest rate on the loans are variable so that as rates rise you receive more income and when rates fall, you receive less income. Unlike most bond funds that have interest rate and default risk, bank loan funds have only default risk. Historically, the default rate in bank loan funds has been less than junk bond funds.

Unfortunately, most bank loan funds are either closed or have loads. Fidelity has a fund called Fidelity Floating Rate High Income (FFRHX) that is still open and has no load. It yields 6.16%. In our advisory firm we are able to buy the Highland Floating Rate A fund (XLFAX) which yields 7.40%. This is a loaded fund, but we are able to buy it through Schwab without a load.

Risk: low to medium Yield: approaching junk bond yields

Maximize Your Tax Free Income

Interest from municipal bonds is tax-free for federal income tax purposes. Most high quality municipals pay only 3.25% to 3.75%. The Vanguard High Yield Tax Exempt fund (VWAHX) invests 75% of its funds in bonds rated A or better. Its current yield is 4.52% which is equivalent to a taxable yield of 6.95% if you're in the 35% tax bracket. The fund's expense ratio is only .15% so it can

Searching For Yield

deliver great returns without taking the added risk of many other high yield funds.

Risk: low to medium Yield: approaching junk bond yields

Capture the Dividend

Since the tax rates were reduced to 15% on qualified stock dividends in 2003, new mutual funds have been created to yield as much dividend income as possible. Most of these funds yield 4% or less. One fund towers above all others in its qualified dividend yield—Alpine Dynamic Dividend (ADVDX). Frankly, I thought the 2006 yield of 13.43% in the Morningstar database was a misprint, so I called the fund manager to check. It turns out the yield number was correct. Alpine generates dividend income in three ways:

1. Using a strategy called dividend capture, it holds a stock for the minimum holding period allowed to get the favorable dividend tax treatment (61 days). It then sells that stock and buys another to capture another dividend. This strategy allows Alpine to collect six dividends a year on the same money on which other funds collect four dividends. (Other funds hold a stock all year and collect four quarterly dividends.)
2. Alpine searches for companies with more cash on their balance sheet than is needed for operations. Many times, these companies declare special dividends with this excess cash. Since its formation three years ago, this fund has received special dividends from over 175 companies.
3. Many foreign companies pay higher dividends than US companies. Approximately 39% of the fund's assets are international stocks.

I would not expect Alpine's dividend yield to remain as high as last year, but its strategies should allow it to outshine all other dividend yield funds.

Risk: medium to high Yield: Exceeding 10%

Report Card on 2006 Predictions

I considered asking an independent testing firm to grade my predictions from last year, but decided that most readers would prefer brevity over accuracy.

Overall stock market and economy—Prediction: exports would increase, unemployment would remain below 5.5%, economy would expand at a 2.5% to 3% rate, and the stock market would increase in the single digits. Result: exports increased, unemployment ended the year at 4.6%, GDP growth in 2006 was 3.4%, and the S&P 500 increased over 15%. Grade: B-

US stocks—Prediction: look for large-cap growth stocks and funds to lead the way. Result: small caps beat large caps and value creamed growth. Grade: F

International stocks—Prediction: international and emerging market stocks should continue to outperform the US markets in 2006. Result: EAFE index (international stocks) returned 26.86% versus 15.80% for the S&P 500. Grade: A+

Fixed Income—Prediction: short-term rates would rise another 1/2% to 1% and the 10 year bond would hit 5% by year-end. Result: the Fed raised short-term rates 1.25% in 2006. The 10 year bond peaked at 5.25% in June and ended the year at 4.71%. Grade: B

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Report Card on 2006 Predictions

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Real Estate—Prediction: real estate investment trusts should have a solid year as long as the 10 year treasury rate stays below 5%. Result: the Wilshire REIT index increased more than 36% for the year. Grade: A+

Commodities—Prediction: commodity prices should show a strong increase by year end. Result: commodity index decreased by 3.04%. Grade: F

Wild Prediction—market volatility would increase from 2004 and 2005 with the difference between the high and low points exceeding 25%. Result: volatility was higher in 2006, but the high versus low difference was only 13.42%. Grade: C-

Overall grade for the year: Solid C

Outlook and Predictions for 2007

Growth in the US economy slowed in the third quarter of 2006 only to pick back up again in the fourth quarter. Inflation seems to be moderating, unemployment rates are low, personal income is increasing, and Goldilocks is eating a bowl of porridge that's not too hot and not too cold. In 2007 there will be ups and downs in the economy and the stock market. There is always the chance that terrorists attack, the housing slowdown deepens, or new legislation aimed at erasing income inequality kills the golden goose. (I know what you're thinking, but two nursery rhyme references in the same paragraph are allowed in a financial newsletter.)

Barring major catastrophes, I expect interest rates to remain stable, the economy to grow at a 2.5%-3.5% rate, and the stock market to increase by double digits.

Below are my predictions for specific asset classes:

US Stocks 2007 is the third year of President Bush's term. Since 1926, there have been 20 presidential third years and 18 of them have resulted in S&P 500 increases. The two down years were both in the 1930's. I expect the market to increase in 2007 with growth finally outpacing value. (This is my third year picking growth over value. A broken clock is right twice a day. This could be my year.)

International Stocks The international stock index (Morgan Stanley EAFE) has outpaced the S&P 500 for each of the last five years. Valuations of foreign companies in developed nations continue to be lower than US stocks. Look for a sixth straight year of international outperformance.

Fixed Income Many experts expect the economy to slow in 2007 and for the Fed to reduce rates. Recent economic reports show the economy increasing in strength. The Fed has to maintain its inflation fighting credentials so I do not expect the Fed to reduce rates but instead to keep rates stable. The 10 year bond rate will end the year below 5% once again.

Real Estate With low, stable interest rates, the housing market will bottom during 2007 and real estate investment trusts will continue to increase in value.

Commodities The Dow Jones commodity index doubled in price from 2002 to mid 2006 before taking a breather in the last half of 2006. With continued global growth in 2007, commodities should continue their upward path.

Wild Prediction of the Year The Nasdaq index has underperformed the S&P 500 for six of the last seven years. For the last three years, the Nasdaq's annual return has been 6.43% while the S&P 500's annual return has been 10.43%. I think 2007 will be a big year for growth stocks and the Nasdaq. I'm looking for the Nasdaq to outperform the S&P 500 and return over 20% during 2007.