



WWW.FORTPITTCAPITAL.COM



FOSTER PLAZA TEN
680 ANDERSEN DRIVE
PITTSBURGH, PA 15220
412.921.1822

801 LAUREL OAK DRIVE
SUITE 103
NAPLES, FL 34108
239.566.1384

CAPITAL

HELPING CLIENTS BECOME SUCCESSFUL INVESTORS

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COMMON INVESTOR MISTAKES

THIRD IN A SERIES

BY: DOUGLAS KREPS, CFA

After four strong years in the markets, investors are generally feeling good about their portfolios. Some have a problem and don't know it, however. Whether as result of incentive stock options, employer stock matches into a retirement plan, capital appreciation or a combination of all three, certain investors find themselves with too large a portion of their savings tied to the fortunes of a single company.

Sometimes the result of dramatic appreciation by an "heirloom" holding that was never sold, this situation is most often reserved for long-term employees with an unflinching belief in their employers. How could they go wrong betting on their own horse? A 30-year employee likely has strong emotional ties to a company that not only fed his family but provided for his retirement as well. Unfortunately, history has shown us how far wrong this sort of emotional investing can go.

"A 30-YEAR EMPLOYEE LIKELY HAS STRONG EMOTIONAL TIES TO A COMPANY THAT NOT ONLY FED HIS FAMILY BUT PROVIDED FOR HIS RETIREMENT AS WELL."

As Charlie Smith notes in his (nearby) article, 10,000 Lucent employees lost their jobs in 2000. How many thousands of others suffered a double hit when the stock fell more than 80% that same year? Consider the folks who bet the farm with Bernie Ebbers at WorldCom. Or the thousands who believed Ken Lay and Jeff Skilling had a can't-be-beat business model, only to lose their jobs and most of their retirement savings at Enron.



The lesson is simple: diversification is important. This is not to suggest that investors who can afford the risk, and have a strong day-to-day role in the operations of their companies, should call their advisor and sell their company stock. Rather, it is a reminder that no company is bullet proof. Even well-run firms experience significant declines in value. And if the stock decline coincides with a pink slip, the financial impact can be devastating, especially for those who thought they were set for life.

In our managed accounts, we pay extra close attention when an individual stock accounts for more than 5% of the overall account value. We get nervous when we see one stock that exceeds 10% of an investor's net worth. This is especially true for those in or near retirement. Given today's historically low long-term capital gains tax rate, and our date in the tax calendar (taxes on gains booked today will not be due until April 15, 2008), it may be a good time to consider selling some shares of a concentrated position. Just ask the folks who used to work at Enron.



QUARTERLY REVIEW

BY: GREG MASTREAN

After suffering through a bear market from 2000 through 2002, investors have seen gains in four consecutive years after most indexes posted positive results in calendar-year 2006 (see accompanying chart). Both the large capitalization S&P 500 Index and the small capitalization Russell 2000 Index posted their largest yearly returns since 2003. The Dow Jones Industrial Average also posted its largest yearly increase since 2003, and climbed above 12,000 for the first time.

"INVESTORS WITH EXPOSURE TO INTERNATIONAL AND EMERGING MARKETS HAD REASON TO SMILE IN 2006"

A rally during the second half fueled the year's gains. First-half concerns over a market correction, rising energy prices and Federal Reserve rate hikes abated as the year came to a close. The Fed held rates steady for four consecutive Open Market Committee meetings following a June increase. Inflationary pressures continued to loom large in the minds of both retail investors and the Federal Reserve, however. December's Federal Open Market Committee minutes showed that inflation remained a primary concern of central bankers. Any increase in inflationary pressures and a corresponding upward move in the Fed Funds rate would have a materially negative effect on the markets.

Contrary to the upward-trending stock market, the economy slowed somewhat during the second half of 2006. This slowdown was primarily due to a rapidly-cooling housing market. Through it all, the American consumer remained resilient, and corporate investment is stable to accelerating. Continuing declines in the price of oil will only accentuate these trends.

In general, smaller capitalization companies performed better than their larger-capitalization brethren over both the fourth quarter and the full year. Value stocks again outperformed growth stocks during 2006. Investors with exposure to international and emerging markets had reason to smile in 2006 as well, as both the MSCI EAFE and Dow Jones World (ex. U.S.) Indexes shook off sharp corrections in May and June to end the year ahead by more than 20%. Finally, European stocks outperformed U.S stocks despite ongoing rigidities in the European labor market.

STOCK BENCHMARK INDEXES

INDEX	4 th QUARTER RETURN	2006 YEARLY RETURN
DJIA	7.4%	18.3%
S&P 500	6.7%	15.8%
S&P Mid Cap 400	7.0%	10.3%
Russell 2000	8.9%	18.4%
DJ Wilshire 5000	7.3%	15.3%
Russell 3000	7.1%	15.7%

Data from January 4, 2007, *The Wall Street Journal*



HAVE WE SEEN THIS FLICK BEFORE?

BY: CHARLIE SMITH

In one of my favorite M*A*S*H episodes, Colonel Potter acquires a well-worn copy of the movie "My Darling Clementine" to show to the 4077th.



The film breaks repeatedly, and Hawkeye laments each restart with the phrase "We saw this!" His frustration came to mind the other day as I examined the burgeoning "business" of ethanol production, the latest sickly issue of a marriage between coercive government politics and the law of unintended consequences.

Investors will recall the Telecom Act of 1996. Putatively written to foster competition in the local and long-haul telecom markets, the bill created a race to fill local telephone offices with duplicative (co-locate was the buzzword of the day) switches. It did so by forcing incumbent carriers to sell access to their retail networks for far less than the cost of building new. Upstarts avoided the cost of building out the last mile, and instead splurged on the latest and greatest high-speed switches and software. And splurge they did. Between 1996 and 2000, nearly \$9 billion was spent signing up customers, deploying state-of-the-art technology and building

new capacity. You will also recall that this did not end well. Lucent fired 10,000 workers in January of 2001; Nortel shares fell from \$89 in July of 2000 to 43 cents 27 months later.

Fast forward to the summer of 2005. The Energy Policy Act signed in August of that year essentially did for ethanol producers what the Telecom Act did for telephone switch makers. The act mandates a doubling of ethanol and biodiesel in the national fuel mix over six years, requiring refiners to sell over 41 billion gallons of renewable fuels by 2012. This time the bulk of the subsidy comes not from entrenched competitors, and their largely private shareholders, but from public taxpayers like you and me. And as long as oil remains above \$45 or so, the game works. The subsidy is invisible because competing fuels are (temporarily) expensive enough to make ethanol a viable alternative. The entire enterprise rests on the assumption that oil prices reside on a permanently high plateau. As taxpayers (and investors), we don't like that bet.

"WE SAW THIS!...THE LATEST SICKLY ISSUE OF A MARRIAGE BETWEEN COERCIVE GOVERNMENT POLITICS AND THE LAW OF UNINTENDED CONSEQUENCES."

Nevertheless, the nation's largest distillery will soon rise from the site of a former television factory here in western Pennsylvania, 800 miles from the epicenter of U.S. corn production. There's another large still

being built in southern Georgia, where it will cost \$25 per ton to ship corn from Ohio to feed the beast. In total, there are 116 existing U.S. ethanol plants, 79 under construction, 11 undergoing expansion and 200 more on the drawing board.



Private equity groups are lining up to buy existing stills and finance new ones. They're known as patient investors. How patient will they be when (inflation adjusted) oil prices resume their long term downtrend? Crude oil prices are down 20% since Thanksgiving. Will Archer Daniels Midland (ADM) be handing out thousands of pink slips in the spring of 2009?

Hawkeye was right: we saw this.

› FYI ›

1099 TAX MAILINGS

Federal tax law requires that custodians and fund companies distribute the 1099 tax report by January 31. However, we have seen many corrected statements generated in February. Therefore, it may be wise to wait to file your tax return until early March, in order to avoid the need to file an amended return.

NEW OFFICE REMINDER

Our Pittsburgh employees moved up the hill in Greentree to larger space in Foster Plaza Ten, 680 Andersen Drive, in November. Our phone number, fax number, and zip code remain the same.

ANOTHER MILESTONE

Thanks to the trust of our clients we exceeded \$1 billion in assets under management in the fourth quarter of 2006.

