

# Financial Focus



Pegasus Asset Management

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1st Quarter

## 2005 ANNUAL MARKET WRAP

Last year was a grueling, grinding year for stocks. After spending a good part of the year in the red; the Dow Jones Industrial Average surged in November and look primed for a yearly gain – only to sag to a 2005 decline of 0.61%.

Although the industrial average pushed within 100 points of 11000 in March and again in November, it ran out of steam both times. It finished the year more than 1,000 points, or 8.6%, short of its record of 11722.98, hit January 2000, nearly six years ago. The Standard & Poor's 500 stock index closed up 3%, at 1258.29, while the Nasdaq Composite Index rose 1.4% to 2205.32. The Nasdaq remains 56% off its record, and the S&P 500 18% short of its record both hit in March 2000.

The mediocre returns on stocks for 2005 have come as a surprise to many investors. After all, the economy is strong, with economic growth and corporate profit growth steadily outpacing forecasts, despite the impact of last year's hurricanes. Stock prices are looking less and less expensive, compared with corporate profits. The ratio of prices to earnings is steadily falling back to the average of the past few decades.

The price-to-earnings ratio of the S&P 500, for instance, the most widely used gauge of market P/E ratio, ended the year at approximately 18. Some analysts take that to mean stocks are less expensive, although the ratio is really just returning to normal. The average level over time is 15 or 16. The ratio grew to 40 at the height of the 1990's excess and has been sliding ever since. To conservative investors, this means stocks may rise from here, but since the ratio of stock prices to corporate profits isn't likely to rise significantly, share price gains aren't likely to outpace profit gains by any significant measure.

There are plenty of unknowns going into the New Year, and that is one reason some analysts warn investors to prepare for sharper ups and downs. Among the uncertainties: how strong profits will be, whether the economy will continue to boom, whether inflation will return, what oil prices will do, how the midterm congressional election will affect the stock market and how much longer will the Federal Reserve continue to raise rates. The Federal Reserve is one wild card that could help

stocks. In an effort to keep the economy from overheating, the Fed has been raising its target for overnight bank lending steadily since the end of June 2004, when it was at a 45 year low of just 1%. It currently stands at 4.25%. The Federal Reserve hinted after its December policy meeting that it could call a halt or at least a pause, in the interest rate increase campaign some time in the first part of 2006.

What the Federal Reserve does will depend heavily, in turn, on inflation numbers. But as the year ended, inflation seemed the last thing on many investors' minds. Investors were worried again about the bond market, which was flashing unsettling signals. The problem was that the yields of the short-term Treasury notes moved higher than those of longer-term notes. This is very unusual, since investors typically want higher yield for longer term bonds. It can mean that the market expects interest rates to fall, which can happen when the economy is slowing. It even can signal recession. The situation is known as a "yield-curve inversion".

At this time many experts think the concerns are exaggerated. They believe the latest inversion is being caused by exceptional demand for 10 year Treasury notes from governments abroad, and not potential economic weakness.

### Retirement Corner... Did you know?

That Company Sponsored Retirement Plans such as 401(k)'s account for the sole savings of more than 50% of plan participants? With such an important part of the nest egg, what are your employees doing to ensure it is being managed properly? We can help. For more information contact John Sebastiano at 845-369-9422 or [jms@pegasusassetmgt.com](mailto:jms@pegasusassetmgt.com)

### Introducing ROTH 401(k)'s

Beginning in 2006, 401K plans will be permitted to allow employees to designate their contributions as Roth contributions. These Roth contributions will be subject to the same rules as Roth IRAs. This will allow employees to contribute money that has been taxed into a Roth where contributions and earnings will grow tax free until the participant retires.

## COMPUTER BYTES

More and more the integration of computers into everyday items continues to revolutionize the way we work and play. A new gadget called the Fly Pentop addresses the later.

Designed for children 8 and over, the Fly Pentop is a pen with a brain. Turning what you write and draw into an interactive educational and entertaining piece of equipment.

Draw a picture of a calculator and you have a working calculator that verbally gives you the answers. Draw a keyboard and you have a musical instrument. Write words and have them translated into Spanish. Play word search games or learn the capitals of the fifty states. Even play a baseball game based on baseball cards, and hear game like sound effects, as if on radio, with the crowd roaring and the crack of the bat.

The Fly Pentop combines a tiny camera at the base of the pen that can capture 70 images per second and a tiny computer chip built into the pen. A small cartridge that snaps into the pen can change and add software for different functions. The entire pen is powered by a single AAA battery.

The only constraint is the need to use special paper that contain a barely visible crisscross of dots that allows the camera to detect the coordinates of whatever you write and to associate a function with that image. All of this behind the scenes integrated technology works to create a gadget that functions like an aide, commenting on your working, offering encouragement with tests and games and adding clever sound effects to make the whole experience fun.

Of course all of this technology doesn't come cheaply. Retailing at \$99.99 the pen is clearly more than a toy; which is exactly what it professes to be.

Technology marches on...

## NUMBERS TALK

Percentage of households making more than \$118,800 annually that spends more than their income...15.7%

Percentage of household debt versus personal disposable income in 2000...96

Percentage of household debt versus personal disposable income in 2004...113

Average American household credit card balance, in dollars, for 2000...7,842

Average American household credit card balance, in dollars, for 2004...9,312

Percentage of American workers age 45-54 who have saved less than \$25,000 for retirement...41

Percentage of 75 and older Americans who claim they rely on Social Security for more than half of their income...60

Percentage of 62 to 74 year old Americans who claim they rely on Social Security for more than half of their income...40

Percentage of the American population at large that clip supermarket coupons...65

Percentage of Americans earning more than \$125,000 per year who clip supermarket coupons...72

In trillions of dollars, total net worth of the wealthiest 400 Americans...1.13

Estimated percentage of American wealth to be controlled by women by 2010...60

Percentage of credit carrying college students in 2004...76

Percentage decline in the number of Americans starting or running a young company in 2004...18

Number of small businesses opened in 2004...580,900

Number of small businesses closed in 2004...576,000

Percentage of the world population in the United States...5

Percentage of the world litigation in the United States...94.8

*If you would like to discuss any of the topics contained in this issue of "FINANCIAL FOCUS," contact either Rodd Berro or John M. Sebastiano, at 845-369-9422 or rberro or jms@pegasusassetmgt.com.*

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