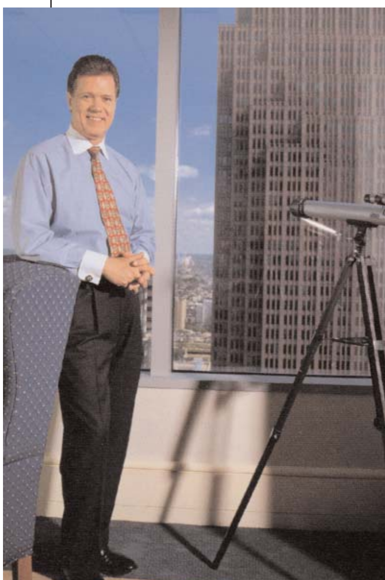
THIRD QUARTER 2006

A Tough Quarter Except for the Dow!

The above might seem like a strange title for this Report, but it really does sum up the past three months. Almost every money manager, except those invested in a few mega-cap stocks, is trying to decide how to explain what happened to performance during this very tough quarter. As you will see below, the Dow Jones Industrials did indeed do very well, however, other indexes enjoyed much less success. While the Dow, which is an index of mega-cap stocks returned 5.35% for the quarter, the S&P 400 mid-cap index lost 1.08% and the Russell 2000 index of small-cap stocks returned less than .50%. This means that an investor with a diversified portfolio of large-, mid-, and small-cap stocks fared poorly when compared to the big-cap stocks. This is discussed in more detail later as we look at each of the Navigator Programs and how they were affected during the quarter and the year.

The market had every reason to fall apart earlier this year and instead held together.

The Dow Jones Industrial Average has finally exceeded its old high which was set way back on January 10, 2000. The media hype has tended to obscure the fact that only ten Dow Jones Industrial stocks are actually at highs above their prices on 1/10/2000. The other twenty are still playing catch up. The



HARRY J. CLARK, CFP PRESIDENT / CHIEF EXECUTIVE OFFICER

CCMG In The News

October 10, 2006
CNBC "Morning Call"
Harry Clark, Chief Executive Officer of Clark Capital Management Group, addresses the fact that the market typically experiences a correction going into the mid-term elections. While this year will be no exception, investors should not be overly concerned as the last three quarters in the market have seen solid returns.

October 2, 2006
CNBC "Power Lunch"
Sean Clark, Chief Investment Officer, joins "Power Lunch" as the market maven on the first trading day of the fourth quarter. Sean sees a slowing trend in the economy and points out that earnings are just one component of what drives the market. Other factors include investor sentiment and valuations.

August 14, 2006
CNBC "Power Lunch"
According to Chief Executive Officer of Clark Capital Management Group, Harry Clark, the Fed will barely avoid a recession. Election time might be a good time to buy.

average Dow stock is still 20% below its 2000 high and the entire index is still 20.6% below that 2000 level when you adjust for inflation. The top ten stocks are Altria, Caterpillar, United Technologies, Boeing, Exxon Mobile, 3M Company, Johnson & Johnson, Citigroup, and American Express. **The other twenty stocks are, on average, 25.1% below their 2000 high.** Some notable laggards, are GM @ 59.8%, Microsoft @ 51.2%, and GE @ 29.5% below their 2000 highs. By the way, GE is the only original Dow Jones Industrial Stock still in the Index. A very favorable note is that 23 of the 30 stocks have increased earnings per share so that the Price Earning Ratio has declined from 29 to 18; a good omen for the future. Along the same line, while the S&P 500 has not made a new high, underlying earnings of the stocks in the index have been increasing nicely and the Price Earnings Ratio (P/E) is now at just 15 times 2006 estimated earnings. This is the cheapest P/E ratio for this index in more than ten years and is well below the average ratio of 25.5 since 1994.

While the Dow set this new high, other indices are still far below their prior highs. **The S&P 500 would have to advance by 14%, the NASDAQ by 122%, and the Russell 1000 Growth Index by 76% to reach their all time highs from 2000.** There are many other "non-confirmations" that could potentially cause problems if they are not resolved. Classic Dow Theory notes that the Industrials and Transports must be in synch to have a true Dow "Buy" signal. This is certainly not the case at this time. Fewer and fewer stocks have been participating as the Dow moved higher. For instance, when the last peak occurred on May 10th, 398 stocks were at new 52-week highs while at the most recent peak only 194 were at new highs. Volume flows and advancing/declining issues also failed to confirm the new high. Non-confirmations can be corrected over time but if not it does not bode well for this market move.

A Very Unusual Year, So Far

If you are a regular reader of this Report you know that we have been expecting a correction in the equity markets of far greater magnitude than we have seen so far this year. We had based that expectation on prior market action following multiple increases in the Federal Funds rate, the discount rate moving to 6%, the yield curve inverting, the record of recessions and bear markets following prior Federal Reserve Board actions, the four year stock market cycle, and the Presidential Election Cycle. These various factors had caused severe market upheaval in the past and while the stock market does not repeat prior movement exactly, it quite often rhymes. As examples:

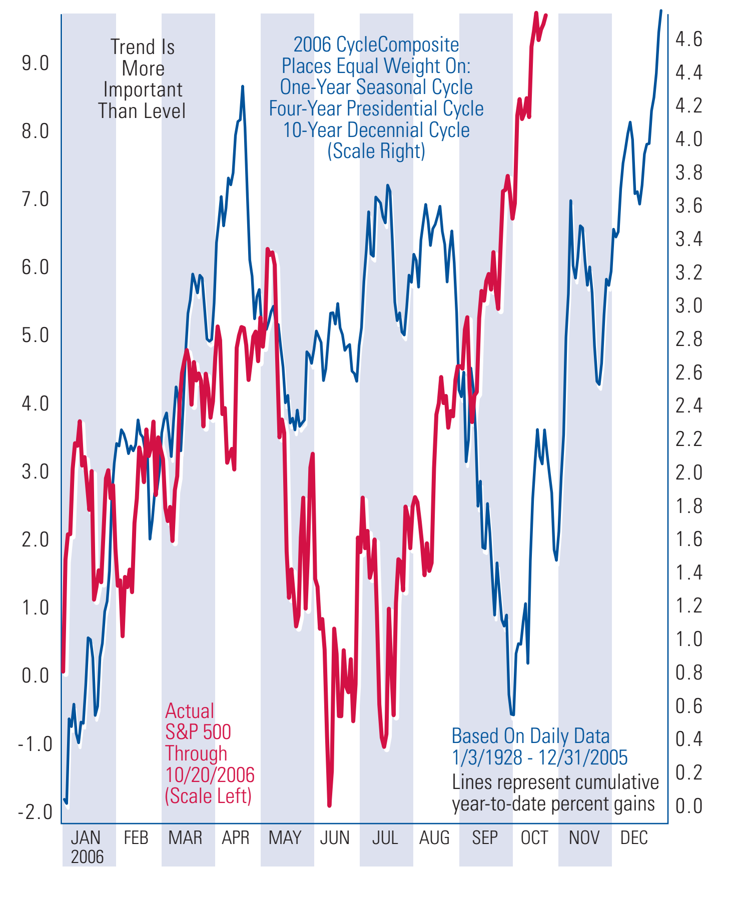
Discount Rate: the discount rate has been raised to 6%, or higher, seven times over the years. In every instance the equity markets had either just begun a bear market or would begin one within one month. **The average decline was 41%.** This time the market declined by 7.7% (S&P 500).

Federal Reserve Action: the Fed has raised the Federal Funds rate two or more times in a row on 14 prior occasions causing 11 bear markets and 12 recessions. This year: no bear market. It appears that the Fed may have engineered the third "soft landing" of the past 60 years. Quite an accomplishment.

Inverted Yield Curve: an interest rate spread of .50% or less between the 10-year Treasury note and the 90-day Treasury bill has only failed to lead to recession once since 1968. The spread has gone to .50% or lower eight times and recession followed seven times. The only exception was in 1998 when the Fed panicked due to a very large hedge-fund disaster and lowered the discount rate twice by year-end. The average lead-time to recession has been nine months. This month is the ninth month! No recession in sight, thankfully!

Market Peak: The stock market has seen a significant peak between mid-August and mid-September in 16 of the last 20 years. Not this year!

Four Year Cycle: The stock market goes through a cycle every four years. This cycle has caused a decline in the fourth year (this year) of that cycle that has averaged **27%** over the past 80 years. The previous smallest decline was 10.4% in 1994 but the decline this year, so far, has only been **7.7%.**



We had expected the market to follow the typical pattern for this year (see chart) and expected a major market bottom in October or early November to coincide with mid-term elections based on all the data above. These factors had no impact this year and the market just went its merry way. **Quite historic when you consider what could have happened, and has in the past, given the above factors.**

PROGRAM REVIEW

The Master Program
The Navigator Master Program is a separate account program featuring world-class money mangers in diversified, structured portfolios. In addition, this program features a protection strategy, utilizing S&P 500 Index puts, designed to protect the portfolios from serious loss. The program offers eleven structured, protected, portfolios with differing combinations of large-cap, mid-cap, small-cap and international portfolio managers. Since inception, manager excess alpha (extra return over a particular benchmark) has allowed overall return for the portfolios to be very commensurate with the S&P 500, which is the program benchmark. The first quarter of this year was great as all managers exceeded benchmarks and provided excess return. Second quarter was hard for some of our managers but performance for the year was still at benchmark. This quarter was indeed the "tough" quarter as almost all managers performed well below benchmark goals.

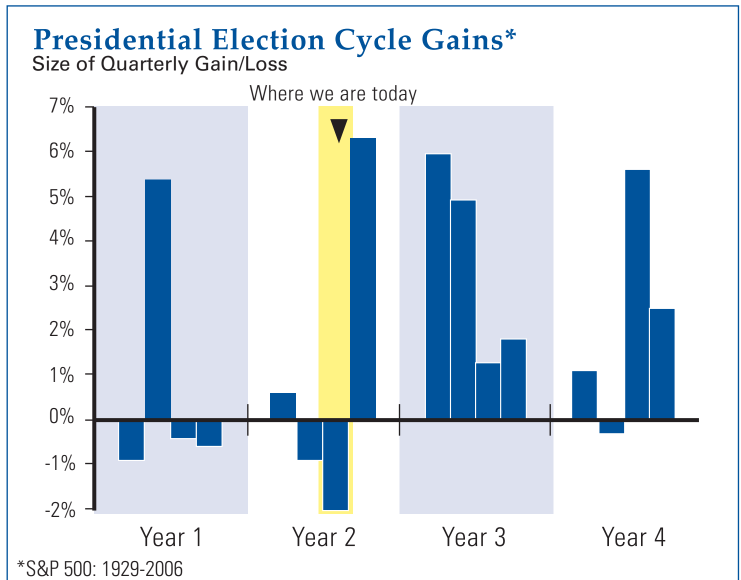
As an example, Navellier Large-cap Growth underperformed by 7.23% for the quarter and 11.71% for the year so far. That is huge underperformance. Their ranking system turned upside down. Stocks ranked 10 (worst), outdid stocks ranked 1 (best). This has happened in the past and it has proven to be a good time to buy. Their three-year performance is 9.5% vs. 4.4% and the five-year is 13.5% vs. 8.3%. They are by far one of the very best Large-cap Growth managers in the world. We are confident that they will recover and performance will return to what we have come to expect from this excellent manager. Navellier is not alone; Victory Capital, again with a superb long-term record, has underperformed by 4.81% for the year; NWQ International Value, one of the very best in the world in international investing, has underperformed by 7.06%; and Global Capital Small-cap has missed their benchmark by 5.98%. **As I said earlier, "a very tough quarter."** These are all superb management groups and as long as they do not change the methodology that has made them successful, we will stick with them.

ETF Core & Explore
This is a fully diversified program utilizing ETF's as the investment vehicle. The core segment of the portfolio is diversified into several market styles and the explore into sectors that Ned Davis Research ranks as his best. We also utilize the put strategy to limit large losses is in this program. **Diversification hurt results in the core and lack of sector movement hurt results in the explore portion.** We have changed the emphasis here to utilize our own "Style Preferred" ranking in the core and our own sector weightings in the explore. Style Preferred is a program that we acquired in the merger with RTE Asset Management and it determines which market style (large growth, large value, small-mid growth, small-mid value) to overweight. The program has an excellent 5-year track record. We are also offering Style Preferred as a stand-alone program utilizing ETF's, mutual funds, and annuity sub-accounts. We have found the sector rankings from Ned Davis Research (while superb in their overall response) move too slowly in a rapidly changing environment. When CCMG combined with RTE Asset Management, David Rights also joined our firm. David has as extensive research background and he has developed a sector analysis system to help us allocate the explore portion in this program. We have had very good success with the ETF Core & Explore program and we believe that these changes will help us overcome the recent quarter's problems.

Other Programs
The Premier Bond Program had excellent results for the quarter and should have an excellent year. Premier Equity suffered from the same things that affected our managers. Diversification hurt performance.

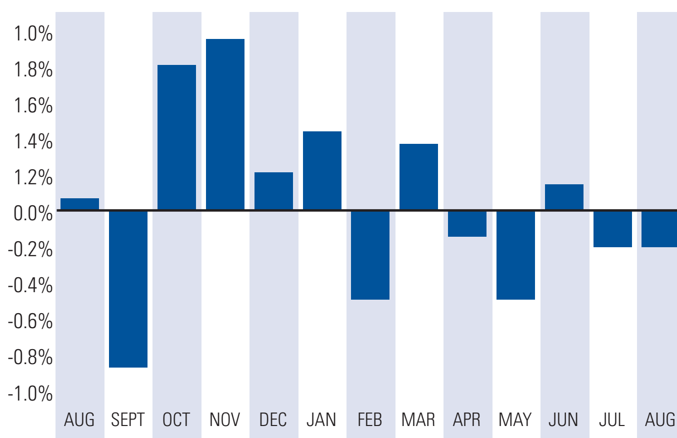
The Dynamic & Strategic programs suffered from holding too much cash and we are looking for the proper opportunity to fully invest these programs.

Style Preferred was overweighted in the best market styles during the quarter and turned in the best performance of all of our programs. Anyone looking to make a change would do well to inquire about this option.



Looking Ahead

Where do we go from here? Will this market keep on chugging higher, or is the correction that we have been expecting going to throw a monkey wrench into the works? Unfortunately we cannot answer that question. I believe that a major market correction was avoided so far this year because of declining oil prices and the Federal Reserve Board suspending further interest rate hikes. Will this be enough to sustain the current rally? Probably not, but if the housing market holds at current levels and begins to recover, a large weight will be lifted from the market and we could see the typical seasonal and yearly patterns return. The chart on the previous page shows how market cycles could behave to make this quarter (4th quarter) and the next two quarters the most profitable of the four-year cycle. There is a pattern in the market, that has been repeated for the past 84 years, that shows a very good market move from the low point in the mid-term election year to the top of the pre-election year (low point this year to high point next year) that averages 51%. If the July 10th bottom holds (10,739) and we get an average move of 51% to next year's top, we will see the Dow at 16,215! Well you know how wrong we were this year by looking at history, so let's discount that a bit and use half of the average movement. **That would put the Dow at 13,500 at some point next year.** Don't know about you but I would like to see that!



The chart above shows that the leading indicators have recently slowed and have been negative in four of the last five quarters. While I believe that the Fed has possibly engineered the third soft landing in their history, we must watch these indicators for a message about the overall economy. GDP for the second quarter was down to 2.6% and probably slowed more during the past quarter. If GDP falls into the 1 to 2% range I don't believe that corporate earnings, which continue to be a positive surprise, can remain in double digits. That being said, I believe that we have to give this market the benefit of the doubt because of where we are in the overall cycle. The market had every reason to fall apart earlier this year and instead held together. The market is extended and should have a normal and healthy correction. If that comes to pass, we will use it to realign some portfolios and put any excess cash back to work. We have already seen a pickup in small- and mid-cap stocks and if the economy holds together, avoiding recession, any correction should be shallow and we should be able to hit that Dow target we mentioned for next year.

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The cited performance data assumes the reinvestment of all dividends and capital gains distributions, and reflects the deduction of the maximum management fee changed by CCMG for the referenced program. Historical performance is available upon request.