TRADITION CAPITAL MANAGEMENT, LLC

Economic & Market Commentary
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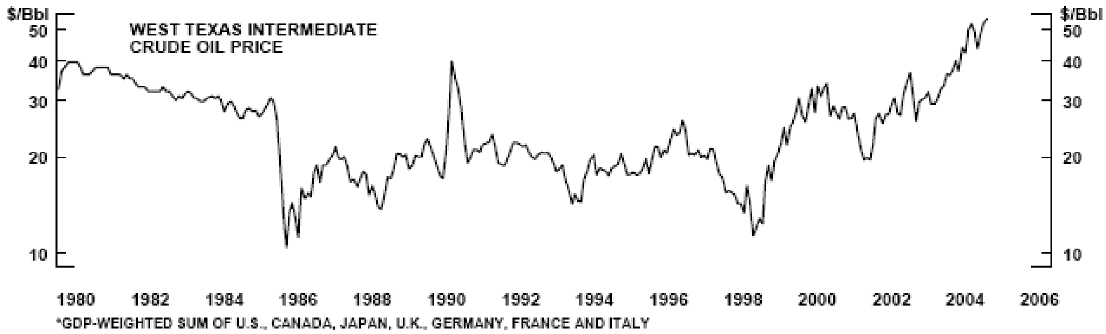
It has often been said that the more things change, the more they seem to stay the same. It is with this phrase in mind that we thought it would be interesting to put the recent fifth anniversary of the peak in the NASDAQ index, together with the current high price of energy, in some historical perspective.

From its peak on March 10, 2000 at 5,048, the NASDAQ Composite index fell to a low of 1,114 on October 9, 2002, a decline of 78%. By comparison, the NASDAQ index was 1,999 on March 31, 2005. At its peak, the three largest NASDAQ companies were Microsoft, Cisco, and Intel. While Microsoft, Cisco and Intel have maintained a leadership position in their respective market areas and their profits are higher today than they were in 2000, the companies' stocks are down significantly from their peaks. How could the stocks of some of the world's greatest companies have suffered such a horrible fate? Investors basically made two fundamental, but frequently repeated mistakes: assuming the companies' earnings would continue to increase significantly above their normalized rate (despite the historically cyclical nature of both the economy and individual sectors) and buying these leading stocks when they were trading at exorbitant multiples of those earnings. Despite the limited record of success, it is not unusual for investors to extrapolate such presumed and speculative growth trends well into the future.

Of course, it wasn't just technology stocks that became overpriced and have suffered a significant price decline. General Electric and Wal-Mart are two examples of very successful companies whose stocks are significantly lower since 2000, in spite of higher profits. Just in case you might think that the technology/telecom bubble was a unique market event, the same phenomenon occurred in the 1970's with the so-called "Nifty Fifty" stocks, such as Avon Products, Coca Cola and Merck.

Our view is that while it is important to identify qualitatively superior companies, it is also important to only buy a stock when it is selling at a meaningful discount (we use 20%) to the current value of the business. We often refer to this discount as our margin of safety, which reflects the reality that we are not always going to accurately forecast a company's future earnings and business value.



In contrast to the "irrational exuberance" investors had for technology oriented stocks in March 2000, expectations for the energy sector were very low. At the time, crude oil prices were trading around $30 a barrel and natural gas was $1.50 a thousand cubic feet (mcf). The exploration and production company stocks were trading at about 5 times cash flow and the global integrated energy companies were trading at a significant discount to the market on a price/earnings basis. Since then energy prices have risen as high as $58 a barrel of oil and $7.75 a mcf of natural gas. Now the energy-related stocks are discounting higher prices and some analysts are talking about a super spike in oil potentially going over $100 a barrel. Barring a serious and prolonged supply disruption, we do not believe oil will reach $100 on a sustainable basis in the next few years, because a marked increase in energy prices would ultimately be self-correcting. While it would take individuals and businesses a while to make major adjustments in their consumption patterns, in a freely functioning global economy, as the price of goods (energy included) rise, conservation should increase, demand should moderate and supply should rise.

We have been advocating over-weighted positions in the energy sector for more than a year, based on the view that energy demand was going to grow at a faster pace than supply, putting upward pressure on prices. Even though oil prices ran up from $35 a barrel last March to $55 in October, most investors continued to assume an average price in the high $20's to low $30's for the foreseeable future. Indeed, oil prices did decline from $55 in October to $40 in December. However, we think most investors have now raised their energy price assumptions to more realistic levels now and we believe many of the energy stocks are fully valued, based on our estimate of how much the energy companies are expected to earn over the next four years. Accordingly, we have been reducing the energy exposure in client portfolios (where objectives and tax considerations permit) to free up cash to invest in undervalued companies in the healthcare and technology sectors of the market. Healthcare and technology stocks have performed poorly over the last few years, investor expectations are very low and selective stocks are selling at a discount to our estimate of fair value.