

Quarterly Strategy and Observations

April—2007

DENVER
INVESTMENT
ADVISORS LLC



In the first quarter of 2007, stocks continued to plug along, with mid-cap stocks leading the way. Bonds marked time as investors "clipped coupons." Stocks weathered the global sell-off in February and came roaring back in March. It seemed as if investors were waiting for...something. Whether that is a decision on interest rate direction by the Federal Reserve, news that the housing slump is over, a resolution to an overseas conflict, or something else, it seemed as if investors were waiting.

The U.S. economy continued to expand, albeit at a slower pace. Gross domestic product (GDP), the broadest measure of growth, decelerated from a 5.6% annual rate in the first quarter of 2006 to 2.5% by the end of the year. Continued weakness in the residential housing market and worries about lending standards in the housing boom of the last decade contributed to this slowdown. Capital expenditures by the corporate sector, once expected to bail out the economy in the event of a consumer-led slowdown, have been lackluster. While these weak economic indicators would suggest recession, many indicators suggest that inflation is a larger threat. The unemployment rate hit a cycle low of 4.4% in March, with widespread increases in employment costs and slowing productivity gains for workers foreshadowing inflation. Oil prices have begun to rise again. The Fed's preferred measure of inflation, the chain price index for personal consumption expenditures rising at 2.4% is well above the Fed's self-described "comfort zone" of 2%. Meanwhile, corporate profits continue to be robust, as U.S. companies have more cash in the bank than ever before. We'll talk about what they are doing with that cash later.

	First Quarter
S&P 500	0.6%
Russell Midcap Index	4.4%
Russell 2000 Index	1.3%
Dow Jones Industrial Average	-0.9%

20 Years Later

The sharp decline in equity prices we saw in February reminded us of the upcoming 20-year anniversary of the 1987 market decline. We decided to take a look at that event (with the benefit of two decades of hindsight) and see if we could draw any parallels to the current environment.

*The View
 From a Mile
 Up*

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“The reality of October 1987 unmasked the flaws in the portfolio insurance theory.”

On Monday, October 19, 1987, the S&P 500 lost 20% of its value in one day. An invention called portfolio insurance has universally been blamed for exacerbating an already declining market. (Portfolio insurance was supposed to minimize losses by automatically re-allocating from one asset to another. Predetermined trading rules would cause portfolios to be rebalanced by small amounts that would theoretically minimize losses.) The reality of October 1987 unmasked the flaws in the portfolio insurance theory. As stock prices gapped down, the portfolio insurance programs sold stocks at increasingly lower prices, rather than the incrementally lower prices they were designed to exploit, leading to indiscriminate selling of stocks. (Could there be a parallel between "portfolio insurance" and hedge funds using complex derivative strategies today?)

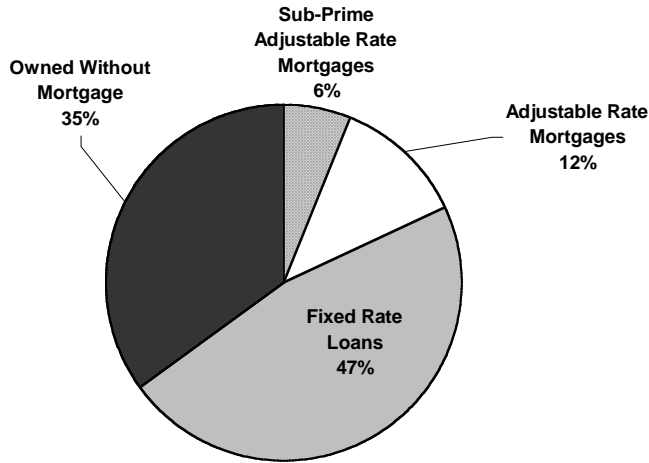
"Black Monday" as the 1987 event was called, ended up being a world-wide phenomenon. The FTSE Index on the London Stock Exchange lost 11% on Monday, and a further 12% the following day. Was the February 2007 sell-off a precursor of another "Black Monday"? When we look back two decades, we see that conditions leading up to the market crash were much less friendly than conditions today.

The U.S. budget deficits were large - 5% of Gross Domestic Product (GDP) for four years running. The budget deficit in 2006 was 1.9% of GDP. The P/E ratio of the S&P 500 was high by historical standards at almost 23 times earnings. Today it is in the mid-teens. Investors could achieve a risk-free rate of return of 9.5% on the 10-year U.S. Treasury, compared to 4.75% today. Commentators at the time were calling for global economic catastrophe. (The U.S. economy ended up doing quite well, despite all the media speculation to the contrary - in fact, the S&P 500 finished 1987 with a positive return.) Any "reassessment of risk" in the global financial system today is likely to be most pronounced in the riskiest asset classes, as opposed to the U.S. equity market, which continues to trade at or below historical valuations. This leads us to continue to utilize all of the resources at Denver Investment Advisors LLC to identify attractive businesses at reasonable valuations.

Sub-Prime on Prime Time

You would have to be living in a cave to have missed the media hype about the "sub-prime" mortgage problems plaguing the nation. We'd like to take this opportunity to offer perspective on the sub-prime mortgage market and how big a headwind it may present to the economy. While it is true that the sub-prime mortgage market (borrowers with less-than-stellar qualifications) represented an oversized portion of recent mortgages, the overall housing stock tells a different story, as the chart below shows.

Ownership of All U.S. Single Family Houses



Source: Mortgage Bankers Association

“The bulk of houses in this country are either owned outright, or with a fixed-rate mortgage.”

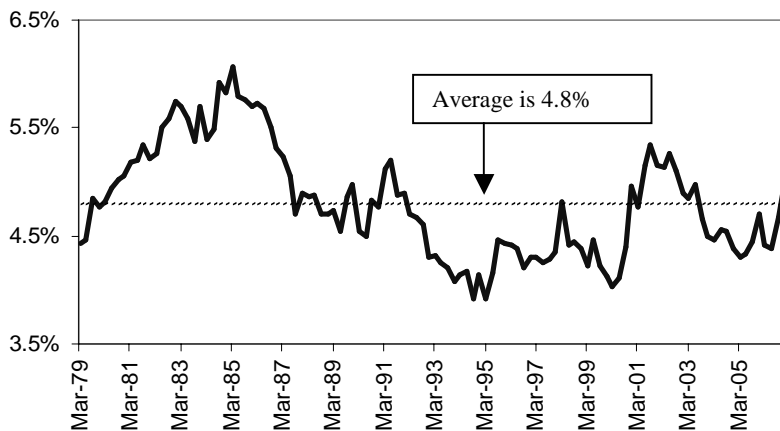
The bulk of houses (82%) in this country are either owned outright without a mortgage, or with a fixed-rate mortgage. Of the 12% of homes subject to a standard adjustable rate mortgage, many have capped out and will not be subject to further interest rate increases. That leaves six percent of houses in the United States with sub-prime adjustable rate mortgages that are the subject of countless media reports—*six percent*.

Yes, delinquencies are going up, especially in the sub-prime sector. The most recent data shows that 87% of sub-prime borrowers are paying their mortgages on time. Only 13% of sub-prime mortgages are delinquent, below the recent high of 15% delinquency rate achieved in 2002. So while the sub-prime mortgage market continues to garner news headlines and generate Congressional hearings and lots of political hand wringing, it continues to be a small percentage of the overall housing market.

“...delinquencies are going up, especially in the sub-prime sector.”

Will there be a "sub-prime contagion," where problems in the low end of housing creep into areas dominated by borrowers with good credit? Overall mortgage delinquency rates (all borrowers) show a similar pattern. Mortgage delinquencies were much higher during the early 1980s and as recently as 2001 to mid-2003. The average delinquency rate for mortgages

Mortgage Delinquency Rates, United States



Source: Bloomberg

over the last three decades has been 4.8%, a rate that we just recently eclipsed. However, the trend is not our friend, as the saying goes. Delinquencies are increasing, and we will be watching this data closely to see if housing continues to deteriorate.

“...there is probably more fall-out to come in the housing market...”

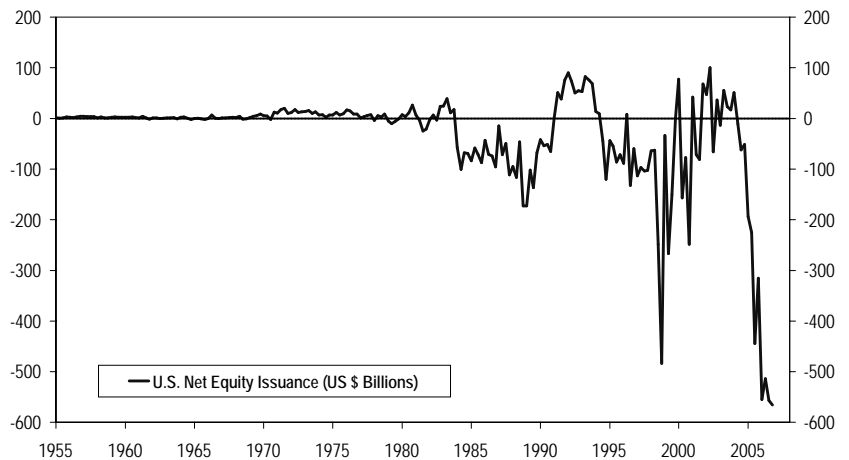
In March we had the opportunity to sit down with a legend in the home mortgage business, Angelo Mozilo, Chairman and CEO of Countrywide Financial. It is one of the nation's largest mortgage lenders, and a company he founded in 1969. He has been recognized by Barron's as one of the 30 most respected CEOs in the world. We don't pretend to know where the ultimate bottom will be in the housing market, and interestingly enough, neither did Mr. Mozilo. He commented that, even with over 50 years in the mortgage business, he couldn't predict the ultimate outcome of the current deterioration of sub-prime mortgages. He did reiterate the view that there is probably more fall-out to come in the housing market, but added that historically housing has been very resilient in this country.

The Incredible Shrinking Share Count

Is common stock an endangered species? We don't think so at this point, but aggregate share count continues to decrease, meaning that there are less and less publicly traded shares available for purchase. Part of this stems from a record amount of companies "going private." Last year a record \$548 billion of stock was taken off the market. While we always welcome the short-term increase in the price of a company we own that is the target of a private equity bid, we are aware that these "going private" actions have tax consequences for our taxable clients. As much as we hate to see companies that we have owned for long periods be taken off the public market, we recognize that every cloud has its silver lining; and current long-term capital gains tax rates are quite favorable. The chart below shows how this trend has accelerated in the last few years.

“..a record \$548 billion was taken off the market.”

NET EQUITY ISSUANCE (IN \$BILLIONS)



Source: ISI Group

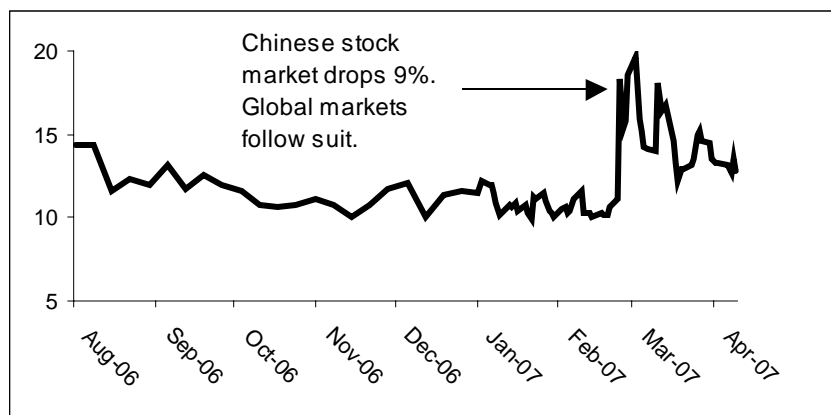
Another explanation of the shrinking share count is that U.S. corporations continue to plow money back into their own shares. With the record profitability that corporations are experiencing today, comes record amounts of cash sitting on corporate balance sheets. One investment opportunity that corporate America is availing itself of is investing in its own stock. The record amount of stock buybacks that we are seeing helps shrink the supply of stock available for purchase. It makes us wonder, with less supply of stock available for purchase, what happens to prices when demand increases?

“Could this be a precursor to increases in global risk premiums?”

Following Up on Volatility

Last quarter we wrote about the lack of volatility and commented "...we are uneasy with today's apparent confidence in continued low volatility..." Just weeks after we expressed that sentiment, global markets were unsettled by a 10% decline in Chinese equity prices in one day after the central bank in China gave its rendition of the "irrational exuberance" speech. Sure enough, volatility spiked in almost every market around the world, almost doubling, (as measured by the VIX Index), here in the U.S. Alas, it was not to be as volatility settled back down as markets rebounded.

VIX MEASURE OF VOLATILITY



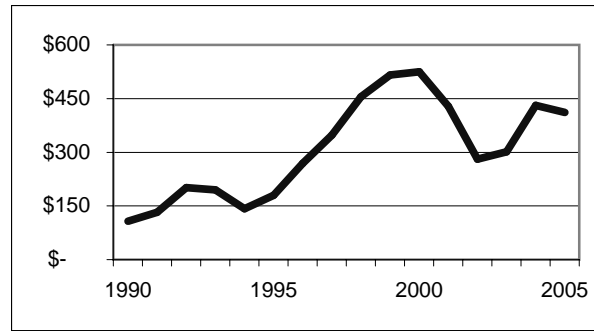
Source: Bloomberg

While volatility came down, it did not retreat to pre-February levels. Could this be a precursor to increases in global risk premiums?

A Look at Executive Pay

Are highly paid executives at public companies worth their sky-high paychecks? It seems like the public, (and more importantly, investors), are reaching the boiling point when it comes to the compensation that CEOs take home. Recent SEC disclosure rules make it easier for investors to learn how much the executives at a public company earn in total compensation.

CEO pay per \$1 of average employee compensation



Source: Institute for Policy Studies

“...the boards of public companies are finally listening to the public outcry...”

After years of outpacing shareholder returns and the pay increases of the average worker, as shown in the above chart, it seems like CEOs’ pay has started to more accurately reflect the value they provide to shareholders. Last year, corporate CEOs at the 350 largest U.S. companies saw their total compensation increase an average of 8% compared to an average total shareholder return of 17% at these companies. Could it be that the boards of public companies are finally listening to the public outcry over executive compensation? We hope that increased focus on executive compensation and shareholder returns is turning the tide back to rational compensation for corporate executives of public companies.

The Bond Box

Comments from the bond trading desk courtesy of our own Tom Stevens.

Though volatility rose in the first quarter due primarily to sub-prime fears and a temporary stock slide in late February, the 10-year Treasury note yielded 4.64% at quarter end, only 5 basis points lower than where it stood on December 31, 2006. The best performing fixed income sectors in the first quarter were three-year and shorter maturities. The Lehman Aggregate Index returned 4.50% for the quarter, while the Lehman Municipal Bond Index provided tax-free investors a quarterly return of 0.81%. Short maturity municipal bonds from 1-5 years returned 0.95%.

We do not anticipate any changes by the Federal Reserve over the next three months. Further, we believe the bond markets will continue their range-bound trading pattern until the Federal Open Market Committee indicates its next policy move, whether it is a hike or a cut to the Fed Funds Rate.

ASSET ALLOCATION ADDENDUM

Brief Review of Economic Scenarios

Recession - The economic expansion that started in 2001 grinds to a halt. Consumer spending slows and businesses fail to make up the lost demand. GDP growth goes negative. Current weakness in housing permeates through other sectors of the economy leading to stagnating demand that produces a global economic slow down. Stock returns are below average and bond returns are average as the U.S. economy struggles and real growth turns negative.

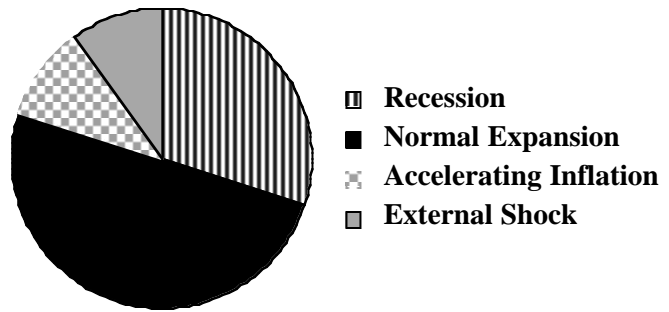
External Shock - Here we acknowledge that there are risks to the financial markets that are not related to the business cycle and interest rates. Possible events leading to this scenario could be terrorist attacks, a preemptive strike against Iran's nuclear facilities, natural disasters, global pandemics, or political instability in large geographic areas leading to massive international trade disruption. A global financial crisis due to central bank tightening around the world could shock the world's economies. The consumer is shaken and stops spending. Other possible effects include additional weakness in the dollar, skyrocketing energy prices, and excessive inflation. Here a flight to quality is quite likely. Stocks and bonds could each do poorly depending upon the external event.

Normal Expansion - Under this scenario, we expect the economy to follow a relatively typical business expansion. The current cycle matures and slows; i.e., the "mid-cycle slowdown" that has occurred at this phase of the expansion. Corporate profits moderate from record levels. Housing weakness takes its toll on the economy, and the interest-rate hikes from the Federal Reserve are felt after the typical 12 to 18 month lag as the economy slows into a "soft landing". Economic growth is tempered by moderately increasing interest rates and prices. Stocks post above-average gains and bonds have mixed results.

Accelerating Inflation - Accelerating GDP growth fosters higher prices across wide sectors of the economy, exacerbated by high energy costs that are passed on to consumers throughout the economy. Labor costs increase at a faster pace, and prices of commodities increase at an accelerating pace. Inflation starts to take its toll and eventually the Federal Reserve is forced to accelerate and magnify its increases of short-term interest rates in an effort to keep prices from spiraling upward. Under this scenario, both stocks and bonds do poorly.

Asset Allocation Addendum

Scenario Weights



Conclusion

We are seeing signs of a slowdown in the economy. This is typical of our Normal Expansion scenario. This expansion may be long in the tooth and starting to slow, but there are still signs of growth in many sectors and industries. While we are carefully watching the tension between inflation pressures and the effects of a housing slowdown, we remain mindful that the U.S. economy is quite resilient. Our model asset allocation stands at 65% Equities, 25% Fixed Income, and 10% Cash. Next quarter, we will enhance our asset allocation work, and we look forward to feedback from our clients in this regard.

NOTES:

Please note that the asset allocation targets presented are for a "model" account. Individual clients will have greatly different asset allocation targets based upon a variety of external factors not taken into account when we derive our "model" asset allocation targets. Please contact your portfolio manager if you have any questions regarding your asset allocation targets and your investment objectives and goals.

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