



Sitka Pacific
Capital Management

June 2007

Dear Investor,

It's been two years since Sitka Pacific opened in July 2005, and during that time we've managed accounts with two investment strategies: the *Hedged Growth* portfolio and the *Absolute Return* portfolio. The goals of both portfolios have been to provide growth that is independent of the market, with lower volatility and lower risk. These goals remain the foundation of how we invest, and with those values in mind we are introducing two new portfolios to expand the range of investment management options available to you.

We are pleased to announce our first sector focused portfolio: ***Commodities Focus I***. This portfolio is a diversified energy and metals portfolio designed to take advantage of the long-term bull market in real assets.

We are also pleased to announce the addition of our third stock portfolio: ***Dividend Growth***. This new long-only stock portfolio will provide management for accounts focused on long-term growth, with less of an emphasis on managing short-term volatility.

These new portfolios, along with our existing portfolios, will provide a diverse array of investment management options to match an investment plan to your goals and risk tolerance. A detailed review of our new and existing portfolios is provided below, after which will move on to the markets.

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New Portfolio: Commodities Focus I

As we have been discussing over the past few months, the change in the investment landscape in 2000 marked the end of a 20 year bull market in paper assets (stocks, bonds, etc.) and ushered in a new era dominated by real assets. Since 2000 we've seen commodities outperform stocks and bonds by a wide margin, and this long-term cycle has a long way to go.

Not long after Sitka Pacific opened its doors, most energy and metals sectors began a correction phase that continues today in some areas. During this correction we have been in an out of precious metals and energy stocks on a limited basis in *Hedged Growth* and *Absolute Growth* accounts, but as this corrective phase draws to an end it is clear that a stand-alone portfolio focused solely on commodities will provide a more comprehensive approach to this sector.

Here are a few key features of this portfolio:

- The *Commodities Focus I* portfolio is a broadly diversified portfolio of stocks and trusts from sectors including energy, precious metals and industrial metals.

- Market exposure and sector allocation is actively managed to provide exposure to these sectors with less volatility and less risk.
- This portfolio is ideal for risk-tolerant investors with time horizons longer than 5 years who are seeking a managed exposure to the long-term bull market in real assets.
- The *Commodities Focus I* portfolio has a minimum initial investment of \$50,000, and is available for both taxable and tax-exempt accounts.

The *Commodities Focus I* portfolio is intended to provide investors with a concentrated focus in energy and metals, in line with our expectation that real assets will continue to outperform in the years ahead. Although this portfolio is well diversified and actively managed, natural resource stocks and trusts can be highly volatile so investors should be tolerant of short-term volatility.

New Portfolio: Dividend Growth

For some time there has been a need to offer a long-only growth portfolio for accounts less than the \$500,000 minimum required by the *Absolute Return* portfolio. The new *Dividend Growth* portfolio is now available for risk-tolerant investors who are looking to maximize the long-term growth of their account. This unhedged long-only portfolio is more correlated to the market and more volatile than the *Hedged Growth* portfolio, but will likely provide better long-term returns. Here are a few of the key features:

- The *Dividend Growth* portfolio is a diversified portfolio of growth and dividend-paying stocks. The portfolio's goal is to maximize long-term growth under a variety of market conditions.
- Based on over 20 years of data, monthly volatility and risk of this portfolio is in line with the S&P 500.
- This portfolio is ideal for investors with time horizons longer than 5 years who are tolerant of short-term volatility, such as those with IRAs who are more than 5 years from retirement.
- The *Dividend Growth* portfolio has a minimum initial investment of \$50,000, and is available for both taxable and tax-exempt accounts.

Like our *Hedged Growth* and *Absolute Return* portfolios, the new *Dividend Growth* portfolio seeks to provide a better risk-adjusted return than the general market. However, as this portfolio will be long-only and will not employ the use of hedging general market exposure, the volatility and correlation to the general market of this portfolio will be the highest of the three stock portfolios. For investors who can tolerate short-term volatility and who have an investment horizon longer than 5 years, this portfolio will likely produce superior long-term results.

Hedged Growth

The *Hedged Growth* portfolio is a long/short portfolio that seeks to create low-volatility growth that is uncorrelated to the market. The core portfolio has kept an allocation of 70% to long positions and 30% to short positions, and we have also taken positions in various ETFs and in specific sectors. We have also used short positions in ETFs of major stock indexes to hedge market exposure beyond the coverage the 30% allocation to short positions provided. Although this portfolio has kept pace with the market over its two year history with much lower volatility and risk, we have decided to make some improvements:

- The methods used in constructing the core Hedged Growth portfolio have been improved, and the performance of both long and short groups are likely to provide a better return going forward.
- The long/short ratio is being changed to provide a more consistent management of volatility and risk, and the number of positions in the portfolio is being increased to provide better diversification. The long term safety of the new core portfolio remains robust: for example, while the largest one-month drop in the S&P over the past 20 years was 22%, the largest one-month drop in the improved core portfolio was 7%. Over the same time span monthly volatility was roughly 2/3 that of the S&P 500.
- Based on over 20 years of data, the monthly correlation of the improved core portfolio remains near zero – which means that the market has virtually no influence on short-term portfolio performance.
- Although over the past two years we have at times speculated in energy and precious metals, speculative activity in these sectors is being shifted to the *Commodities Focus I* portfolio. This change will allow the *Hedged Growth* portfolio to more closely adhere to its core goals: low-volatility growth than is uncorrelated to the market.
- The Hedged Growth portfolio has a minimum initial investment of \$50,000, and is available for taxable accounts only.

With the improvements mentioned above, Hedged Growth accounts will likely perform better going forward as they stay within the increased diversity of positions provided by the core portfolio. Not only will this provide growth that is independent of the market with lower volatility, but it will now likely provide more consistent performance.

Absolute Return

While the *Absolute Return* portfolio has in the past used a long-only strategy similar to the new *Dividend Growth* portfolio, it has evolved into a strategy solely dedicated to providing a positive return with low risk and low volatility. For investors seeking capital preservation first and foremost, the goals of this portfolio will continue to be to preserve capital and provide a positive return:

- The *Absolute Return* portfolio will continue to take hedged positions in sectors that provide the best potential return for the risk taken. This will include positions in stocks and ETFs in both domestic and foreign markets.
- This portfolio will continue to hedge individual positions and market exposure with options to both manage risk and increase yield.
- This portfolio is ideal for investors who wish to avoid any significant drawdown in their account while remaining open to growth possibilities.
- The Absolute Return portfolio has a minimum initial investment of \$500,000, and is available for both taxable and tax-exempt accounts.

Accounts managed by the *Absolute Return* portfolio may at times be fully invested and at other times may only be partially invested in fully hedged positions and cash. This portfolio makes no attempt to match or beat the returns provided by any particular stock or bond indexes, but seeks only to provide a positive absolute return with low risk.

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In June, the S&P 500 fell modestly from a high set early in the month, and ended the 2nd quarter with a year-to-date (YTD) gain of 6%. The market is currently in a weak season period, and negative technical factors such as a dramatic decline in market breadth over the past few months have kept us in a defensive posture in *Hedged Growth* and *Absolute Return* accounts. Even so, *Hedged Growth* accounts have gained an average of 5% YTD. *Absolute Return* accounts, which have been defensively positioned through most of the year, have returned an average 1% YTD. All portfolio returns are after fees.

Last month we talked about how rising bond yields could affect the stock market as it continues its long-term cycle of contracting valuation from 2000. Here is an excerpt:

... bond yields have now revisited the top of their channel, and it appears yields could potentially break higher and end their 25-year downtrends. If bond yields do break higher this year, we can expect the market to begin re-valuing stocks in light of the new trend in interest rates; even if the level of interest rates themselves do not rise significantly at first, the market will likely begin to anticipate higher rates down the road, as it did in the late 1960's and early 1970's. This could completely change the character of the current decline in the market's P/E from the 2000 peak, which has up to now benefited from lower long-term interest rates. Up to this point the market's P/E has been able to come down even while the price of the market has remained buoyant, but that would likely change for the worse under a new trend of rising long-term interest rates.

It was only a few days after the May letter was sent when yields on the 30 and 10 year Treasury bonds broke higher out of their channels. The chart below shows the 30-year Treasury bond yield since 1980, and you can see the break out in the red circle on the bottom right.



Since that break in early June, stocks, bonds and commodities have been moving together in almost lock-step fashion. Stocks declined from their early June peak as soon as the market realized what was going on in the bond market, and have only modestly recovered as the panic selling of Treasury bonds has subsided. From their mid-June low, bonds, stocks, and the CRB index along with gold all rallied briefly before falling back to the earlier lows. This highly correlated action shows the short-term risk present as bonds decline: if bonds continue to decline in the coming years, there could be only a few places to hide during peaks in bond selling. However, it is certainly possible that the bond selling is over for the short-term. A change this big could be followed by months of “testing the break” in which yields try in vain to move below 5%. This would leave room for the positive trend in stocks to continue.

Beyond the short term, this break higher in yields sends us two clear messages about the larger trends. First, the cycle of contracting valuations in stocks will now be accompanied by rising interest rates, which makes that market more vulnerable to price declines as the P/E of the market continues to contract. After this extended rally from the 2002 low the stock market is quite vulnerable given the breakout of bond yields. As the summer wears on, we will learn much more about any good opportunities for market exposure heading into 2008.

Second, the inflationary trend of commodity prices over the past 6 years has now been *confirmed*, so-to-speak, by the end of the dis-inflationary bull market in bonds from 1981 to 2007. The bull market in real assets has a long way to go before it reaches its end, as we are only just now seeing bond yields break their trend to follow commodities higher. Although there will certainly be short-term volatility in the coming years, the breakout in bond yields makes the continued outperformance of real assets even more likely.

The new *Commodities Focus I* portfolio gives you a managed approach to investing in this long-term trend of real asset outperformance. In every bull market there are extended periods of stagnation and correction where prices in some sectors are left behind by gains in other sectors, and commodities are no exception; the rally in energy over the past few months while precious metals shares have continued lower is a recent example. In the *Commodities Focus I* portfolio you will have an actively managed portfolio that will move in and out of sectors as they perform and correct, so you can have the best of the bull market while missing some of the volatility - which is the hallmark of how we invest.

You may have recently received a letter discussing these new *Commodities Focus I* and *Dividend Growth* portfolios and how these new investment options could provide a more valuable service to you. If you would like to discuss adjusting any aspect of your investment management strategy, we will be happy to work with you to find the best overall approach to meet your goals.

That's all for this month's update. Next month we'll be back to our regularly scheduled discussion of the markets.

Sincerely,
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