STELLAR CAPITAL MANAGEMENT, LLC

Economic & Market
Commentary

Portfolio Positioning

1999 has offered much different markets than 1998. The global economies seem to be on the road to recovery, and fears of deflation have been replaced with fears of inflation. As a result, we have experienced rising bond yields, and the narrow market advance has given way to a broadening of participation. While this has resulted in a continuation of the market indexes advance, it has caused far greater volatility, and dispersion amongst the individual S&P 500 stocks. For example, many of the cyclical companies have advanced at the expense of financial, healthcare and consumer staple type firms.

This “cyclical revival” would lead one to believe that a capital-spending boom to build plant and equipment to satisfy pent up demand is just around the corner. The only problem with that analogy is that capacity utilization rates in many industries are not rising, which means there doesn’t seem to be a shortage of manufacturing capacity. Further, commodity prices (except for oil) still remain near year-end levels. While oil shot up over fifty percent in March/April (due largely to supply issues), it has since backed off as inventories were a bit higher, production cutbacks a bit lower and demand a little weaker than expected. Yes, demand will ultimately go up for oil products as the world economies resurrect themselves, but it won’t happen overnight, and it will not continue at the same pace experienced in March/April 1999. As long as the Federal Reserve Board remains committed to the “price rule” for monetary policy, inflation should remain low, and under control.

Rising revenues, which support rising earnings are important components to successful investments. Companies can cut expenses to grow earnings in the short-term, but at some point those benefits begin to diminish. Firms with rising revenues have a better platform to produce long-term earnings growth, and reward their shareholders with increasing share prices.

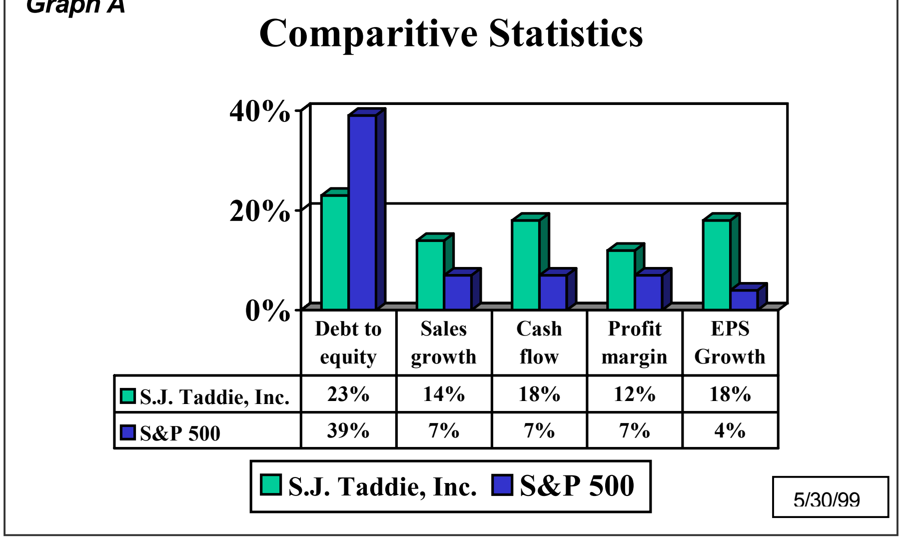
The market climate is, and has been, focused on the valuation of future cash flows. When market participants believe that inflation (while low) has a risk of rising, valuations of future cash flows fall. This typically results in lower bond prices, and the pressure on the price/earnings multiple afforded company stocks, can cause otherwise good firms to fall in price also.

There has been an effort to adjust some of the thirty to thirty five holdings in client portfolios to accommodate for this shift in market sentiment. With a focus on improving the overall earnings quality of client portfolios, companies with below average prospects for increased revenue and earnings growth rates have been replaced with firms offering better prospects. Some of these firms have nice track records for increasing revenues; others are coming off lackluster years but are well positioned for the future. Some of the newer names in portfolios include Schlumberger, Enron Corp., AES Corp., Chase Manhattan, and Sprint

Corp. In addition, I have taken this opportunity to bring portfolios more in-line with desired allocation levels amongst certain stocks. While this has resulted in a higher number of transactions than I would prefer, the benefits gained through these moves are well worth it.

The companies found in client portfolios exhibit some similar characteristics as shown in Graph A. You will continue to see a focus on companies that produce higher growth rates and sport higher quality balance sheets than the S&P 500 companies. While there are many more comparative studies performed on stock investments, companies in client portfolios are selected for their ability to grow earnings at an above average rate, with an effort not to overpay for that growth.

Graph A



	Debt to equity	Sales growth	Cash flow	Profit margin	EPS Growth
S.J. Taddie, Inc.	23%	14%	18%	12%	18%
S&P 500	39%	7%	7%	7%	4%

When focused on long-term growth rates for sales and earnings, changes to sales growth forecasts, or the ability of a firm to convert sales to earnings are critical issues. At the same time, maintaining reasonable price multiples for the expected growth rate, relative to the market, often distinguishes the difference between good companies, and good investments.

Lulls in the financial markets have often presented good opportunities to reposition holdings, upgrade portfolio quality, and improve the prospects of continuing to earn competitive, risk adjusted rates of return in the future.

If you would like to discuss anything about the markets, your individual portfolio, or other issues you feel are important, please contact me for more information.

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