

May 7, 2008

Healthcare & Energy

We believe the odds of success increase when one uses technicals and fundamentals together. A company's share price is a function of two components: Earnings & Multiple. There is no better window into earnings than fundamental analysis, which considers factors such as the company's markets, its competitive positioning, the management team and its cost structure. On the other hand, the valuation multiple assigned to those earnings, in our opinion, is significantly driven by emotions, which is best monitored via technical analysis. We don't believe an investor should favor one tool over another because both are needed.

Pure fundamental investors fall into two traps. First, they fail to recognize that great companies don't always make great stocks. Second, they manage risk by waiting for the fundamentals to change, which in our instantaneous market environments often equates to "closing the barn door after the horses have already escaped." Pure technicians, on the other hand, aren't necessarily any better off. They run the risk of buying great charts, but lousy companies and when the market ultimately figures out the truth the entire investor base stampedes for the exits at once.

Every day we look through a number of charts trying to "tune-in" to the signal the market is sending. Once we find a signal, we use fundamental analysis to provide a reality-check on whether the signal is worth listening to. Today, we are hearing several signals that pass our reality check test.

- 1. Energy:** A number of energy stocks, particularly in the E&P sector registered new all-time highs yesterday. This is a strong technical signal that the energy bull market is intact and additional future strength is likely. From a fundamental perspective, valuations remain reasonable, even before considering that analyst earnings estimates have yet to be ratcheted up to fully reflect today's commodity price environment. In the short-term many of the E&P companies are stretched and probably need to digest their recent run-up, however the energy services companies look less stretched and may have some "catch-up" potential. A few of our favorites include: BJ Services (BJS-N-\$28.86), Hornbeck Offshore (HOS-N-\$43.41) and SPDR ETF Services & Drillers (XES-A-\$45.45).
- 2. Healthcare:** From a technical perspective the declining relative strength of the healthcare sector since 2003 has been concerning, but has not worried us because much of the weakness was confined to the big drug companies. Chart 1, which displays the relative performance of the group from a **market-cap** weighted perspective looks pretty dismal. However, in Chart 2 it is apparent that prior to 2008 an equally weighted index of healthcare companies (which lowers the impact of the largest healthcare companies, particularly the drugs) performed in-line with the market since 2003. In 2008, something appears to be changing – not only has healthcare from a cap-weighted basis continued to underperform, it would appear that this underperformance is beginning to be led by companies outside the pharmaceutical group. We don't know the exact reason for this shortfall, but do recognize that there are real fundamental storm clouds beginning to appear on the horizon for all healthcare companies. The most obvious storm-cloud is the election, and the very different strategies the contestants have for healthcare. With the government footing the majority of the country's healthcare bill, potential changes to reimbursement policies, coverage universes etc. represent very real concerns. Another real fundamental storm cloud has to do with the troubles plaguing the American consumer. Healthcare is a non-discretionary need, however the willingness and ability to pay one's healthcare bill is very much discretionary. Healthcare costs incurred by the uninsured have only been fractionally recovered in the past (\$0.08-0.13 on every dollar), and the population of the uninsured is growing everyday. Bottom Line: We would be wary of overweighting healthcare in the near-term and would be trimming/cutting positions where necessary. The weakest areas of are : Healthcare Services and Pharmaceuticals. These would be our first candidates for trimming.

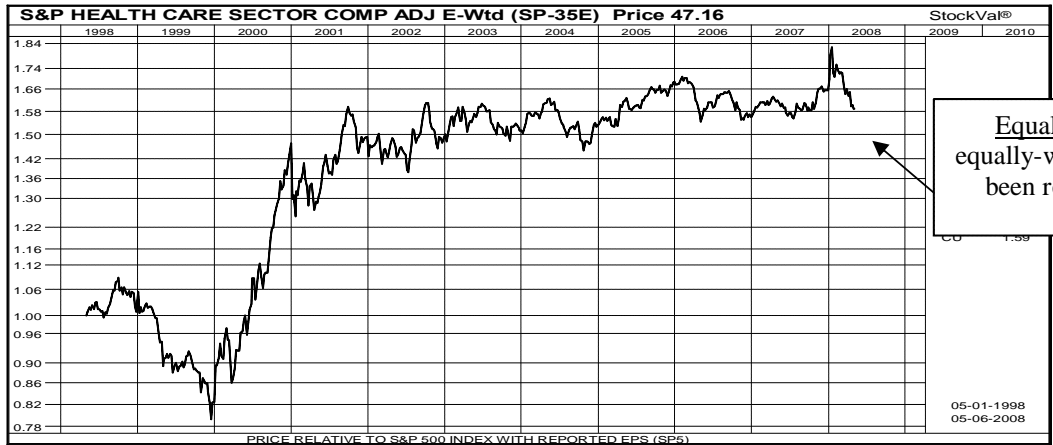
Chart 1:



Cap Weighted Healthcare has been losing relative strength since 2003. The group recently made a new relative low

Charts Courtesy StockVal

Chart 2



Equally Weighted : On an equally-wtd basis, Healthcare has been resilient until recently.

Charts Courtesy StockVal

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