THE *Talon*

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HAWK INVESTMENT MANAGEMENT, LLC
REGISTERED INVESTMENT ADVISER

BUYING BLUE CHIPS

LARGE CAP STOCKS PENDING RETURN TO FAVOR

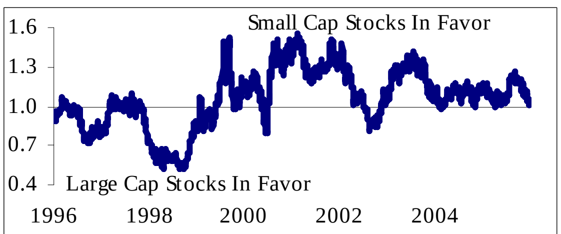
Stock markets in the U.S. have indicate that large cap stocks may have begun to return to favor. To date during the quarter, the S&P 500 Index (U.S. large stocks) outperformed the S&P 600 Index (U.S. small stocks) by 4%. Cyclical trends and fundamental valuation support the argument that investors should examine their asset allocation strategies with an eye toward the so-called blue chip stocks.

Reviewing relative strength of large versus small stocks, we project a potential reversal of market favoritism that small stocks enjoyed since October 1999. Call it the "seven year itch" but stocks exhibit a cyclical pattern whereby small cap stocks beat the large caps typically for 7 years before underperforming in ensuing years. If this cycle holds, large stocks should dominate in coming years.

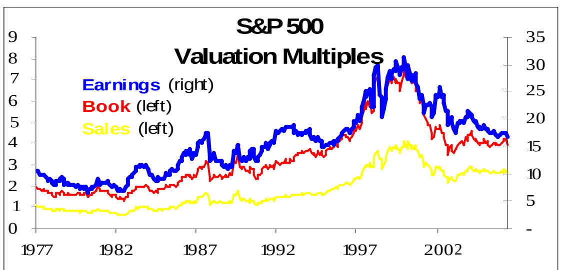
Our top chart compares rolling year-over-year performance of small stocks versus large stocks. We use S&P 500 and S&P 600 as proxies for large and small stocks, respectively. Ten years of data reveals small stocks have mostly dominated since 1999. Projecting forward, the recent downtrend may move to favor large stocks.

Fundamental valuation ratios support the case for blue chips. We examined valuation trends for large and small stocks focusing on reported book values, sales, earnings, and cash flows.

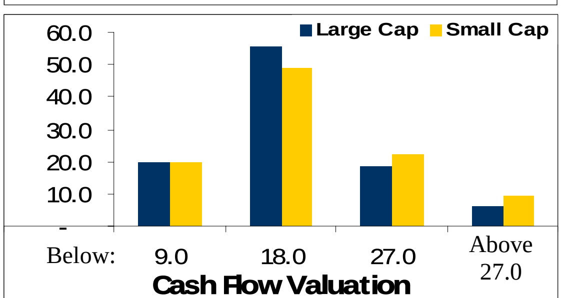
Our middle chart shows valuation multiples for the S&P 500 representing large stocks. We present thirty years of valuation trends. Stocks were increasingly expensive through 1999 while the economy grew, inflation was low, and bond yields mostly fell — hardly a surprise in hindsight. In the seven years hence, valuations have consolidated to normal levels. Further, we observe a foundation building whereby valuations are ending the descent.



Source: S&P Comstock, Hawk Investment Management, LLC, as of 6/26/06



Source: Reuters, BARRA, Hawk Investment Management, LLC, as of 5/31/06



Source: Reuters, Hawk Investment Management, LLC, 5/31/06

This important observation for large stocks is in stark contrast with small stocks. While not presented in the chart, small stocks have been increasingly expensive since March 2003. The S&P 600 earnings multiple illustrates our case. Three years ago, it was 15 but approached 20 this year.

Cash flow valuation confirms our valuation analysis and conclusion. With reported book values, sales, and earnings somewhat susceptible to manipulation, cash flow serves as a much stronger valuation basis.

Our bottom chart compares the distribution of cash flow valuation for large and small stocks. Based on Reuters data, the price to cash flow ratio averages about 9.0 for the 1500 S&P index stocks (500 large, 400 mid, and 600 small). Notice the distribution of cash flow valuation ratios skews lower for large stocks and higher for small stocks. Thus, it has become easier to find opportunity among large stocks versus small stocks.

Hawk is shifting its U.S. equity strategy in favor of large stocks. Prioritizing diversification, Hawk won't abandon small stocks completely. Even when bargains are hard to find, small stocks add value to a diversified portfolio.

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