

# NEWS ALERT



## Managing Equities in the Face of a Tightening Fed

On June 30<sup>th</sup>, the Federal Reserve began the process of raising the Federal Funds rate from the historical low point of 1%. **We forecast they will continue that process in “measured moves” of 1/4 point at every meeting of the FOMC for the remainder of this year.** We believe their ultimate target is to establish the Funds rate in the range of 3% and observe the effects on the economy. This should occur by the first quarter of 2005.

The Fed’s excessive monetary stimulation over the past two years has produced a turnaround in the economy; we are starting to see signs of inflation across the board as a result of the economic expansion.

It is a given that when the Fed begins the process of tightening the money supply and raising interest rates, the result in the stock market is the lowering of price earnings ratios (see box) in general. This has been the traditional and logical reaction of the markets. Historically, as interest rates rise, there is more competition for stocks for investors’ funds and we expect it to be the case in this cycle of Fed tightening as well.

This leaves the equity manager with a dilemma. The manager must continue to seek to perform well in a period when the tide is going out for price earnings ratios. It is easy to perform well in a period when price earnings ratios in general are rising. There is an obvious logical answer: **own those stocks whose earnings are rising at a much faster rate than the market in general and more important, whose earnings are rising at a rate faster than their price earnings ratios are declining.** These are the stock groups that will produce capital gains even in a period of Fed Reserve tightening.

At Stratton, we have enacted that strategy by buying those stocks that are business cycle sensitive; whose operations will benefit from increased volumes and better product pricing; their profits will grow substantially faster than the economy or the universe of all stocks. This strategy also would say to avoid those stocks where earnings cannot outperform in a rising economy. We have placed our investments in the sectors that should benefit most from a rising economy and reduced our investments in the defensive sectors of the economy. This strategy worked well in the first six months of this year as energy and industrials were two of the best performing market sectors.

### What is Price/Earnings or P/E ratio?

The P/E ratio is a valuation ratio of a company's current share price compared to its per-share earnings. Think of it as the stock's price tag, because it tells you as an investor how expensive the stock is.

Calculated as:

$$\frac{\text{Market Value per share}}{\text{Earnings per share (EPS)}}$$

EPS is the amount the firm earns on each share held by the public.

Sometimes the P/E is referred to as the "multiple," because it shows how much investors are willing to pay per dollar of earnings.

In general, a high P/E means high projected earnings in the future. However, the P/E ratio actually doesn't tell us a whole lot by itself. It's usually only useful to compare the P/E ratios of companies in the same industry, or to the market in general, or against the company's own historical P/E.

For more information about the Stratton Funds and the funds' performance, go to [www.strattonfunds.com](http://www.strattonfunds.com). You should consider the investment objectives, risks, charges and expenses of the Stratton Funds carefully before investing. A prospectus with this and other information about the Funds may be obtained by calling 1-800-634-5726 or by downloading a copy from the website. Please read the prospectus carefully before investing.

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