

Market Commentary

February 28, 2007

Volatility Returns

Until February 27th equity markets were moving along quite respectably this year, with the S&P 500 up 2.5% on a total return basis. Combined with 2006's 15.8% return, the S&P's continued positive momentum was warmly welcomed by investors. On the 27th the stock market in China fell 8.8%, which along with a few other pieces of bad news that day set off a wave of selling worldwide. For the U.S. markets, the Dow Jones Industrial Average ended the day lower by 416 points, or 3.3%. The S&P 500 was down 3.5%, its worst day since 2001.

Prior to this sell off, an overlooked phenomenon of the recent markets had been the historically low level of volatility in many of the stock indexes. One measure of volatility for the U.S. equity markets is the CBOE Volatility Index, known by its ticker VIX. The VIX is a measure of the volatility in the S&P 500 and is driven by changes in stock option prices. Low values of the VIX point to high levels of investor optimism, while high levels of the VIX imply investor anxiety. The chart below shows the trend of the VIX for three years:



Chart courtesy of StockCharts.com

Although interrupted by occasional spikes, the generally declining trend in market volatility seen in the chart before February 27th can mean that optimism is widespread in the markets. Such optimism can be justifiably based on positive earnings growth in stocks and continued strength in the economy, which we have experienced lately. However, a declining trend in volatility can also mean that the markets are becoming overly complacent and that investors are willing to accept both lower returns and higher risk. The chart above is one example of how investors were calmly accepting of risk recently, prior to the 27th.

Complacency has not been confined to the equity markets. Another example of the high degree of optimism in financial markets is seen in the lower yields accepted by investors for riskier bond market investments, such as the high yield (also known as “junk”) debt markets. Current rates on high yield debt are now averaging 7.5%.

In the recent past, such yields were well above double-digit levels. Because of the more risky nature of investing in bonds of low-quality companies, high yield debt throughout time has been one of the more volatile areas of fixed income investing. The fact that investor demand for lower yields of junk-rated debt has remained strong means that buyers are willing to accept less return while discounting the higher risk.

Recent data suggest that complacency is not just confined to the U.S. markets. Global market volatility and other measures of risk reflect a complacent belief that both solid economic growth and good returns can continue.

<i>Market Statistics</i>		
<i>February 28, 2007</i>		
	Level	YTD%
Dow Jones	12,269	-1.56%
S&P 500	1,407	-0.81%
NASDAQ	2,416	+0.03%
Oil	\$61.77/bl	
Lehman Agg Bond Index	+1.60%	
Federal Funds Rate	5.25%	
6 Mos Treasury Bill	5.11%	
2 Year Treasury Note	4.64%	
5 Year Treasury Note	4.52%	
10 Year Treasury Note	4.57%	

Why does volatility and complacency matter? Low volatility, whether it be in equity markets or high yield corporate bond markets can bring in buyers who might otherwise avoid risky investments or who historically exit such markets quickly after the good returns have been made. Such “marginal” buyers typically will tolerate smaller levels of loss before selling. Should market volatility increase, these marginal buyers leave rapidly, further increasing volatility and amplifying losses. This was particularly true on the 27th in markets like China.

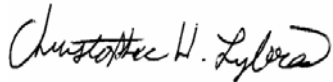
The key for investors is to occasionally rebalance portfolios to their long-term asset allocations, employ an active approach rather than indexing and to watch out for a change in economic fundamentals and corporate earnings growth. Our bottom up work on stocks is keenly focused on such changes, company by company.

Should recent earnings strength continue and the economy deliver moderate growth with low inflation, the increased volatility of the past few days could subside and a reasonable return environment could continue. There are still significant amounts of money on the sidelines, as evidenced by the record sized private equity merger deals that are announced almost daily. However, history with respect to longer periods of low-volatility and complacency, along with our bottom up stock research, continue to point to the need to be vigilant while building quality stock portfolios at reasonable valuations.

4th Quarter 2006 Corporate Earnings – Brief Review

With nearly 90% of companies in the S&P 500 having reported earnings for the fourth quarter of 2006, the data suggest solid earnings growth at the end of last year, albeit at a slower pace than prior quarters. According to Thomson Financial, year-over-year earnings growth averaged 9.7% for companies in the S&P 500 Index in the quarter. S&P now estimates that earnings will grow 7.6% in 2007, down from a forecast of 9.6% at the start of the year. The downward revisions to estimates for 2007 are a product of lower guidance from companies early in the new year. We are not surprised by the lowering of estimates and will continue to watch this trend closely.

Our bottom up research process will continue to seek stocks with dependable earnings and uncover value opportunities created by the recent weakness.



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Acadia Trust, N.A. is a Maine-based wealth management firm, with a research-based, value-oriented style of equity investing and a high quality approach to fixed income investing. As a trusted advisor to our clients, we provide portfolio management, trust, estate, financial planning and retirement plan services throughout New England.

At Acadia Trust, we distinguish ourselves through our disciplined investing, our team-oriented approach and our dedication to providing a client experience “second to none.” For more information, please contact Tamara Gifford at (207) 774-3333 for Individuals, Trusts or Endowments; Connie Worcester at (207) 299-1320 for Retirement Plan Services.