



Fourth Quarter 2005 Review & Commentary

Overview

The fourth quarter of 2005 was unusually good for broadly diversified investors, especially following on the heels of what was a great third quarter. Once, again those who invested beyond the traditional large company US stocks and bonds that consume the headlines did exceptionally well.

Equities (Stocks)

The average US stock fund gained 2.2% for the quarter and just under 7% for the year. Once again the average equity mutual fund handily outperformed the S&P 500 for both the quarter and the year. This was made possible largely by Mid-Cap stocks having continued their outperformance of Large Cap stocks. The average Mid-Cap fund gained nearly 2.5% for the quarter and just over 10% for the year while the average Small Cap fund returned 1.2% and 6.4% for the quarter and year respectively. Growth outperformed Value across the US equity market caps in the fourth quarter.

International funds, from both developed and emerging markets, once again significantly outperformed their US counterparts. The average International stock fund returned 6.7% for the quarter and just under 15% for the year. Emerging Markets funds had an impressive average return of 6.7% for the quarter and just under 32% for the year.

Natural Resources funds had a slow finish to another spectacular year, losing 0.5% for the quarter, but finishing the year with an incredible average 1 year return of over 41%. Real Estate funds cooled their blistering performance, returning 2.5% for the quarter and a more historically normal 11.8% for the year.

Fixed Income (Bonds)

Bonds continued to have lackluster returns. The average Long Term US Bond fund gained about 0.5% for the quarter, and 2.3 % for the year. High Yield bond funds didn't do much better, gaining 0.8% for the quarter and 2.4% for the year.

All indices cited above are Lipper Mutual Fund Indices as reported in The Wall Street Journal Online, January 5, 2006.



When the only tool you have is a hammer, every problem looks like a nail.
Attributed to Abraham Maslow

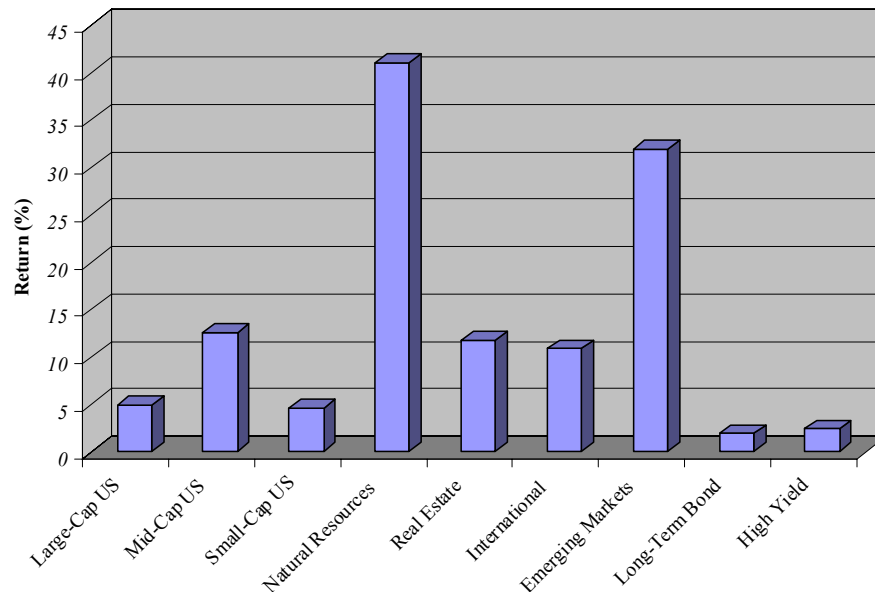
The Year In Review

Much Ado About Nothing

Investors in traditional stocks and bonds could well have spent 2005 at the beach and missed nothing. Measures of what the media continues to insist on referring to as The Market was virtually flat for the year. The S&P 500, the measure of the 500 largest US stocks, gained just 3% for the year, not including dividends. The Dow, the index made up of the 30 largest “industrials” (which was probably a good measure of something when it was started in 1884) lost 0.6% in 2005. The NASDAQ Composite, made up of over 3,000 stocks that have nothing in common other than they chose to list on the NASDAQ exchange rather than the New York or American Exchanges, gained 1.4% for the year. If you bought into the traditional investor’s version of diversification and bought bonds, there wasn’t much help there either. The Lehman Aggregate Bond Index, an actually quite useful index that includes just about every bond available in the US, returned 2.4% for 2005.

The three widely quoted stock indexes and the bond index above were all equaled or bettered last year by money market funds. Traditional stock and bond investors could have taken the year off, put the portfolio in cash and been no worse off for it. In other words, for these investors, nothing happened last year.

2005 Asset Class Returns



No Ado About Something

Outside of the widely reported world of The Market a great deal happened that didn't get much attention at all. As noted in the overview above, Emerging Markets, Natural Resources and International Stocks returned between 15% and 41% on average last year. Clearly something happened here, yet it received peripheral media coverage at best. When was the last time a mainstream TV or newspaper program reported on the return of the EAFE (Europe, Australasia and Far East) Index, the Goldman Sachs Commodity Index or the Emerging Local Markets Index? Never, in my recollection.

International Stocks, Emerging Markets Stocks and Small Cap US Stocks all have higher long term returns than The Market. All of these asset classes along with Natural Resources have also been shown in numerous academic studies to dramatically reduce portfolio risk. So, the obvious question becomes why doesn't the media cover them with the same vigor as The Market (The Dow, S&P 500 and NASDAQ)? The clear, if not seemingly cynical answer, is that large US brokerage firms and banks make enormous sums of money from underwriting for companies in The Market. By "enormous" I mean \$32.4 billion (with a "b") in fees in 2005. That sum is even more impressive when you consider that the top 10 investment banks garnered over \$18 billion of that. Not only is underwriting a big revenue generator, but the margins are huge due to minimal associated costs.

Some of these big underwriting fees go into advertising. So much so, that the investment industry is one of the largest sources of ad revenues. Since once the securities are underwritten they have to be sold, the last thing the underwriters want is for you to get the message that you could be putting your money somewhere other than the securities they've underwritten. Said another way, they want to shout from the mountain top that which is most profitable for them, not what's best for you. Since they fund a good part of the mountain top, they get to do that.

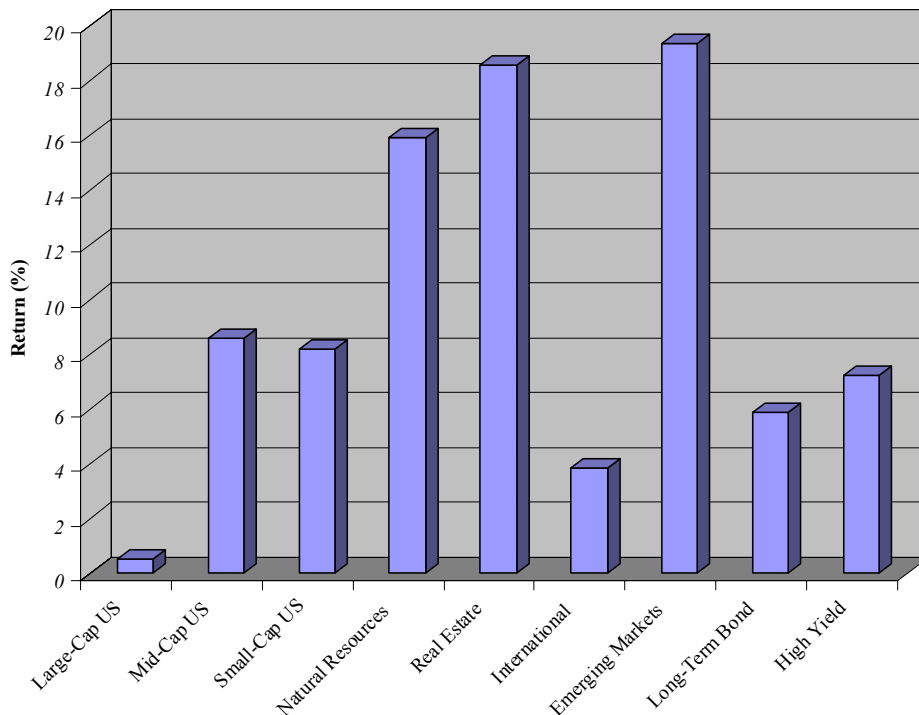
While the above paragraph may sound like something of a David v. Goliath rant, the chart below neatly illustrates the cost of following the wisdom of investing in The Market. If you had followed the conventional wisdom of investing in say 70% US Large Cap stocks and 30% Bonds¹ (we'll call this the Traditional Portfolio) you would have had an annualized return of 3.7% over the last 5 years and 6.3% over the last 10 years. On the other hand, if you would have had a more diversified portfolio comprised of the same 70% stock/30% bond mix, made up of the following; 25% US Large Cap stocks, 10% Mid Cap stocks, 10% Small Cap stocks, 5% Real Estate, 5% Natural Resources, 10% International stocks, 5% Emerging Markets stocks and the same 30% Bonds² (we'll call this the Enlightened portfolio), you would have had a 5 year average return of 6.2% and a 10 year average of 8.5%.

To put actual dollar amounts to it, if you started with \$100,000 in the Traditional portfolio, you would have \$119,782 dollars after 5 years and \$184,756 over 10 years. However, in the Enlightened portfolio you would have had \$135,211 over 5 years and \$226,703 over 10 years. A very significant difference to be sure.

Perhaps even more interesting (what, you say, could be more interesting than this?) is that you would have achieved the same returns with less risk. More return, less risk. The elusive free lunch realized. Just like all the theory says.

The point of this isn't just to rehash the theme "of diversified investing is better," although that certainly is a favorite, but rather to show that there are a number of areas to diversify into that are largely ignored by mainstream investors. This is to their peril and your benefit.

5 Year Average Asset Class Returns



Conclusion

For the year ahead, a number of observations stand out. Riskless assets, represented by money market funds with their yields back above 4%, are again beginning to present a valid alternative within the context of a portfolio. In

contrast to 10 year US Government bonds yielding around 4.3%, it would clearly seem not to be worth the extra risk for an extra fraction of a percentage point.

Stocks, both domestically and internationally, are currently very reasonably valued. The risk to stocks is not, therefore, endogenous (from inside), but rather exogenous (from outside the markets). This may well manifest itself through some global political event that becomes magnified by misunderstood risks taken on by hedge funds that are massively leveraged, even beyond their own understanding. Given the assets currently committed to hedge funds and the number of new, relatively inexperienced hedge fund managers, potential exists for a hedge fund generated crisis, such as the one that occurred in 1998 following the Russian Government defaulting on its bonds.

Traditionally, non-financial assets would serve as a sort of insurance against such a scenario, but it is precisely these assets that have been the subject of speculation from these very hedge funds. So, expect to see a portfolio that has a little more cash, stocks from across the globe of all market caps and less long term bonds.

2005 Asset Class Returns and 5 Year Average Asset Class Returns – *The following asset indicated in the graph are comprised of the following indices; Large Cap US – S&P 500, Mid-Cap US-S&P 400, Small-Cap US – Russell 2000, Natural Resources – Lipper Natural Resources Fund Average, Real Estate – Lipper Real Estate Fund Average, Emerging Markets- Lipper Emerging Markets Fund Average, International – MorganStanley EAFE Index, Long Term Bond – Lipper Long Term Bond Average, High Yield – Lipper High Yield Taxable Fund Average*

¹ *Large cap stocks here are represented by the Lipper S&P 500 Funds Index and bonds are represented by the Lipper Intermediate Bonds Index.*

² *Large cap stocks here are also represented by the Lipper S&P 500 Funds Index and bonds are represented by the Lipper Intermediate Bonds Index. Emerging Markets, Small Cap, International, Natural Resources¹ and Real Estate are all represented by their respective Lipper benchmarks.*

These are indices made of mutual funds that manage to these objectives and include the fees and expenses within those funds. 5 years may not be representative of longer term average returns and is necessarily indicative of what may happen at any point in the future. The Lipper data used is as reported in the Wall Street Journal Online, January 5, 2006.