



Fourth Quarter 2006 Review & Commentary

Overview

As you've likely noticed both in the news and your account balances, the fourth quarter of 2006 was very good for nearly every asset class. This helped most markets to achieve above average returns for the year.

Equities (Stocks)

Gains in equities were impressive across the board for the fourth quarter of 2006 propelling some markets to impressive multiyear gains. US Large cap stocks, as measured by the S&P 500, returned 6.7% for the quarter and 15.8% for the year. Mid-Cap stocks as measured by the S&P 400 Mid-Cap Index had a somewhat more modest showing, returning 7% for the quarter and 10.3% for the year. Small Cap stocks were the domestic winners returning 8.9% for the quarter and 18.4% for the year for the Russell 2000 Index. Value beat growth in all market caps for the quarter and the year.

International funds also continued to do very well. The average International fund returned 10.5% for the quarter and 24.9% for the year. Emerging Markets funds again did exceptionally well for the quarter and year, gaining an average of 17.4% and 31.1% respectively.

Natural Resources funds bounced back from their third quarter loss to return 9.8% for the quarter and 15.2% for the year. Gold funds did somewhat better than the rest of the category, returning 14.7% for the quarter and 31.5% for the year.

Real Estate funds gained 10.2% for the quarter, wrapping up another in a string of spectacular years with a return of 34.3%.

Fixed Income (Bonds)

Bonds had a very average quarter and year. The average US Taxable Bond fund gained 2.06% for the quarter and 5.5% for the year. High Yield bond funds also performed relatively well, gaining 3.9% for the quarter and 9.9% for the year.

All indices cited above are Lipper Mutual Fund Indices as reported in The Wall Street Journal Online, January 4, 2007.



Fourth Quarter 2006 Commentary

Telling the future by looking at the past assumes that conditions remain constant. This is like driving a car by looking in the rearview mirror.

Herb Brody

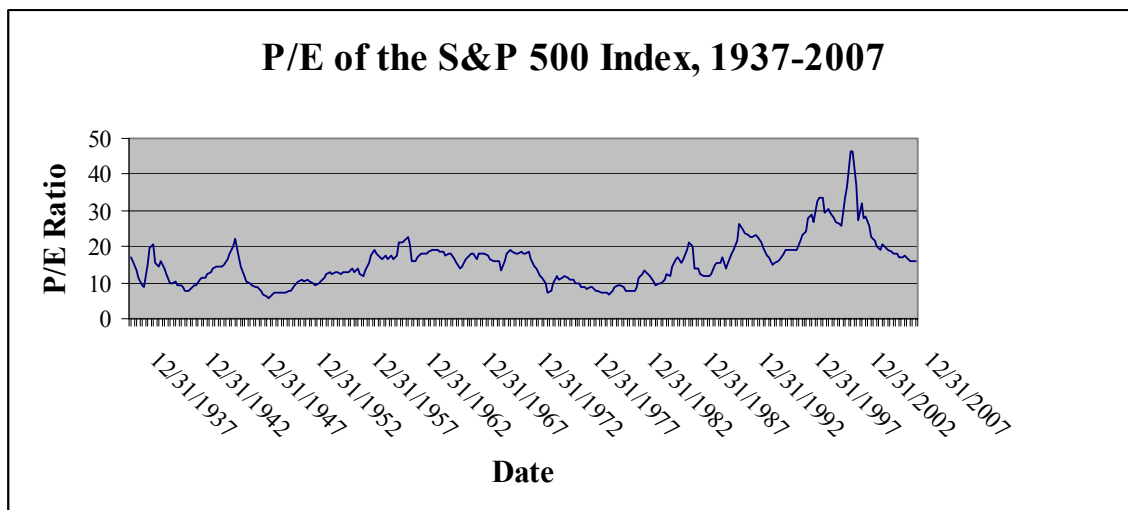
Since the most widely followed markets have begun hitting new highs in the last few months, I've encountered the question of whether some sort of calamitous comeuppance is lurking around the corner for the Dow Jones Industrial Average and the S&P 500. The short answer is I really don't think so. The much (much) longer answer follows.

The first piece of information to look at when deciding the outlook of the US Large Cap market (what most of the overwhelming majority of people refer to as simply "the market") is valuation. In other words, is it currently overpriced or expensive? Just like a good politician, we have to initially answer that question with another question, specifically, relative to what? The answer is relative to its historical average and then relative to the current value of other alternatives.

To facilitate our discussion we're going to use the Price to Earnings ratio (P/E) as our measure of value. To refresh your memory, P/E is the price paid for a dollar of annual earnings. If a stock has a P/E of 15 that means that the price of that stock is 15 times the per share earnings. As an example, if a company earns \$2 per share over the course of a year and the P/E is 15 then the price of the stock is \$30. This is useful because it can provide a consistent measure across different stocks and markets. So much for the refresher course, let's get back to the task at hand.

I suspect that some of the angst that surrounds the US Large Cap markets comes from the fact that the last time they were at these levels (seven years ago) things ended badly. What they miss is that, although the price may be about the same, the value is very different. At the end of 2001 the P/E ratio of the S&P 500 reached an all time high of 46.5. In marked contrast, it is now approximately 17. Standard and Poor's forecasts it to be under 16 (based on the current price level of the index) by the end of the year. By my calculation the average since 1937 is also just under 16.

To state matters more simply, we can equate this to laundry detergent. Let's say in 2001 you paid \$10 for a box of laundry detergent. Today a box of laundry detergent is again \$10, but the big difference is that the box is 2 ½ times bigger. If math really isn't your interest and you think a picture is worth a thousand words, perhaps this will help:

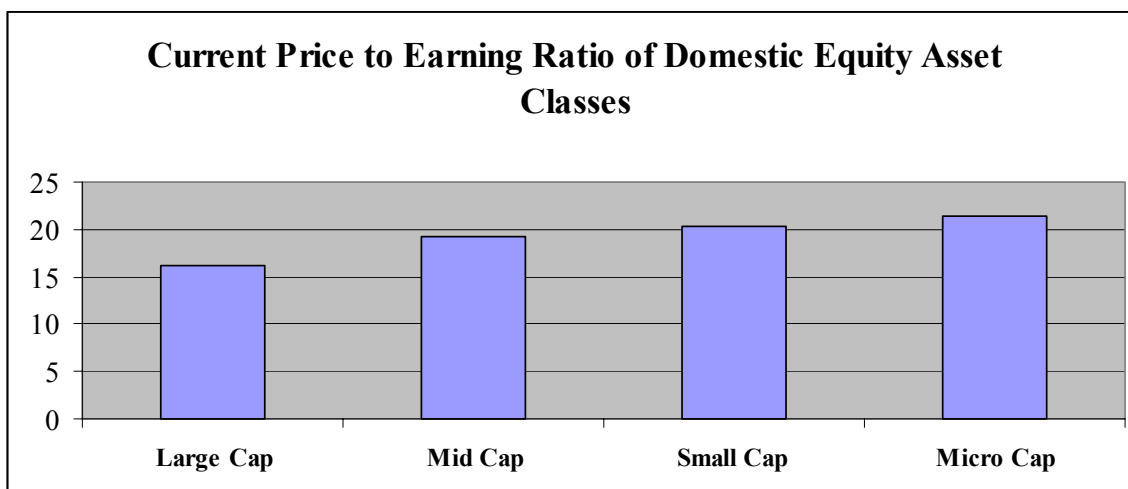


Source: Standard & Poor's, Data subsequent to December 2006 is based on estimates by Standard and Poor's and may or may ultimately prove to be correct, of course.

What the graph above shows is that US Large Cap stocks are currently at least a reasonable value. Meaningful and long lasting market declines are the products of historically expensive assets. Clearly US Large Cap stocks do not now fit that mold.

What about the other asset classes that compete for our attention and dollars? Let's first look domestically by comparing Large, Mid, Small and Micro Cap US Stocks. By doing so we cover virtually every stock starting with a market capitalization of just \$20 million at the small end up to and including ExxonMobil with a market cap of just about \$425 billion (about 21,000 times larger than the smaller company).

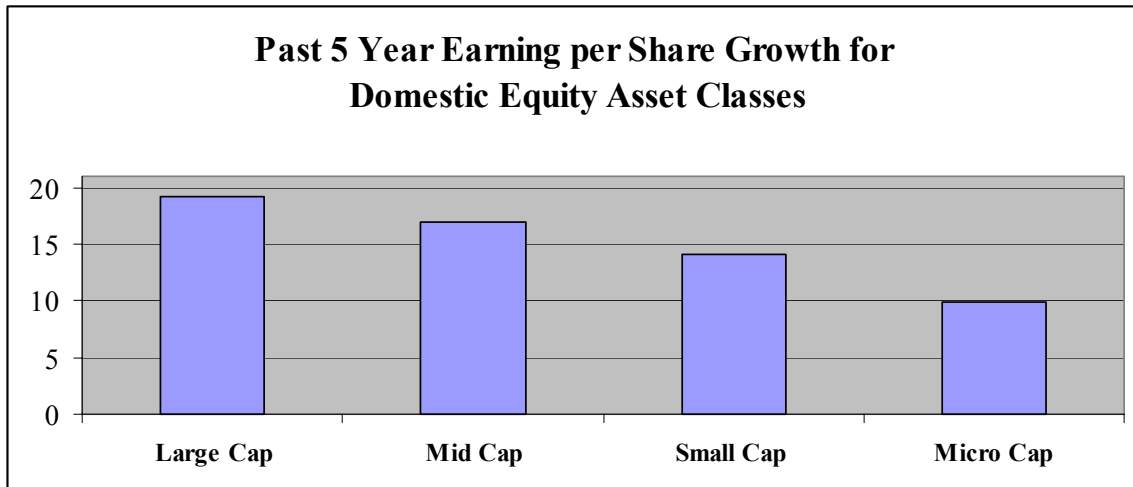
Let's begin by comparing the P/E ratios of the various market caps.



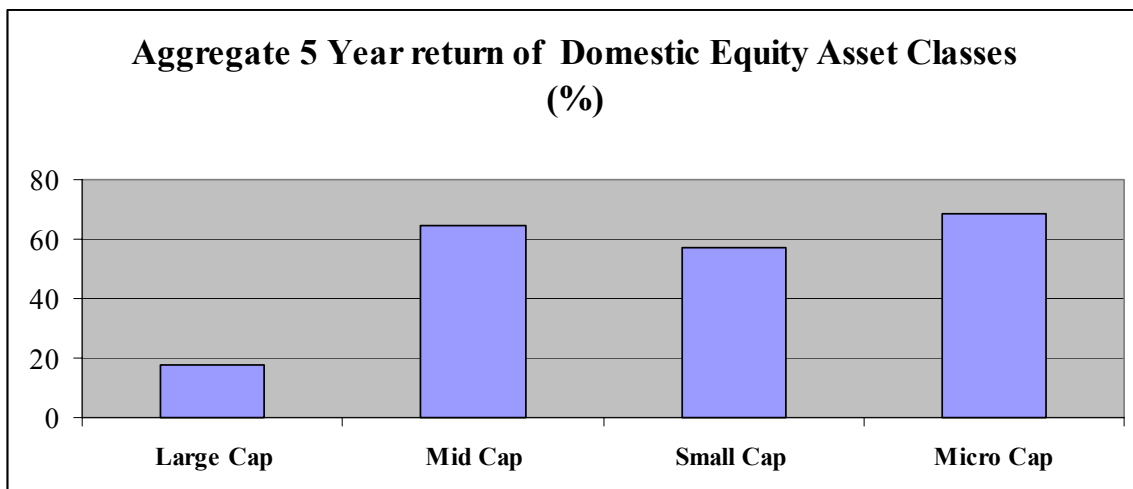
Important note: The Russell Top is used for Large Cap in this and subsequent graphs. The Russell Mid Cap Index is used for Mid Cap, Russell 2000 for Small Call and Russell Micro Cap for Micro Cap.

As this chart shows, Large Cap stocks are currently the “cheapest” of the domestic asset classes, with Micro Cap stocks currently having a price to earning ratio of over 20.

Next let’s look at the earnings growth of the various categories over the last five years.

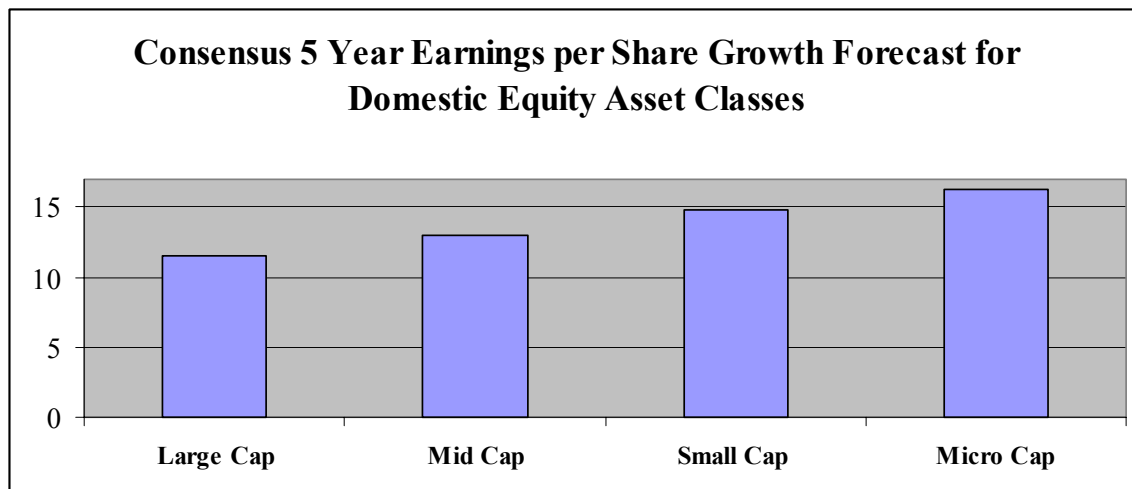


At first glance it would certainly appear strange that the asset class with the highest earnings growth would have the lowest price/earning ratio. As the graph below shows, not only does it have the lowest price/earnings but it also has had the lowest return by far of any of the asset classes over the last five years.



But, as the quote at the beginning of this commentary states you can’t just take recent results and assume that the trend will continue indefinitely into the future, or you’ll risk the equivalent of driving while looking in the rearview mirror.

So let's see what all of the pros say the earnings growth for the next five year will be for these asset classes.



Well now, that sure is interesting. The consensus (of all the brokers who cover each company in the respective index) is that earnings growth is going to magically grow 50% for Micro Cap stocks and decline almost 50% for Large Cap stocks. It would seem that they are arguing that what has gone up in price in the past will be justified by future earnings increases and what has performed poorly will be justified by slower earning growth. Said another way, we should discount reality in favor of their projections. Experience suggests to me that it may not quite work out this way.

Going back to our laundry soap analogy, the box of Large Cap brand detergent went down significantly in price and the box got much larger. The boxes of Micro Cap and Small Cap brands meanwhile went up significantly in price and the boxes got smaller. The consensus estimate, however, says that the Micro and Small Cap boxes will get bigger and the Big Cap box will get smaller.

This reminds me a little of the late 1990's, or any bubble for that matter. Market participants (the pros included) began employing ever more far-reaching and improbable forecasts and explanations to support the continuation of recent returns into the future. Anyone still have their copy of the 1999 book "**Dow 36,000, The New Strategy for Profiting from the Coming Rise in the Stock Market?**"

The next three asset classes to consider have been a little less mainstream for most investors, at least until the last couple of years. We can begin by discussing some attributes that apply to all three of these asset classes, Emerging Markets, Real Estate and Hard Assets. Among these is, relative to US Large Cap stocks, they all have equal or higher long term returns as well as having low correlations. The other significant attribute is that all three asset classes have enjoyed truly

remarkable returns over the last seven years and subsequently, an enormous increase in popularity and coverage. As you likely know, whenever anything begins to become too popular, I begin to get nervous.

You can just imagine my angst when I opened the Mutual Fund Quarterly Review section of the Wall Street Journal and the lead story was about..... Emerging Markets Funds and all of the money that has poured into them (remember, you pay me to get excited about this sort of thing). In 2005 \$20 billion of new money went into Emerging Markets funds followed by another \$22 billion in 2006. Without getting into gritty details, suffice to say that it's roughly equivalent to 10 people going into your local grocery store with \$100,000 each that they have to spend. You don't need a Nobel Prize in economics to figure out that prices are going to get bid up pretty quickly.

A recent commentary by David Wilson for Bloomberg.com pointed out that the value of China's stock market exceeded \$1 trillion dollars a few days ago, just as Russia's had done last month. He makes the comparison of these markets to the stock of Cisco, the computer networking giant and dot-com era darling. In 2000 some analysts predicted that Cisco would be the first company to reach a \$1 billion market cap. It didn't do that, but it did begin a plunge of 90% from its high not long after that. He further points out that the Morgan Stanley Capital Emerging Markets Index has gone up 312% in the last four years, just a mere eight percentage points less than the NASDAQ index's 1995-1999 rally. I'd better stop there before this starts sounding too much like all of those weird coincidences between Kennedy and Lincoln.

I've covered real estate quite extensively in past commentaries, so I won't cover it too deeply here. But much as we have discussed, the price/earning ratio of domestic stocks, it's worth taking a moment to cover the dividend yield of REIT Equities. These are simply Real Estate Investment Trusts that can trade on the stock markets. Nearly every account at the firm owns some in the form of a mutual fund or Exchange Traded Fund.

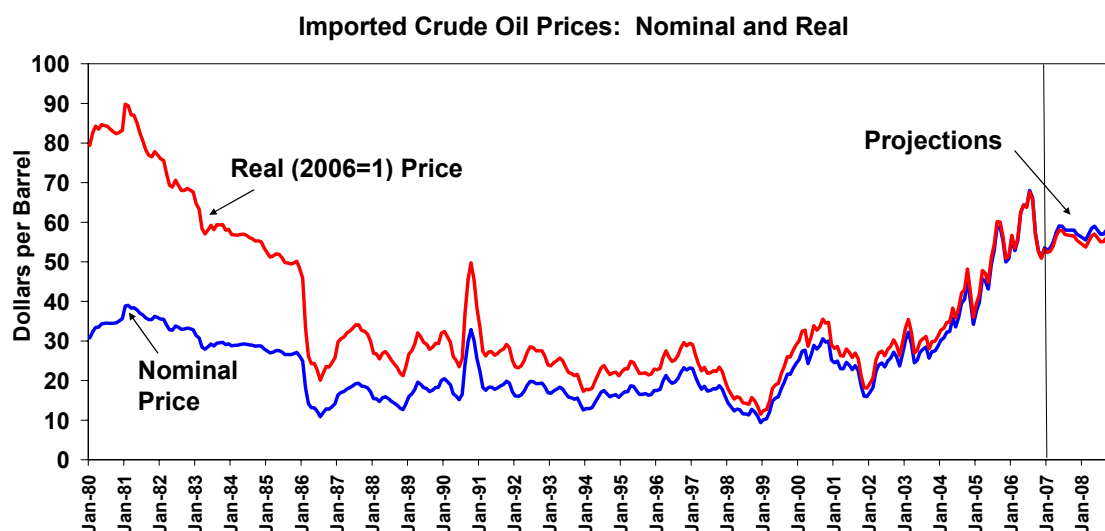
The index that tracks Equity REITs, the NAREIT Equity REIT Index (I don't make up these names) shows the index had a yield of 3.6% at the end of November, which was the lowest yield in the 35 year history of the index. In terms of price to dividends (what you pay for \$1 in dividends) the index currently has one of just over 27 versus an average of just under 13 for the life of the index. Said another way, real estate stocks are selling for about twice their long term average. It's probably worth noting that at the end of 1999 the index had a yield of 8.7%.

Our last asset class to cover is Hard Assets. This can be a particularly difficult asset class to value because it is really an amalgamation of a number of different commodities including Energy (oil, oil distillates & natural gas), industrial metals (aluminum, copper, etc.), precious metals (gold & silver), agriculture (wheat, corn,

etc.) and livestock. Hard assets are valued differently than financial assets, which is exactly what makes them so valuable as a portfolio diversifier. In short, hard assets simply don't produce dividends or earnings. In fact, they generally have "negative dividends" in terms of security, storage and other costs.

Another factor to be aware of before we discuss the valuation of Hard Assets is that the Goldman Sachs Commodity Index has a near 70% weighting to energy, nearly all oil related. So to a large extent as oil goes, so goes the Commodity Index.

The price of oil has been covered in great length in prior commentaries, so I won't go into great detail here. Suffice to say that the graph below shows that crude oil prices remain historically high in real dollar terms.



Source: Energy Information Administration

After looking around the equity investing topography we can come to some conclusions. Nearly every equity asset class has become at least somewhat expensive relative to its own history, with US Large Cap and perhaps Mid Cap stocks being the exception. US Large Cap stocks have had the highest earnings growth as well as the lowest total return over the past five years of any of the major domestic equity asset classes. Additionally, the return expectations for US Large Cap would seem to be the lowest of any major equity asset class. Other competing asset classes, Real Estate, Emerging Markets and Hard Assets would also appear to be near historic highs and accompanied by unrealistic future return expectations.

All of this adds up to make US Large Cap just the sort of asset we love. The one that is reasonably or cheaply valued and overlooked by the masses as they rush to jump on yesterday's expensive winners.

While US Large Cap stocks are beginning to look more attractive than the other asset classes mentioned, it's important to note that doesn't imply a wholesale abandonment of the other asset classes in favor of US Large Cap stocks. These other asset classes still perform an important function in terms of the diversification benefits that they provide because of their low correlations. In multi-asset class investing we rarely completely eliminate asset classes, but rather overweight and underweight them over time as market conditions warrant

In the coming year expect the equity portion of your allocation to continue to be increasingly comprised of US Large Cap stocks. Additionally money will continue to be taken off the table of those equity assets classes that have a low correlation to US Large Cap as those opportunities become available.

Sources:

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