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Financial Markets Commentary
4th Quarter 2006

Summary January 20, 2007

Last quarter just about everything went right for stock investors. As we have stated in previous reports, sometimes the most important development during a quarter is what doesn't happen. Investors expected higher oil prices as winter approached and they expected the economy to slow as the weak housing market cut into consumer spending. When it became clear that that this winter was going to be another mild one, oil prices began a downward descent that has continued to this day. Housing may or may not be a concern for the economy, but lower gasoline and heating oil costs have more than offset any negative effects housing might have had so far. Whenever markets are priced for a certain amount of risk and those risks are not borne out, stocks are going to be "re-priced" higher. In other words; "No inflation, No recession, No holding back!"

The average stock fund gained more than 7% last quarter and almost 16% for the full year. Mid-cap companies did not do quite as well, but smaller companies did slightly better. Oddly enough, the three industries that did best in 2006 each have some defensive quality to them – utilities (recession resistance), gold (inflation protection) and real estate (higher dividend, lower market correlation). The worst sectors were health care, technology, and biotech. Foreign markets were even more generous to U.S. investors due to the weaker dollar and higher growth rates overseas. International stocks gained 10.3% during the quarter and close to 26% for the year. Rising commodity prices and improving balance sheets led emerging markets to even larger gains (though that has reversed recently).

Bonds tend to do best when the economy is weak and inflation is low. Last quarter they got one out of two. As a result, most bonds earned their coupon, maybe a little less. For a bond yielding 4.5% annually, that comes out to about 1% for the quarter (just under what you would have gotten in a money market fund). Series I Bonds (TIPs) thrive when inflation expectations rise, so they were a decidedly poor choice (-1.3%). On the other hand, high yield bonds do not need the economy to be weak since they are more sensitive to default risk. They had an excellent quarter (up 4%). International bonds (+3%) benefited from a dollar that swung wildly but was weak more often than not.

Performance

It was a very good quarter to be aggressive, so it is no surprise that the All-Equity portfolio gained more than 8.4%. Risk-adverse asset like bonds and cash reduced returns, so to the extent that we sought to mitigate risk quarterly returns were less. The Balanced portfolio returned about 5.6%, for example. We have carried a higher cash (money market) position all year, partially for defensive purposes but mostly as a substitute for bonds (which carry more risk but actually yield less in most cases). Over-weighting value stocks versus growth stocks contributed to return all year, as did carrying a higher international stock position versus the benchmark and using more opportunistic bonds as opposed to more interest rate sensitive bonds. The inflation protected bond and commodity positions were designed to protect against inflation, but that threat did not materialize so those positions did not do well.

Outlook

2007 has already seen a sharp fall in energy prices, which has impacted the market quite a bit. Winners so far this year are commodity <u>users</u> (as opposed to commodity <u>producers)</u>. Lower energy prices also mean that the economic expansion should last longer, such that economically sensitive industries like technology are doing better and defensive industries like utilities are doing worse. Another interesting trend may be emerging countries asserting more control over their natural resources, if recent moves by Venezuela, Ecuador and Honduras are any indication. Emerging markets tend to be natural resource rich, so it will be interesting to see how their economies are affected by falling commodity prices. The other thing to watch for in 2007 is the possibility that the next move in interest rates <u>might be higher</u>.

Commentary

There are excess returns available to those who see something before the rest of the market does. There are also excess returns available to those willing to play a trend more aggressively. If you get in first, you buy in at a lower price than subsequent investors. If you employ leverage, you can profit more from an existing move. However, each strategy has its risks. If you are first in but wrong, you will lose money. If you are leveraged and the market moves against you, your losses will be much greater. For example, if you are among the first to realize the potential of a young racehorse, you will be able to bet on it at a price that is cheap relative to its chance to win. Eventually, as others discover the horse, the price on it becomes fair and perhaps (if the horse becomes the favorite) even overvalued. Even if it continues to win, you get less and less for betting on it. If odds fall from 4-1 to 2-1, you have to double your bet to win the same amount of money.

Investing is not gambling, but there are similarities. The price for certainty is high. In other words, you don't get paid well for taking a low risk position. The best returns come from identifying a position that seems to be high risk but really isn't. Conversely the worst returns come from buying a very risky asset at a price that assumes it is a safe one. Today, after four consecutive up years, it is very easy to believe that stocks are pretty safe. This is why investment managers have to be good "handicappers" (assessors of potential). Individual investors tend to be poor ones. Common investor mistakes include extrapolating past trends into the future and assuming that assets whose prices have been rising are less risky. For example, an investor might see that emerging markets have more than doubled over the past three years and conclude that emerging markets were an attractive place to invest. The professional would realize that at the very least there would be more downside potential now since valuations are not nearly as cheap. They would also question whether the factors that caused the high rate of appreciation in recent years were still present in 2007.

The bottom line to this commentary is that I don't believe investors are being fairly compensated for the risks that they are taking. The analogy I would make is this – if the market is a racehorse I am less and less inclined to bet on it because the potential payoff keeps declining even as the risks rise. Investors focus on its track record and not on the fact that it is aging and cyclical bull markets don't usually last more than five years. Many large investors are compensating by employing alternative strategies (leverage, private equity, etc.). These strategies are generally not appropriate for our investors. If stocks continue to rise (and they might over the short term as oil prices declines help consumers and businesses) this would more likely be a reason to take profits than to get more aggressive.

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