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INVESTMENT COMMENTARY

Equity Markets - After approaching the low for the year in October, the stock market rebounded during November and December to finish the year with a gain for the third consecutive year following the 2000 – 2002 "bear market". As shown in the table below, foreign stocks, especially emerging markets, continued to outperform US stocks. Significantly, growth stocks outperformed value stocks, reversing a five year trend. Value stocks sell at low multiples of earnings, dividends, and book value. Growth stocks trade at higher multiples based on the perceived ability to grow faster than the economy. During most reporting periods, value stocks have outperformed growth stocks, hence our preference for value style investing. But there have been periods, albeit shorter and less frequent, where growth stocks have sharply outperformed value stocks. We have believed that we are in one such period and we have been adjusting our portfolios to take advantage of this shift.

Fixed Income Markets - Bond market returns were meager, lagging the equity markets in total return. The yield on the benchmark 10-year US Treasury Note remained essentially flat through the quarter as the Federal Reserve Board continued to tighten monetary policy by ratcheting up short-term interest rates another ½%. As a result, the yield curve, i.e. the relationship of interest rate yields to maturity, flattened during the fourth quarter. Normally, the yield curve exhibits a positive slope with long-term rates higher than short-term rates. A flat or negatively sloping yield curve often signals a slowing economy.

Comparative Performance Indices Total Return for periods ending December 31, 2005[1]		Quarter	Year	3-Year Average Annual Return
U.S. Stocks	Russell 3000 Index	+2.0%	+6.1%	+15.9%
Foreign Stocks	MSCI EAFE Index	+3.8%	+10.9%	+20.8%
Taxable Bonds	Lehman Brothers Aggregate Bond Index	+0.6%	+2.4%	+3.6%
Municipal Bonds	Lehman Brothers Municipal Bond Index	+0.7%	+3.5%	+4.4%

The indices above are representative of investment asset classes. The Lehman Brothers Aggregate Bond Index is composed of U.S. Treasury, U.S. government agency, corporate bond, and mortgage-backed securities. The Lehman Brothers Municipal Bond Index is composed of general obligation (GO) and industrial revenue bonds issued by state and local governments. The Russell 3000 Index is composed of the 3000 largest U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market. The Morgan Stanley Capital International Europe, Australia and the Far East (MSCI EAFE) Index is a widely followed group of stocks from 20 countries, excluding the U.S. It is not possible to invest directly in an index.

Is the Dow Relevant? - As we entered 2006, many market commentators have been describing 2005 as a "flat" stock market. Such a characterization neither squares with the data presented in the table above nor, we are pleased to report, with the performance of most of our client portfolios. So what are these commentators talking about? They seem to be referring to the Dow Jones Industrial Average Index (DJIA), which ended the year -0.6% below its starting level. Add in dividends and the total return of the DJIA goes to 1.7%, positive but still significantly different from the broader indices cited in the table above. Although the DJIA is very well known and perhaps the oldest index, as a representative of investment returns, the DJIA suffers from at least two glaring deficiencies: composition and methodology. The DJIA Index only contains 30 large company stocks. 30 stocks cannot possibly accurately track a broad stock market of more than 10,000 actively traded stocks. Moreover, the names of these 30 stocks include many well-known companies whose stocks have recently been struggling. The second deficiency of the DJIA as a broad market indicator is its price-weighted methodology, which simulates a portfolio composed of a single share of each stock. Higher priced stocks therefore have a disproportionate impact on the index, distorting the total return calculation.

[1] Data from Lipper and WSJ Market Data Group as published in the Wall Street Journal, January 5, 2006.

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Consequently, the Dow Jones Industrial Average is simply not a useful indicator of broad market trends or a predictor of your portfolio's performance.

Market Outlook - The broader equity market indices tell a very different and far more positive story than the DJIA – a strong, three-year uptrend in US and foreign stocks. Will it continue? As noted in previous editions of this newsletter, we believe 2005 marked the beginning of a multi-year period in which asset returns will be lower than their historic averages. Stocks are now reasonably valued in relation to their underlying earnings, which have continued to grow at double-digit rates. Bonds are struggling against rising interest rates caused by tighter monetary policy and higher inflationary expectations. Real estate valuations are high and further price rises are likely to slow or turn negative. 1.) Current asset valuations suggest that future returns will be low. 2.) The time-tested theory of mean reversion suggests that periods of high returns, i.e. 1982 – 1999 for stocks, 1982 – 2002 for bonds, and 2000 – 2005 for real estate, are usually followed by periods of lower returns, i.e. reversion to the mean. 3.) And it is possible that the flat yield curve and the high current account deficit in the US are more indicative of a global glut of capital, implying sub-par returns on capital, than a forecast of economic slowdown. These three factors support our expectation of high single digit returns for stocks, low single digit returns for bonds, and low single digit returns for real estate. Though these expected returns may not be as exciting as the experience of the 1990's, a *low return* market is much better than a *no return* market!

Risks to the Low Return Scenario – What could cause low expected returns to disappear or turn negative for either temporary or extended periods [we can almost certainly guarantee negative returns for some temporary periods – remember our November letter]? Among the risks (there are many!) threatening our moderately optimistic scenario:

> ***Housing bubble*** – a sudden, rapid decline of residential real estate prices would almost certainly crimp consumer spending, cause an economic downturn, and result in loss of jobs and GDP tied to the housing and construction markets.
>
> ***Inverted yield curve*** – a sustained inversion may portend a significant economic downturn and resultant stock market decline.
>
> ***Oil price spike*** – sharply higher oil prices could sharply reduce economic growth rates, especially overseas where energy dependence is greater.
>
> ***Current account deficit*** – the US' high current account deficit, which we believe is caused by massive capital flows into the US, could cause foreign investors to lose confidence in the US dollar. If foreign capital ceases to fund our current account deficit and budget deficit, the Federal Reserve Board could be forced to raise interest rates sharply, curtailing economic growth and weakening the stock and bond markets.

Our Plan - Given the low return expectation across all asset classes and the risks cited above, increased diversification remains the most effective investment policy.

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