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INVESTMENT COMMENTARY

Market Review – To the surprise of many observers, both stocks and bonds surged during the third quarter (July – September). The markets apparently shrugged off concerns about geopolitical tensions, a housing market slowdown, and rising inflation expectations. Instead the markets reacted favorably to energy price declines, the Federal Reserve Board's decisions to cease raising short-term interest rates, and continued strength in corporate profits. Oil prices fell from $75 per barrel to close to $60 per barrel, a big move. Long-term interest rates (10-year U.S. Treasury bond) fell from 5.1% to 4.6%, also a big move[1]. And estimates of corporate profit growth, although subject to frequent and significant revisions, remained solid with double digit gains[2].

Comparative Performance Indices Total Return for periods ending September 30, 2006[3]		Quarter	Year	3-Year Average Annual Return
U.S. Stocks	Russell 3000 Index	+4.6%	+10.2%	+13.0%
Foreign Stocks	MSCI EAFE Index	+3.4%	+16.5%	+19.6%
Taxable Bonds	Lehman Brothers Aggregate Bond Index	+3.8%	+3.7%	+3.4%
Municipal Bonds	Lehman Brothers Municipal Bond Index	+3.4%	+4.5%	+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.

Within the broad equity markets, US stocks outperformed foreign stocks, "value" stocks continued to outperform "growth" stocks, and "large-cap" stocks outperformed "small-cap" stocks[4]. These trends were responsible for driving the Dow Jones Industrial Average (a misleading indicator of broad equity market performance in our opinion[5]) to record levels.

Market Outlook – So what do the markets portend as we enter what is historically a very strong time of year for the stock market? The yield curve, i.e. the relationship between short-term and long-term interest rates, remains flat to slightly inverted (long-term rates lower than short-term rates). Under these conditions, the yield premium for moving from money market funds (cash) to bonds is very low in relation to the inflation risk. The bond market seems to be forecasting a recession and near-term decline in interest rates. On the other hand, the stock market, normally an effective leading indicator of economic growth, is suggesting the opposite outcome.

How can the negative economic outlook of the bond market be reconciled with the positive economic outlook of the stock market? One possibility is the reversal of investment capital flows. Since the 2000-2002 stock market declines, investment capital had been flowing out of financial assets (stocks and bonds) and into hard assets (real estate and commodities). If this flow has begun to reverse, then large amounts of investment

[1] Yahoo Finance
[2] Bureau of Economic Analysis, U.S. Department of Commerce
[3] Data from Lipper and WSJ Market Data Group as published in the Wall Street Journal, October 3, 2006.
[4] Wall Street Journal, October 3, 2006
[5] Dow Jones Industrial Average represents only 30 large cap stocks, not the broad equity market - see January 2006 FMA Investment Commentary for more detail.

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capital will be seeking financial assets (stocks and bonds), keeping stock prices high and bond yields low. Such a trend could be enhanced by large amounts of corporate cash (10% of assets, 2x long-term average[6]) and foreign capital seeking the safety of the US dollar.

Until we have greater clarity around the apparent contradictory indications of the stock market and the bond market, we remain cautious and continue to hold above-normal levels of cash (money market) to guard against sudden market declines. Market volatility could be triggered by the same factors discussed in our previous FMA Investment Commentary – 1.) Inflationary pressures force the Federal Reserve Board to raise interest rates; 2.) Corporate earnings reports fall below expectations; 3.) Geopolitical/terrorist events occur in Korea, Iran, Iraq, or at home; and, finally, 4.) Anything else which if we could identify we could prepare for.

Stock Selection – Given the high level of stock prices and potential market risks, we are having greater difficulty finding stocks to buy which meet our value criteria. In selecting stocks for our client portfolios, we examine five principal factors - *Business Model, Valuation, Accounting Quality, Price History, and Catalyst*:

- **Business Model** – we look for solid, well-managed businesses with track records of profitability and revenue growth. The business must offer earnings and cash flow that are positive, scalable, and sustainable.

- **Valuation** – the stock price must be reasonable in relation to earnings, dividends, revenue growth rate, and numerous other fundamental factors depending on the industry. We prefer stocks with low valuations in relation to the fundamental factors.

- **Accounting Quality** – by gauging the relationship between earnings and cash flow, effective tax rates, intangible assets, and write-offs, we assess the degree to which the reported numbers represent the performance of the business. We do not buy stocks where the accounting quality is suspect.

- **Price History** – by examining the stock price chart, we can obtain an indication of whether the "market" is overvaluing or undervaluing the stock. We prefer stocks that are trading at the low end of their historical range.

- **Catalyst (our most important criterion!)** – we search for possible rationales to drive significant stock price appreciation over the next several months. Potential catalysts could include a reversal of negative news, a more optimistic assessment of the business opportunity, an anticipated dividend increase, or a myriad of other possibilities where our view of the business prospects differ from the prevailing view on "Wall Street".

And when some or all of these factors change significantly, we sell.

Conclusion - With the uncertain market environment and dearth of attractive buying opportunities on both the equity and fixed income sides of our portfolios, we believe that maintaining a diversified portfolio and holding some cash reserves are the prudent course.

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[6] Jason Trennert, Strategas, September 29, 2006