



INVESTMENT COMMENTARY

Market Review – The stock market continued its surprising surge during the fourth quarter of 2006, capping a very strong year for the equity markets. Inflation remained tame, oil prices remained relatively flat, interest rates were stable, and economic growth continued. The slowdown in residential housing was confirmed, although its effect on the economy seemed to be more than offset by strength in other sectors, including non-residential construction. The Federal Reserve Board held short-term interest rates at 5.25%. Long-term interest rates remained almost level as yield on the 10-year U.S. Treasury bond rose slightly from 4.6% to 4.7%¹. Corporate profits actually accelerated through the year, remaining well above double digit gains². The fourth quarter economic environment was very favorable for stocks and neutral for bonds, producing the broad market results in the table below:

Comparative Performance Indices		Total Return for periods ending December 31, 2006 ³		5-Year Average Annual Return
		Quarter	Year	
U.S. Large Stocks	Standard & Poor's 500 Index	+6.7%	+15.8%	+6.2%
U.S. Small Stocks	Russell 2000 Index	+8.9%	+18.4%	+11.4%
Foreign Stocks	MSCI EAFE Index	+10.0%	+23.5%	+12.4%
Taxable Bonds	Lehman Brothers Aggregate Bond Index	+1.2%	+4.3%	+5.1%

The indices above are representative of investment asset classes. The Standard & Poor's 500 Index is composed of 500 large company stocks chosen to represent the broad U.S. equity market. The Russell 2000 Index is composed of U.S. companies ranked from 1001 to 3000 based on total market capitalization, representing smaller company stocks with market capitalizations typically below \$1.5 billion. The Morgan Stanley Capital International (MSCI) Europe, Australia and the Far East (EAFE) Index is comprised of a widely followed group of stocks from 20 countries, excluding the U.S. The Lehman Brothers Aggregate Bond Index is composed of U.S. Treasury, U.S. government agency, corporate bond, and mortgage-backed securities. It is not possible to invest directly in an index.

The Pricing of Risk - As 2006 progressed, the price of financial risk was devalued as riskier asset classes consistently and significantly outperformed safer assets. In the taxable bond market, the flat yield curve offers virtually no incentive to extend maturities. Is there no interest rate risk? With corporate default rates at historical lows and strong investor demand, spreads on corporate bonds remained less than 1% above U.S. Treasury rates⁴. As spreads between high yield (junk) bonds and investment grade bonds declined through the year to less than 3%, corporations took advantage by issuing a record number of high yield bonds. 71% of industrial corporate debt is now rated below investment grade, compared to less than a third in 1980⁵. Has credit risk disappeared too?

The pricing of risk has been similarly reduced in the public equity markets. As indicated in the table above, small company stocks outperformed large company stocks, foreign stocks outperformed domestic U.S. stocks, emerging market stocks outperformed developed country stocks, etc. Stock market volatility, an indicator of investor attitude toward risk, as measured by the CBOE Volatility Index, fell in December almost to the lowest level (December 1993) since the index was created in 1990⁶. Margin debt, another indicator of risk, rose by 22% to \$270 billion, approaching the record level reached in March 2000⁷. [And we remember what burst in March 2000 – the technology stock bubble!]

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, January 3, 2007.

⁴ WSJ Market Data Group as published in the Wall Street Journal, January 2, 2007

⁵ Wall Street Journal, January 4, 2007

⁶ Yahoo Finance

⁷ Wall Street Journal, January 2, 2007



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Real estate, private equity, and most alternative asset classes are experiencing similar reductions in risk premiums. Initial capitalization rates (net operating income divided by purchase price) for real estate transactions are extremely low by historical standards⁸. \$215 billion flowed into private equity firms, a record amount and 33% more than 2005⁹. Combined with the low cost debt, as described above, massive amounts of private capital are now chasing equity investments.

Market Outlook – So why is the price of risk important? What does the low price of risk mean for investors? Can we expect it to continue? Some answers are clear, while others are not, as they depend upon the factors which are driving down the price of risk. The price of risk remains important due to the fundamental relationship between risk and return. Investment returns are only available by accepting risk. High risk premiums suggest high future returns. Low risk premiums portend low investment returns. Have risks to financial assets diminished? Unlikely! Are the financial markets better able to absorb and disperse risk? Probably somewhat, but never completely. We believe the principal factor behind the apparent devaluation of risk is the large amount of capital around the world and the portion of that capital which continues to seek the size, safety, and growth potential of United States capital markets.

Though this period of low priced risk may continue for months or even years, bolstering the prices of risky assets, both experience and history suggest that interruptions or reversals are bound to occur. Events and shifts in investor sentiment tend to occur when least expected and in unpredictable ways. Here are a few candidates for triggering a change for the worse:

- Oil supply interruption and resulting price spike
- Congress increases taxes
- Inflation surge causes severe decline in the value of the dollar
- Liquidity crisis in a developing country, a hedge fund, or company
- Protectionist trade restrictions
- Geopolitical crisis – many possibilities

We hope the positive investment returns continue, but we expect interruptions. Maintaining a globally diversified portfolio and periodic rebalancing toward the long-term asset allocation objective is the best prescription for dealing with market uncertainty. In this unusual risk environment, where risky asset classes offer little expected return premium compared with less risky assets, we will continue favoring less risky assets such as large capitalization stocks over small capitalization stocks, developed country stocks over emerging market stocks, and short to intermediate term investment-grade bonds over long-term and lesser credit quality. And with money market yields approaching 5%, holding some cash in reserve is not a bad thing either!

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⁸ Wall Street Journal, January 2, 2007

⁹ Wall Street Journal, January 11, 2007