



INVESTMENT COMMENTARY

Market Review

The stock market continued to advance significantly during the third quarter ending September 30, 2005. The breadth of the advance, however, was spotty as energy, natural resources, and foreign stocks clearly led the way on rising oil and other commodity prices. The table below clearly shows the strength of the stock markets, especially foreign stocks, during the past three years as we are closing in on the third consecutive year of stock market gains following the 2000 through 2002 bear market.

Bonds suffered during the third quarter with both taxable and tax-free bonds producing slightly negative total returns. The interest rate yield on the benchmark 10-year U.S. Treasury bond increased from 3.9% to 4.3%¹, causing prices of intermediate and long-term bonds to fall more than the coupon rate. The Federal Reserve Board continued its steady policy of monetary restraint by ratcheting up short-term interest rates with two more ¼ point increases, ending the quarter at 3¾%². The yield curve, i.e. the spread between short-term and long-term interest rates, is much flatter than it has been at any time during the past five years. Generally, a flattening yield curve portends a weakening economy.

Comparative Performance Indices				3-Year Average
Total Return for periods ending September 30, 2005 ³		Quarter	Year	Annual Return
U.S. Stocks	Russell 3000 Index	+4.0%	+14.6%	+18.1%
Foreign Stocks	MSCI EAFE Index	+9.9%	+22.8%	+21.8%
Taxable Bonds	Lehman Brothers Aggregate Bond Index	-0.7%	+2.8%	+4.0%
Municipal Bonds	Lehman Brothers Municipal Bond Index	-0.1%	+4.1%	+4.2%

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.

Both Gross Domestic Product (GDP) and NIPA corporate profits continued strong growth. Second quarter GDP grew 3.3% while second quarter corporate profits advanced 16% year-over-year and more than 4% sequentially compared to the first quarter⁴. Though these numbers indicate strength in the economy, we note that they represent second quarter data and corporate profits are often a lagging indicator of the economy.

Energy prices continued to rise, with oil increasing more than 17% (52% year-to-date) to \$66 per barrel⁵.

Hurricanes Katrina and Rita hit the Gulf coast in late August with devastating impact on the region and uncertain impact on the future U.S. economy. The economic impact of disruptions to regional production and job losses may be offset by the stimulative effect of spending by the government (expanding Federal budget deficit) and the insurance industry for recovery.

¹ Yahoo Finance

² Bloomberg.com

³ Data from Lipper and WSJ Market Data Group as published in the Wall Street Journal, October 4, 2005.

⁴ Bureau of Economic Research

⁵ NYMEX Light Crude Oil from TFC Commodity Charts



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Current Outlook

As we enter the final quarter of 2005, we sense that the market outlook may be shifting. In the aftermath of Hurricane Katrina, consumer confidence plunged and inflation expectations rose sharply⁶. Between Iraq and aid for Katrina victims, Federal budget discipline is now very unlikely – the deficit will grow. The sustained high levels of oil and gasoline prices have reduced economic growth around the world. Whether these shifts prove to be temporary aberrations or the start of longer term trends will have implications for future economic growth, interest rates, and corporate profits – all drivers of stock and bond markets.

Despite concerns about the negative economic impact of Hurricane Katrina, the Federal Reserve Board has chosen to maintain its inflation-fighting stance by continuing to raise short-term interest rates. Further rate increases threaten employment growth and continued economic growth. Stopping the interest rate increases, though positive for the stock market, risks future inflation. With the U.S. dollar strong and energy prices having a much greater effect on foreign economies than the U.S. economy, these are difficult policy choices for the Federal Reserve Board, especially so with the search for the new chairperson underway.

In our last INVESTMENT COMMENTARY, we discussed the sustainability of real estate and energy prices. We have not changed our views that 1.) current levels of real estate prices are sustainable and 2.) the near-term direction of oil prices is down. Nonetheless, the factors cited above increase the risk to continued real estate appreciation, which has been a significant portion of consumer savings and wealth creation. And the longer than expected period of high energy prices has and will divert consumption spending, lowering economic growth around the world.

Although we maintain our optimistic view of stock market prospects for the balance of 2005, we believe that the risks of a market decline have increased substantially. We shall monitor your equity portfolios carefully and with caution. With taxable accounts, we will look for tax loss harvesting opportunities to offset realized capital gains and to help reduce your tax liability for 2005. In our opinion, bonds and other fixed income investments will continue to struggle against the headwind of rising long-term interest rates. As we enter a period of low returns for most asset classes, the best investment prescriptions remain diversification (by country, currency, industry, company size, asset class, and any other dimension you can imagine) and quality security selection (steady dividends, sustainable earnings, and conservative accounting practices).

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⁶ Bear Stearns, September 27, 2005