Quarter Notes
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Congratulations to Carlos

We are pleased to announce that our esteemed colleague Carlos Carbonell has received his designation as a Chartered Financial Analyst.

The Russell 2000 rose by 7.8% YTD. MSCI EAFE, which represents international stocks, is up 12.2% for the nine-month period.

The 10-year Treasury Bond ended the quarter with a yield of 4.63%, growing only 1.13% for the year. We are still in a time of an "inverted yield curve" where short-term interest rates are higher than long-term rates.

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Market Expectation Slow and Steady with a Soft Landing

Stock markets rallied at the end of the 3rd quarter, pushing the Dow near its January 2000 all-time high and to a 9% year-to-date gain. The S&P 500, still struggling to revisit levels of several years ago, has achieved a 7% year-to-date gain.

The markets, apparently anticipating a soft landing, slowed from the robust growth experienced through the first quarter of 2006, when the economy expanded at an annualized 5.6% rate. For the second quarter, growth slowed to 2.6%. The economy seems to be decelerating just as the Federal Reserve had planned in order to keep inflation in check.

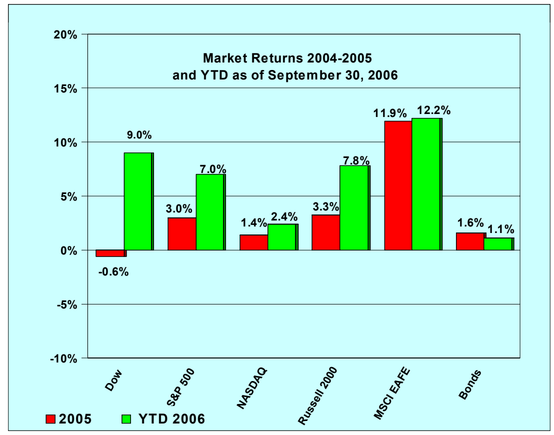
Some of the contraction can be attributed to the slumping housing market. August home prices declined for the first time in more than a decade. The inventory of unsold homes continues to increase, and prices are adjusting downward. If consumers begin to feel their wealth has declined, they might curtail their spending.

Energy prices have retreated from their highs, but inflation may still be a concern. Consumer prices are up 3.2% in the past year. Core consumer prices, which exclude food and energy, are also rising. The core personal consumption expenditure price index--the key inflation gauge followed by the Federal Reserve--has gained 2.5% in the past 12 months, the most since January 1995.

Large Cap Stocks

Stock prices of America's largest blue-chip companies have shown little or no growth during the past five years. But this is not the case with their earnings. Earnings of large cap stocks, as measured by the earnings on the S&P 500 index, have grown more than 200%. While the Dow Industrial Average recently hit new highs, the Dow is just an index of 30 industrial stocks and is not really an adequate measure of the stock market as a whole. The S&P 500 is a broader measure and, although it has its drawbacks, it is a better proxy for the overall market of large-company US stocks.

The S&P 500 is currently trading close to its five-year high, but has returned less than 1.5%



annually since January 2001. Compared with the long-term average return of 10%, this figure doesn't give us much cause for celebration. The largest of the S&P 500 companies, referred to as the S&P 100, fared even worse. This was despite record profit growth for the S&P 100 companies.

With stock prices slow to recognize the increase in profits, the valuations of the largest US companies look appealing. One measure of valuation frequently cited is the ratio of a company's stock price to its earnings, or P/E ratio. The largest 100 companies have a current P/E ratio of about 15, in line with their long-term average. (During the "market bubble" of 2000, many of these companies had P/E ratios at least twice this high.)

In addition to valuation measures, the largest US companies have used the low interest rate environment of the past few years to clean up their balance sheets, reduce debt , and increase their cash reserves. These resources could be put to use to expand operations or increase dividends, undertake capital improvements and acquisitions, or buy back shares. Given these options, investors might once again find these stocks attractive.

In the last few years, we have seen substantial run-ups in other asset classes such as small and mid-cap stocks, international and emerging market securities, domestic and international real estate, energy, metals, and other commodities. As the economy reaches the top of its cycle, these outsized gains cannot continue. The Federal Reserve's interest rate hikes, designed to keep inflation in check, are slowing economic growth.

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Tax Free Bonds

Only two things are certain: death and taxes. We can't do much about death, so let's look at taxes. If you are in a high marginal tax bracket, then you've made a lot of money. Nobody wants to pay more tax than they must.

Consider an investor with a 35% marginal tax rate who needs to allocate money to bonds. Current yields on intermediate high-quality taxable bonds are 5.8%. If taxed at the 35% marginal rate, only 3.77% remains after taxes. Municipal bonds with similar maturities now pay 4.6% tax-free. A taxable bond would have to pay 7.07% to allow you to keep 4.6% after taxes. The municipal bond provides a 1.27% advantage or an increase on after-tax income of over 20%.

Substituting taxable bonds in portfolios would certainly increase stated returns on our performance reports, but if you are a highly taxed investor, you would have fewer dollars, after taxes, in your pocket.

Emerging Markets

Emerging countries accounted for more than 50% of the increase in worldwide output last year, according to a September article in *The Economist* magazine. We have often discussed the higher expected growth rates of the emerging economies versus the forecasts for our own economic growth, but what that means for investors is more complicated than simply having a small emerging market fund allocation in your investment portfolio. A redistribution of the wealth of the world may be taking place during this part of the new century.

Technology created by the developed countries is being used in the emerging countries to ramp up their production. Emerging countries' commitment to capitalism and education is establishing a middle class where before there were only the very rich and the very poor. These new consumers will, in turn, increase global demand for goods and services. At the same time, the efficient use of global resources (including labor) results in higher productivity and thus increased global supply. That sounds like a win-win situation as overall global growth rises, but it won't be a smooth ride. Some of the short-term effects are problematic.

US workers are already feeing the pinch on wages. Unskilled and semi-skilled jobs have dwindled as businesses move production off-shore. "Off-shoring" is now expanding to include some highly skilled, technical positions such as accounting, engineering, and computer services.

The resilience of the US dollar in the face of our enormous deficits is directly affected by the huge foreign reserves held by the emerging countries. They use the dollars with which we buy their output to purchase our bonds. This helps finance the US debt and keeps us buying their goods. Foreign purchases of our bonds have kept interest rates on long-term bonds low despite 17 interest rate hikes by the Federal Reserve over the past two years. This subsidy of long-term interest rates has affected the US housing markets in ways we are just beginning to feel.

Ballooning energy prices, which in past cycles caused recessions, have not shut down global growth, because they are the result of increased demand from emerging countries rather than supply shocks. The inflationary impact of these higher energy prices has been mitigated by the cheaper goods consumers enjoy as a result of all this increased production.

Emerging markets have been considered a risky asset, in part because of political instability. The recent coup in Thailand highlighted that concern. The markets appear to have weathered this storm with limited damage to international investors. Overall, the credit worthiness and financial condition of the emerging market economies are in much better shape than when Russia defaulted on its debt in 1998. Political instability and the painful adjustments of capitalism still present risks. The biggest risk, however, is probably from our reaction to the loss of US economic prominence. The real risk we face is that a US recession will allow protectionism to prevail. The world won't be held back by our creating barriers for globalization. As *The Economist* noted, total US imports only accounted for 4% of world GDP. They don't need us as much as they used to and we have to accept that and deal with it.

Large Cap Stocks

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As the economy slows, we expect investors to favor quality, large-cap companies because the scale and resources of these companies put them in a better position to sustain growth.

We will probably never again see the huge run-up in large-cap stock prices that we saw in the last decade. Diversification has never been more important. Emerging countries continue to enjoy a higher growth rate than that of the developed markets. We can now own commodities through Exchange Traded Funds (ETFs) or through mutual fund proxies and we can now invest in international real estate using mutual funds. This means we can add more diverse assets to our portfolios. Although our enthusiasm for diversification has never been stronger, the case for a full allocation to large-company US Stocks is compelling.