Quarter Notes
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First Quarter Market Summary

The first quarter set the year off to a good start with many portfolios earning in the quarter substantially all of what they earned in 2005.

For the first quarter, the major market indices posted only modest positive gains. The Dow and the S&P 500 both gained 3.7% and the Russell 2000 was up more than 13%.

Despite a stronger dollar, international returns tracked by the MSEAFE index rose 8.8%.

The 10 year treasury bond finished the quarter at 4.85%. This rate is lower than we would have expected given that the Fed raised short-term rates throughout the quarter. At quarter's end the Fed Funds rate stood at 4.75%.

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After a Good Start, What Lies Ahead for 2006?

Are we having a short-term rally in the midst of a secular bear market? Kenneth Solow and Michael Kitces, in a recent article from *Journal of Financial Planning*, argue that we are. A secular bear market is a "period of years or decades, when general stock market index prices are either flat or falling." There are often periods of short-term market gains during a secular bear market, but the longer-term trend is negative or flat. The authors outline several strategies to enhance returns in tactically allocated portfolios, especially when market conditions are flat or bearish.

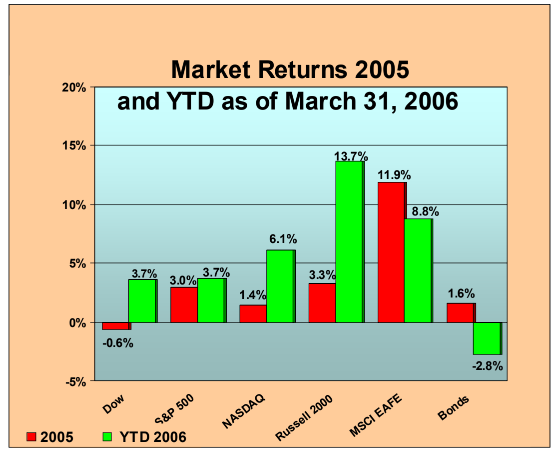
- **Concentrated portfolios.** The idea is that although the broad market will not be rewarding, some companies' stocks will still shine.

- **Sector rotation.** This usually refers to investing in specific industries which are particularly attractive for a period of time. It can also mean asset class rotation, such as temporarily overweighting international equities and underweighting domestic equities, or overweighting large-cap stocks and underweighting small-cap stocks.

- **Alternative investments.** Alternative investments attempt to provide return without regard to what is happening in the broad markets. For example, most clients' portfolios include real estate, an example of an alternative investment.

In news today, the economy is often being described as a *Goldilocks* economy. If you remember from your childhood, Goldilocks settled on the porridge that was neither too hot, nor too cold. She picked the warm bowl that was just right. The metaphor implies that the economy is stable (at least right now.) There is not enough compelling news, good or bad, to push it in one clear direction.

What's the good news that's propping up the economy? Corporate earnings are at an all-time high, GDP growth is reasonable, job growth is strong, wages are starting to improve, inflation is relatively steady, and interest rates are still relatively low. Capital spending by businesses has picked up and is expected to continue to grow, and European and Japanese consumers are starting to take some of the pressure off the American consumer as the final destination for the world's production. On the other



hand, the war, terrorism, inflation threats, energy prices, bird flu, and current account and budget deficits are all a drag on the economy.

Although we're not convinced that the economy is in the throes of a secular bear market, we do believe that tactical asset allocation has enhanced our client returns.Until there is a clear reason to significantly overweight or underweight an industrial sector, asset class, or position, we believe that remaining close to target allocations is the appropriate tact. That said, using some concentrated funds, small tactical sector plays, and the diversification benefits of alternative assets continue to serve our clients well.

Two Faces of Risk

Risk capacity is the ability to sustain losses and still meet your stated financial goals. If you have a large portfolio relative to your ongoing financial needs or a long time before you need to withdraw from your portfolio, then you have greater risk capacity. In other words, you could sustain a period of weak market returns without jeopardizing long-term financial goals.

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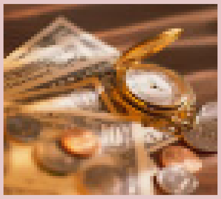

New Ira Limits

IRA Contribution Limits

Whether you choose a Roth IRA or a traditional IRA, there are contribution limits imposed by the Federal government. The chart below shows the maximum dollar amount individuals are allowed to deposit into their IRA each year.

For 2005, those under 50 can contribute $4000. For those over 50; $4500.

For 2006-07, if you are over 50 you can contribute $5,000 under 50; $4000.

In 2008 limits increase to $5,000 for those under 50 and $6,000 for those over 50.

20 Years Later, Asset Allocation Still Matters

In the spring of 1986 a paper was published that would change the nature of investment decision-making. Investment theory changes quickly and often radically, but the core findings contained in “The Determinations of Portfolio Performance” by Brinson, Hood and Beebower so far have withstood the test of time.

Developing investment policies and monitoring asset allocation decisions are now the core of investment management practice. But prior to this study, stock selection and market timing were thought to be a significant source of Alpha, the measure of value managers contribute to portfolio return. Brinson, Hood and Beebower analyzed the returns of 91 large pension funds from 1974 to 1983. Their main conclusion was that 93.6% of the variability of returns can be explained by the mix of assets, which we now call asset allocation or investment policy. They further discovered that security selection and market timing played only minor roles. Their 1991 update using data from 1977-1987 reached a similar conclusion, attributing 91.5% of return to the investment policy (asset allocation) decision.

Since that seminal study was first published advisors have pretty much convinced their clients that an investor’s most important decision is the investment policy that will guide the allocation of portfolio assets.

Subsequent studies have reached similar conclusions. In 1999 Surz, Stevens and Wimer divided the question of portfolio return into two components: policy and everything else. They concluded that policy actually explained more than 100% of return. This means that everything else was a detractor from return. They measured both pension funds and a cross-section of balanced mutual funds, comparing them to index (passive) portfolios with the same investment mix as the policy. Their final results concluded that while policy was the most significant driver of performance, skilled management did add value. The best-performing mutual fund managers added greater value, primarily because they were willing to make larger timing and selection bets than were the pension managers.

Given the conclusions of these studies, investment managers would be inclined to create static asset allocations and all passive or indexed portfolios. In our practice we have concluded that asset allocation should be a dynamic process. We take into consideration the investor’s unique goals and make tactical decisions based on current market opportunities and risks.

Like the professional pension consulting community, we separate the policy decision from the investment selection decision (choosing which investments are appropriate to fill an asset class). This permits us to focus on adding value by selecting the best investments within the strategic asset allocation framework we construct for clients. While we may have made a lot of refinements to the investment process over the years, the fundamental thesis of the Brinson, Hood and Beebower study does hold up 20 years later: policy is the most important decision we make in the investment process.

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Risk tolerance is more of an emotional issue, relying on an investor’s willingness to stick to an investment program despite market downturns. It has nothing to do with whether long-term financial goals will be realized, just with whether an investor can live with the hurt and uncertainty of seeing investments go down in value.

Often there is a conflict between someone’s risk capacity and risk tolerance. That is a problem if the portfolio is modest in size and it will be difficult for a client to meet financial goals without having growth-oriented assets. In such a case, if the client has a low risk tolerance, reality sets in and choices will have to be made and financial goals modified. This could mean having less income in retirement or having to work longer or sending children to public schools as opposed to private.

Alternatively, we occasionally see clients whose financial goals have been realized, but who want to assume greater risk and reach for higher returns. Generally, we try to point out that the risk associated with higher potential returns may not be necessary.