Quarterly Investment Commentary | *January 2007*

Most equity asset classes did well in 2006, with smaller-caps once again leading large-caps, continuing their run of out performance that began in 1999-2000. The small-cap Russell 2000 index was up 18.2%, while the large-cap S&P 500 was up 15.6%. **The value indexes vastly outperformed their growth counterparts across all market caps.** As a group, the broad universe of diversified equity fund managers underperformed their benchmarks, with value managers having a particularly tough year. Despite a multi-year run of great returns and uncompelling valuations, REITs surged by 35.1% in 2006 as investors continued to pile into the asset class. While a rational case can be made that REITs aren't severely overvalued, it is hard to imagine them performing as well as the broader equity market in coming years given current valuation levels. We sold our REIT funds at the end of 2006 and reinvested these proceeds in other equity asset classes.

December Benchmark Returns (Preliminary)

	Dec.	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	1.4%	15.6%
Russell 1000 Growth iShares	0.3%	8.9%
Russell 1000 Value iShares	2.2%	22.0%
Mid-Cap Benchmarks		
Russell Midcap iShares	0.0%	15.0%
Russell Midcap Growth iShares	-0.9%	10.4%
Russell Midcap Value iShares	1.0%	19.9%
Small-Cap Benchmarks		
Russell 2000 iShares	0.3%	18.2%
Russell 2000 Growth iShares	-0.3%	13.1%
Russell 2000 Value iShares	0.9%	23.2%
Other Benchmarks		
Vanguard Total Int'l Stock Index	3.1%	26.6%
Vanguard REIT Index	-1.8%	35.1%
Vanguard Total Bond Mkt Index	-0.5%	4.3%
Merrill Lynch High-Yield Bonds	1.1%	11.6%
Salomon Brothers World Govt Bond	-1.9%	6.1%
DJ-AIGCI (Commodity Futures)	-4.6%	2.1%
JPMorgan ELMI +	1.5%	12.3%

On the fixed-income side, domestic high-quality, intermediate-term bonds had a respectable year, with the Lehman Aggregate gaining 4.3%. Foreign bonds were aided by a currency tailwind, lifting developed markets foreign bonds to a 6.1% gain, while developing local markets short-term bonds (in which we have a tactical position) gained 12.3%.

A broad observation about returns in 2006 is that riskier asset classes generally did best. With a return of 26.6%, foreign stocks did very well, but the riskier emerging-markets asset class gained 28%. Back home, the high-yield bond benchmark was up about 11.6%, while the riskiest bonds in the high-yield universe—those rated CCC and below—gained about 19%. **And as noted, smaller-caps once again outpaced larger-caps.**

Investors' willingness to take on risk implies a lower risk premium. Interestingly, though, valuations for the S&P 500 reflect a different story: Our analysis suggests this index's valuation is either too low or investors are pricing in an economic slowdown, which wouldn't be good for risky assets. Meanwhile, real interest rates are very low, which usually means bond investors are worried about recession (suggesting risk aversion). **This is all an interesting dynamic to observe, and we can't always know who is right.** Valuation analysis is complicated by the participation of foreign investors and hedge funds, which have their own agendas that may have little or nothing to do with the aforementioned observations—for example, interest rates might not be low because of recession fears, but rather because foreign investors currently prefer our bonds to their own.

Investment Review

It was an eventful and at times tumultuous year in 2006. The ongoing difficulties in Iraq and the related shift in power in Washington D.C. were just two of the big headlines that most everyone watched with rapt attention. We too were interested in those events from a human-interest standpoint, although neither of them was especially significant from an investment standpoint**. Our mission is to focus on factors that can be analyzed with confidence and that are likely to directly impact our investment portfolios, and politics and international affairs rarely meet those criteria**. Below are some events we observed and evaluated with keener interest in 2006 and how we responded to them.

Oil and Energy Prices

We saw record oil prices in 2006. Oil started off the year around $60 per barrel, about $10 below its peak of the prior year, but still higher than what the markets had become accustomed to. As the months moved on, so too did oil prices, ultimately peaking near $80 per barrel, amid a widespread belief that this would either ignite inflation or cause the Fed to raise interest rates to a recession-inducing level. As is often the case, many assumed that this trend of higher oil prices would continue indefinitely (pundits were talking about the inevitability of $100 a barrel oil) although many of the managers and strategists we follow believed that oil prices would come down. The latter turned out to be true, and oil is back to roughly the same place at which it began 2006. **We don't make portfolio changes on the basis of something as difficult to predict as short-term oil prices, and we didn't buy the secular arguments that ever-rising oil prices are inevitable, so from an investment standpoint we didn't take any action in response to oil prices.**

Housing Prices

When would the housing bubble burst? Would the inevitable crash be deep enough to cause a crippling recession, or even worse? Those were the questions on everyone's minds at the beginning of 2006 amidst rising interest rates and a rapidly softening housing market. In fact, it was perhaps one of the most frequently asked questions we received throughout the year, as it was in 2005 as well. But focusing on disciplined, broader analysis suggested that while the risk of a housing decline was very high, the magnitude and spill-over into the broader economy was not sufficiently high to warrant a defensively oriented portfolio move. **We're glad we stuck to our guns on that, since a defensive posture would have caused us to miss out on a portion of the very good stock market returns for the year.** As of this writing, the housing market has already cooled off considerably, but it's still too soon to say how much further it might have to go.

Fed Policy

When we started the year, the Fed was about 300 basis points into its tightening cycle, and investors were beginning to grow concerned about the possibility of an interest-rate overshoot causing a recession. By the time summer rolled around, the Fed had added another 125 basis points to the Fed Funds target rate, raising these fears even more, and the stock market started to feel the pinch. However, once the Fed finally announced that it was on hold for future hikes, the market spent the rest of the year bouncing higher. **Today, there is growing talk of the economy cooling off, with some suggesting that a recession in 2007 has a real chance of materializing and that the Fed will begin cutting rates soon. This provides a nice illustration of the fickle nature of short-term sentiment.** In less than six months, the market went from concerns about rising rates, which could be damaging to the economy, to relief that the rate hikes were over, to fears of a cyclical recession (which would lead to falling rates). In the real world, things seldom change that quickly, and indeed, such movements are virtually impossible to predict. That is why we focus our energies on the factors that are knowable or at least can be reasonably estimated.

What is the message in all of this? First, it pays to be disciplined and rely on objective analysis when making investment decisions, and ignore emotion. It can be difficult at times—and in fact is the most difficult at the times it's most needed—but being rational and objective is a requirement to succeed at investing. **The other message is that keeping a focus on the long term is a big advantage.** Being in "reactive mode" is an almost sure-fire way to get whipsawed. The market reflects investors' sentiments instantaneously. By the time any of us start worrying about oil prices, a housing collapse, or rising interest rates, it is highly likely that the market has already priced in those concerns. **By reacting to our short-term concerns, we're most likely going to be taking action to "protect" us from something that has already happened.**

Going forward, our outlook for the coming years hasn't changed significantly despite the eventful year we had in 2006.

Equity Market Outlook

While the S&P 500 put up good numbers in 2006, the valuation picture has actually changed very little. This is because earnings have gone up along with stock prices, leaving the relationship between prices and earnings at about the same place. At year-end 2006, the valuation model we follow showed the S&P 500 as being approximately 18% undervalued (this model showed the market at a 15% discount to fair value at this time last year).

However, an interesting thing is about to happen with this model. One of the inputs used—normalized earnings—takes the average of the prior four years of reported earnings and one year's forecasted earnings. On 12/31/06, the last of the bad quarters from the 2002 earnings depression will roll out of the calculation, returning us to a more normal, although still cyclically inclusive, data set. When that change occurs, and assuming that the 6% to 7% earnings-growth consensus forecast for 2007 is approximately right, this model will show a 5% improvement in the valuation picture (meaning stocks will register as even more undervalued than they do now) even though nothing in the current environment has actually changed.

This model, like any valuation model, is little more than a rough approximation of general valuation levels of stocks. That is why we use several different methods that utilize a range of earnings measures and a variety of approaches, and we view them all in historical context. In order for us to conclude that the market is likely over- or undervalued, the overwhelming majority of these data points must point towards the same conclusion**. Today, a small number of approaches show the market as fairly valued, some show it as modestly undervalued, and a couple show it as being significantly undervalued.** We have also seen models that show the market as being overvalued, although we have less confidence in their underlying methodology, and therefore put less weight on those. **This leaves us with a valuation backdrop that is attractive, but not enough so to meet our criteria for a tactical overweight.**

As part of the mosaic that informs our long-term return expectations, we also like to factor in cyclical considerations. When we look at how long it has been since the last recession (about five years), it suggests the next may not be far off. On the other hand, there have been economic expansions lasting as long as nine or 10 years, in which case this expansion could have a ways to go. **But we can say for sure that the longer we go without a recession, the closer we are to the next one, and this is one reason to be careful about increasing the risk level in portfolios.**

Another cyclical variable we like to think about is recent stock market returns. While this is admittedly a backwards-looking variable, it helps contextualize where we are in relation to where we've been. As of year-end 2006, the trailing annualized returns for the S&P 500 were as follows:

1 year	15.6%
3 years	10.3%
5 years	6.1%
10 years	8.3%
15 years	10.5%
20 years	11.6%

What does this suggest? The most obvious thing is that we've started to recover from the big bear market in the early part of the decade. But it also tells us that returns over the last five and 10 years were below average, meaning that the bear market was so deep that it more than offset the run-up that preceded it. All things being equal—and in all fairness, they rarely are—a period of abnormally low returns is often followed by a period of better-than-average returns.

Much has also been made of the recent "new all-time high" for the Dow Jones Industrial Average, and that this suggests the market is overvalued. While we don't believe that the Dow is a particularly representative benchmark, this nonetheless provides a good opportunity to think about what it means. **True, the Dow is at a new all-time high. But the prior high occurred nearly seven years ago! In other words, we have only just regained the levels we last saw three-quarters of a decade ago.** To us, that's hardly a sign of irrational exuberance, and that is at least in part supported by the fact that domestic-equity mutual funds have been in net redemption mode during the second half of 2006. But what about the broader indexes that provide a more representative view of the overall market? The S&P 500 is the one we put the most weight on, and it is still more than 8% below its prior all-time high (reached on 3/24/00, almost seven years ago). And the Nasdaq is still an amazing 53% below its peak on 3/10/00. In fact the Nasdaq is at roughly the same place it was in January 1999, before the bulk of the bubble occurred. Let that sink in a moment: if you'd bought and held the Nasdaq eight years ago, you'd have a 0% annualized return as of today. Not exactly a spectacular return from a group that includes many dynamic and innovative companies.

Where does this all leave us? First, it suggests little in the way of froth in large-cap stocks. Attractive valuations tell us the market is either cheap—meaning returns going forward are likely to be better than average—or that the market is discounting a meaningful decline in the fundamentals. We've seen signs of slowing earnings growth and a deceleration in the economy. Part of this is normal cyclical behavior, and some may be in response to the slowdown in the housing market, but in either case it is clear that we're coming off of a spectacular period of earnings growth, and things are likely to cool off a bit.

While the overall equity exposure in our portfolios is at a neutral weighting, this doesn't mean we aren't seeing some opportunities within that universe. For example, the extended period of small-cap outperformance created a valuation disparity relative to large-caps, which caused us to shift some money from small-caps to large-caps. Another dynamic we've observed from many of the fund managers we speak to is that many high-quality companies—some of which were once the darlings of growth stock investors—are attractively valued. Interestingly, many of these stocks have not been performing well in recent years, causing many of our favored managers to underperform. We have not made any explicit moves at the portfolio level to overweight these stocks as there's no easy way to assess or implement this type of move.

Looking overseas, valuations of foreign stocks are slightly undervalued with their historical average relative to the U.S. and we have increased our international allocation. As always we prefer to let the geographical allocation be determined on a stock-by-stock basis by our fund managers.

Bonds and Bond-Replacements

Intermediate-term, investment-grade bonds: With the Lehman Aggregate Bond Index yielding better than 5%, intermediate-term investment-grade bonds are likely to generate annual returns in the 4% to 6% range on average over the next five years. The beauty of bonds is that their returns are based on straightforward math. For example, we know that if interest rates go from 5% to 3%, a bond yielding 5% with a 4.3 year duration will return 5.7% annualized over a five-year period. Individual calendar years can be higher or lower, depending on the pattern and timing of rate changes, but on average we expect bond returns going forward to be generally in line with their long-term historical average.

Emerging-market short-term bonds (local currency): The U.S. current-account deficit remains near its worst level in history. Sustaining this imbalance requires that overseas investors continue to invest in the U.S., either through purchases of securities, such as stock and bonds, or through direct investment in projects and businesses. The U.S. has been a desirable place for foreigners to invest, but over time their portfolios are becoming less diversified, and more exposed to dollar risk. If they were to slow their buying of our stocks, and more importantly U.S. Treasury bonds, it would put downward pressure on the dollar, and upward pressure on interest rates, which could harm the economy.

The dollar declined in 2006, most notably and significantly against the euro. Our positions in our two emerging market mutual funds did well, and significantly outpaced the domestic bonds from which they were funded. Not a whole lot of that return came from currency, however. And while the dollar has declined over the past few years against a basket of major currencies, it has declined far less relative to the group known as Other Important Trading Partners (which includes China, Mexico, and much of Latin American, and Asian emerging markets). Record-high trade deficits suggest that the dollar's declines to date have been insufficient to correct the root of the imbalance, and that on a long-term basis, the dollar is likely to experience further declines.

In addition to the overall decline in the dollar that we think is likely over the coming years, we also favor emerging-market short-term local-currency bonds because they have higher yields than U.S. bonds of similar maturity, and are further helped by improving fundamentals in many emerging-market countries. That said, this investment will not be a particularly good hedge if we see a disorderly collapse in the dollar. In that scenario, emerging markets could face pressure as a result of their strong ties to the dollar and a broad move away from riskier economies. Developed-market foreign bonds would probably do better in that kind of dollar-crash scenario, but are considerably less attractive in a base-case scenario (which we think is far more likely) because of their lower nominal yields, the fact that most developed market currencies, with the exception of the yen, have already had big moves versus the dollar, and that some countries with which our largest trade imbalances exist (such as China and Mexico) aren't represented at all in developed-market foreign bond fund portfolios.

Our municipal arbitrage strategy had another strong year as total return exceeded 12% and tax free income exceeded 8%. This has proven to be a favorable strategy as this investment has continued to generate strong absolute returns. Our hedged category also posted returns in excess of the Lehman Brothers Aggregate Index. Our allocation to hedged managers continued to be in the 20% - 25% range as we continue to believe these managers can perform better then the expected 4% - 6% returns from investment grade bonds.

Performance Discussion

2006 was an unusual year for our stable of managers as there was a synchronized and material underperformance of several of our managers. Our asset allocation was a positive and enabled our portfolios to outpace the Vanguard Balanced Index. As a reminder, we seek to add value both through asset allocation and manager selection. With few compelling tactical-allocation opportunities, our relative performance is more dependent on manager selection, and we know this is less reliable over shorter spans.

As always, we are in regular contact with all of the managers we use in our portfolios, and we are careful to understand what is driving performance. If any developments, performance or otherwise, impact our original basis for confidence in the manager, we will act accordingly. **That is not the case now, however, and we remain highly confident in our managers.**

We will say that the poor relative showing of some of our top managers in 2006 warrants the same caveat we've given frequently during our many-year stretch of benchmark-beating performance, which is that it is not realistic to expect a manager to beat a benchmark each and every calendar year. In order to outperform in the long term, a manager has to have the conviction to look different from the benchmark, and this will inevitably result in periods of underperformance. Lengthy slumps among even top-performing managers are common. Selling managers after slumps solely on the basis of performance is likely to result in poor long-term returns. We don't know if our performance will be better than our benchmarks in 2007, since our investment discipline is not based on predicting shorter time periods (which we think is not possible). But we are confident that over longer time periods our managers, and our portfolios, on the whole will beat their benchmarks.

In Summary

At current valuation levels, we think return prospects over the next five years are reasonably good under the scenarios we consider most likely—in a range from mid- to high-single-digits for our most conservative portfolios to perhaps low double digits for our all-equity portfolios. We can't predict the timing of those returns, except that it is highly unlikely that they will be smooth from year to year. We are confident, however, that by remaining aware of overall portfolio-level risk and setting allocations accordingly, taking tactical allocations only when highly compelling opportunities are presented to us, and using managers we believe to be highly skilled, we can earn above-average long-term returns while keeping our shorter-term downside risk within our loss thresholds. As always, we appreciate your confidence and trust, and wish everyone a prosperous 2007.

Lido Advisors Investment Team

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