

Quarterly Investment Commentary | January 2006

We're often reminded of the importance of discipline and long-term thinking in achieving sustained investment success. The lessons of 2005 reflect the importance of discipline and patience. It was a year with lots of macro-level worries (low interest rates, high commodity prices, high gas and energy prices, increasing account deficit, increasing budget deficits etc.). For much of the year markets were flat or falling but there were short periods when returns came in bunches. Timing these short bursts of performance would have been difficult. It was also a year when diversification away from the most mainstream asset classes paid off. Committing to a fundamentals-based asset allocation paid off. So, in the end, even though 2005 didn't feel like a very good year for investors, it wasn't too bad, especially for our clients.

December Benchmark Returns (Preliminary)		
	Dec	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	0.0%	4.8%
Russell 1000 Growth iShares	-0.3%	5.1%
Russell 1000 Value iShares	0.6%	6.9%
Mid-Cap Benchmarks		
Russell Midcap iShares	1.0%	12.6%
Russell Midcap Growth iShares	1.1%	11.8%
Russell Midcap Value iShares	1.0%	12.7%
Small-Cap Benchmarks		
Russell 2000 iShares	-0.5%	4.5%
Russell 2000 Growth iShares	-0.2%	4.0%
Russell 2000 Value iShares	-0.8%	4.5%
Other Benchmarks		
Vanguard Total Intl Stock Index	5.1%	15.6%
Vanguard REIT Index	-0.1%	11.9%
Vanguard Total Bond Mkt Index	1.0%	2.4%
Merrill Lynch High-Yield Master	0.9%	2.8%
Salomon Brothers World Govt. Bond	1.1%	-6.9%
DJ-AIGCI (Commodity Futures)	3.2%	21.4%
JPMorgan ELMH+	1.1%	3.2%

Stocks, as measured by the S&P 500, returned a boring but respectable 4.8%. But foreign stocks delivered a downright exciting 15.6% return (in dollars) mostly thanks to the performance of stocks in Japan and emerging markets. Overall, investors with global equity exposure had the opportunity for a reasonably good year. Within the U.S. stock market, based on most benchmarks, value-type stocks outperformed growth-type stocks for the sixth consecutive year (though in the second half of the year growth began to outperform). Value's outperformance was largely due to energy stocks, which were far and away the year's strongest sector. Outside of the equity markets, fixed income offered only small nominal returns and non-dollar bonds delivered slightly negative returns due to a stronger dollar, which resulted in currency losses. Other asset classes did better, including commodity futures (up 21.4%), and REITs (up 11.9%). In short, in 2005 investors were rewarded for diversifying beyond domestic stocks and bonds.

Performance Commentary

We would love to deliver fantastic performance for our clients every year. However, we've learned through our own experiences and from our study of and contact with many great investors that pursuing greatness year in and year out is not only unrealistic, it is not wise. Even the best are wrong sometimes and miss out on some opportunities. Eventually, for virtually all investors, at some point the experience is humbling. Acknowledging this, we focus on the more realistic goal of having a high batting average. **We do this by following our discipline and only deviating from each portfolio's neutral asset allocation when there is a clearly compelling ("fat-pitch") opportunity that we strongly believe either raises the portfolio's return potential without materially increasing the risk, or lowers the portfolio's downside risk level without lowering return potential.** If we pursue only high-conviction opportunities we believe we greatly increase the odds of being right more often than we are wrong, which in turn can lead to good performance most of the time. Reasonably good performance most of the time can result in a very good performance over a very long time. We were rewarded in 2005 by having a high allocation (Up to 30% for some clients) in hedge funds and other alternatives and our investment in a Municipal Bond Arbitrage strategy substantially outperformed the bond market delivering tax-free distributions of over 10%. We were right in 2005, but that doesn't always mean our tactical decisions will pay off year over year, but over the long run we are confident they will.

We Think In Years (Not Months or Quarters)

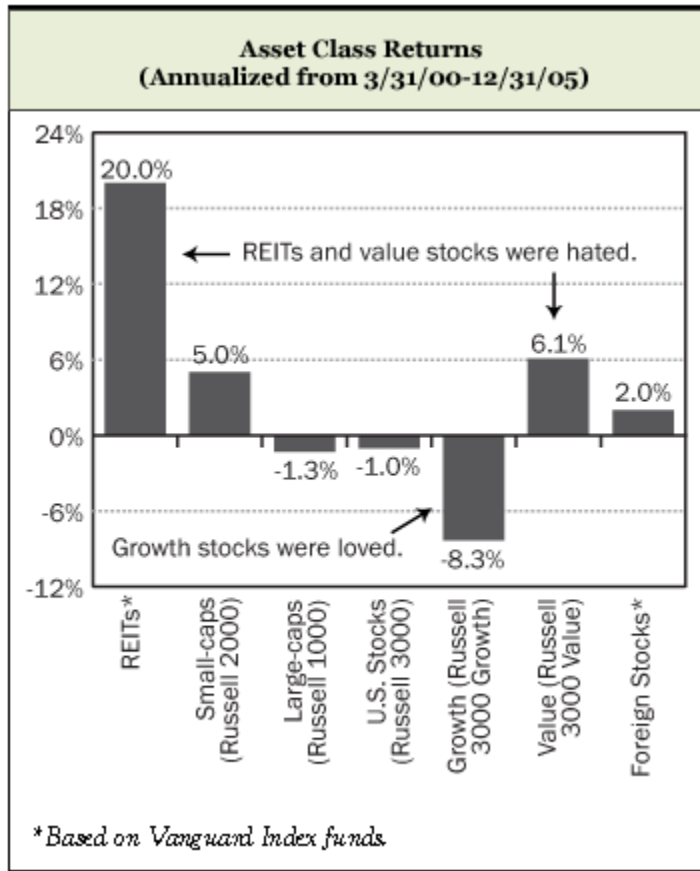
What was the popular thinking back in 1999?

- Large companies had a competitive advantage compared to smaller companies in the global economy. Small companies were at the mercy of their larger and more powerful peers who set prices and terms.
- "New economy" companies were the future and would continue to grow at very high rates. "Old economy" stocks would not deliver strong returns. Investors were discouraged from factoring in valuation or even profitability into their company/stock analysis. Revenue growth and price momentum were the keys to identify winning stocks, valuation be damned.
- U.S. companies and the U.S. economy had a competitive advantage. And because so many U.S. companies operated globally, foreign diversification was not necessary for investors.

For a while the conventional thinking continued to work. But by early 2000 many numbers were clearly signaling "danger" and others were flashing opportunity (though few investors were paying attention at the time). Large-cap growth stocks as measured by the Russell 1000 Growth Index were trading at 48.1x earnings and had delivered an average annual return over

the prior five years that exceeded 30%. This return was a red flag all by itself and the P/E was impossible to reconcile when the average value stock was selling at almost one-third that level. In another area, opportunity knocked with REIT dividends approaching 9% and REIT prices lower than they had been three years earlier.

As is usually the case, the markets did not cooperate with the conventional wisdom. Since 1999 small-cap stocks decisively outperformed large-caps and value massively outperformed growth. In fact growth stocks, as a group, remain below their levels of early 2000 and many of the "you can hold 'em forever" darlings like Cisco, Sun Microsystems, Nokia, Oracle, and Nortel Networks still sell at mere fractions of their prices back then. Over the same period REITs have compounded at over 20% per year and foreign stocks also strongly out-returned U.S. stocks.



Thankfully, back in 2000 and for several years thereafter, our portfolios were underweighted to large-cap growth stocks, overweighted to smaller-caps (including mid-caps) and value stocks, and included REITs, high-yield bonds, hedge funds and foreign stock exposure. These were unconventional positions in the late 1990s and we did not know when we would be rewarded. Initially we were not rewarded. But our valuation work was clear and we believed that regardless of the timing of the returns, at some point, maybe years into the future, we would look back and know that we made the right decisions. ***This is always how we think about our decisions—not expecting immediate gratification but with the goal of looking back years later and knowing we did the right thing.*** As it turned out, these asset class moves were major contributors to our strong record over the subsequent years, including last year.

Then Versus Now

When any investment or asset class is universally loved, investors should beware. But when an investment or asset class is hated, investors are often presented with great opportunity. Back in early 2000 it was easy to see what was loved and what was hated.

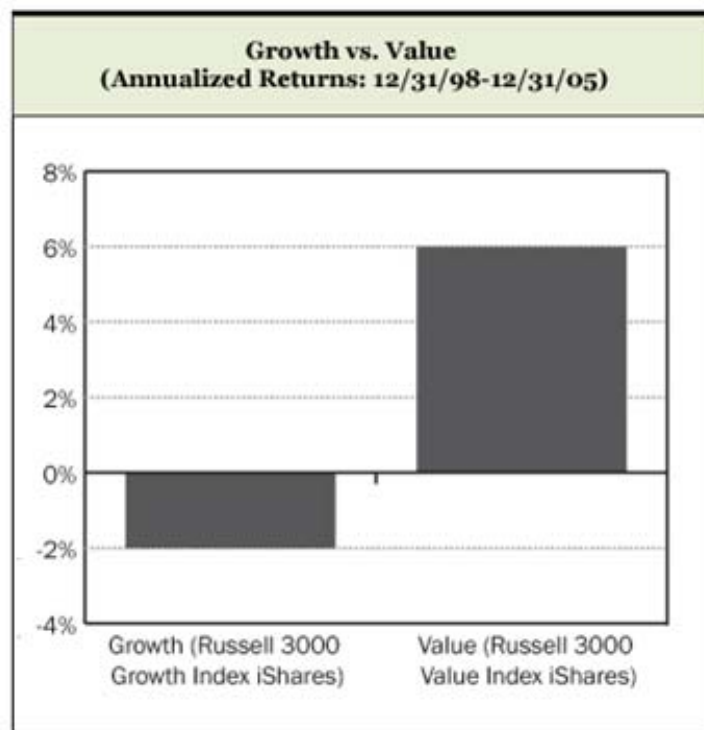
Today most asset classes are neither loved nor hated. The hated asset classes of 2000—value stocks and REITs—have hugely outperformed, while growth has been pummeled. Most asset classes are now priced about right, and while there are some potential opportunities, **there are no clear return-based fat-pitch opportunities.**

Growth stocks: With a sense of history it is perhaps not surprising that some of the best stock-picking opportunities probably now lie in the large-cap growth universe. After almost six years of huge underperformance and losses that are not yet close to being recouped (despite a strong rebound since late 2002) many companies are at least reasonably priced. And we continue to hear from many valuation-conscious managers that they are able to buy high-quality companies at prices that don't reflect the usual "quality" premium. **We**

have added a core position in a new large cap growth manager, but at this point we are not tactically

overweighted to growth stocks. However, because our value managers and GARP (growth-at-a-reasonable-price) managers hold some individual growth stocks that meet their valuation criteria, we are slightly overweighted to growth.

Large-Caps: After a lengthy period of stronger-than-expected earnings growth it is likely that growth will slow but remain positive. At this point S&P 500 earnings are forecasted to grow by over 10% once again. However, with a recent (and unusual) history of underestimating earnings growth we believe the bias may now be for analysts to again overestimate growth. And,

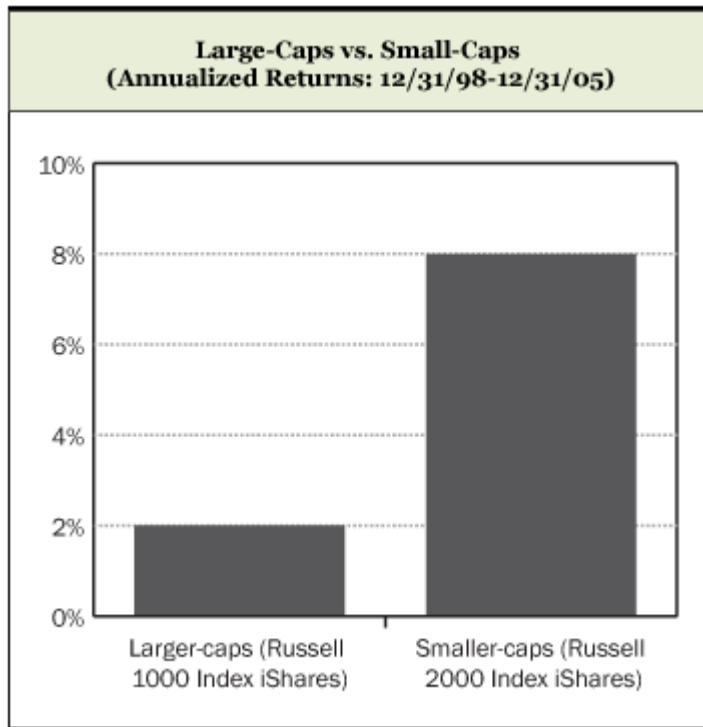


Value has trounced Growth since the end of 1998, despite a big growth year in 1999.

the risk seems to us to be that earnings will disappoint rather than surprise to the upside given rising borrowing costs, the signs of a topping of the housing market, already high profit margins and the age of this earnings cycle. But, even if earnings growth slows, the overall large-cap stock market looks somewhat undervalued and thus reasonably attractive given the possibility that at least mild multiple-expansion will move it closer to fair value. So despite a plethora of potential longer-term risks, we are maintaining a neutral weighting because stock prices suggest some margin of safety (the risks are at least partly reflected in stock prices) and returns that are likely to be better over the next few years than most of the alternatives. If stocks suffer a correction, we may take advantage of cheaper prices and move to an overweight position.

Small-Caps: Small-cap stocks look less attractive than they did a few years ago and less compelling than large-caps. Given their significant outperformance since the late 1990s, they now look slightly pricy relative to large-cap stocks. They also tend to perform best early in the economic cycle. Though it is hard to say how much of this cycle is left, it is not early.

Foreign Stocks: 2005 was a big year for foreign equities. The Japanese market was particularly strong in 2005 and this reflected continued and



important improvements in the health of the banking sector and corporate restructuring. But while the prospects for Japan look better than they have for more than 15 years, the country is still experiencing price deflation and the population is both shrinking and aging. Still, it all nets out to a more positive outlook than we've seen in close to a generation and this is reflected in all our International managers having at least a 20% allocation to Japanese stocks. Emerging

markets look cheap, selling at a P/E of just over 12x trailing earnings. However, on a price-to-book basis emerging markets look historically pricy. A key question is whether emerging-markets valuation metrics deserve to be upgraded due to the significant structural improvements in many of their economies (e.g., current-account surpluses, reduced debt levels, improved

disclosure, higher foreign currency reserves). We are reluctant to bet on a re-rating but our portfolios are exposed to emerging markets via our more diversified international funds (generally we are content to defer country and region allocations to our managers, unless the case is very compelling). We also have allocations to emerging market bonds.

Overall, we have increased our weighting to International stocks to between 10% and 15%.

Commodity Futures: We established a tactical position in commodity futures in some accounts in June 2004 using the PIMCO Commodity RealReturn Fund, which tracks the total return of the Dow Jones-AIG Commodity Index. This position was funded from a mix of equities and cash. We continue to view commodity futures as an asset class with valuable investment characteristics that include long-term return potential on par with stocks (and clearly better than bonds) and diversification benefits by virtue of the fact that they are often negatively correlated with stocks and bonds. Commodity futures are, however, tax inefficient, and for that reason when possible we make the investments within tax-deferred accounts.

REITs: After an initial sharp sell off, REITs have performed well since the spring of 2004. On a valuation basis REITs look somewhere between fairly valued to slightly overvalued. Part of the problem in analyzing REIT values is that REITs do not have a long history and really didn't become a full-fledged industry until the early 1990s. Relative to that history they look expensive, although we believe that historical comparison is misleading because REITs and (underlying) real estate were undervalued for most of that time period. Both real estate and REITs have undergone a valuation re-rating and now sell at higher multiples than in the past. We believe these higher multiples are largely justified and reflect their return potential compared to stocks and bonds. However, there is some risk that this re-rating will not hold. We have not added to our REIT position, but we continue to hold it and will do so until we identify another fat pitch opportunity.

Emerging Markets Bonds: This is a new asset class that we added to our portfolios in late 2004 (they have now replaced high yield bonds). The catalyst for our analysis of this asset class was the fact that corporate high yield bonds were no longer a fat pitch and we still wanted some bond exposure for client portfolios. Domestic bond yields were and continue to be low and with the improving fundamentals, credit upgrades, etc. in emerging market bonds we decided to eliminate high yield in favor of emerging market bonds. With vastly improved fundamentals in many emerging markets, this asset class gives us diversified exposure to a variety of currencies, a higher interest yield than we can get from other fixed-income vehicles, and minimal interest-rate risk because the maturities are very short.

On the negative side, in a typical recessionary environment, domestic investment-grade bonds would probably perform better. Overall, we believe the return potential is materially better than what we can get from U.S. bonds and that the asset class provides some protection against one of the big economic imbalances we worry about (the current account deficit and related dollar-crash risk). Their inclusion in our portfolios leaves us more exposed to cyclical risk, but our analysis leads us to believe that we have adequate defensiveness from other bond positions (Municipal Arbitrage) to keep losses at an acceptable level in a recession scenario. We do expect volatility in these bonds in 2006 as many Latin American and Eastern European countries are having presidential and parliamentary elections. The outcomes of these elections may cause some short-term price volatility.

Investment-Grade Bonds: Investment-grade bonds did not perform particularly well in 2005 as a wide variety of factors (including but not limited to the Federal Reserve rate hikes, foreign capital inflows within a world of capital abundance, oil prices, and inflation) contributed to the slight rise in intermediate-term rates from very low levels. Our view for some time has been that the return potential from bonds is not exciting with expected returns over extended time periods fluctuating around their yield.

From a valuation standpoint, we are not excited about any asset-class opportunities. But we're not wringing our hands in worry. Very important to our "most likely case" is that current valuations throughout the equity markets suggest that over the next few years returns, while not spectacular, will be reasonably good compared to inflation. The trick in this type of environment is not to try too hard to find something that isn't there. **As we repeat often, it's a time for patience.** At some point there will be a shock to the global economy and markets. When that happens our portfolios will feel some pain but that is also when a fat-pitch opportunity is likely to appear with the potential for much better returns.

What About The Economic Imbalances?

The trade deficit, budget deficit, debt levels, and housing prices are all issues that we have written about over the years and that continue to worry us. Macro forecasting is notoriously difficult—with that caveat, here are our thoughts. It appears likely that the global economy will continue to put off any day of reckoning for some time. In the words of PIMCO, a fixed-income firm we regard highly, we are in a state of "stable disequilibrium." As long as it is in the interest of Asian central banks to provide the funding for the U.S. consumer (when needed), the U.S. and the global economy will experience adequate growth. It is likely that this environment will continue for the next several years unless Asian inflation spikes higher. This will likely occur within a backdrop of only moderate inflation given healthy productivity growth

and an abundance of global labor and productive capacity. Thus,



Low current yields will limit bond returns going forward.

consumer spending, though slowing, is likely to stay strong enough to support the U.S. economy.

And, happily, Europe's economy is showing signs of strengthening and so is the Japanese economy. A worry is that the housing market is showing signs of rolling over in some areas and that if this spreads it would be very likely to slow consumer spending. However, the most likely scenario is that house prices slow and flatten but do not

collapse. In that scenario, research we have reviewed suggests that spending would also slow but not collapse and could be largely offset by a healthy corporate sector and improved growth in the rest of the developed world. In the very long run the imbalances cannot indefinitely continue to grow worse. There will have to be a reversal. **However, the large supply of global capital is the ultimate reason why it seems likely that the day of reckoning is not near.** And even layering in some pessimism and assuming some of the structural imbalances end badly, current equity valuations suggest that after accounting for a bear market at some point, long-term (10-plus years) returns can still turn out okay, which is to say, competitive with inflation. That is the more negative outlook.

Watchful in 2006

As we head into the New Year we take comfort in the reasonable valuations we see in almost all asset classes and the risk reduction we gain from prudent diversification. We are not particularly worried about the slight yield-curve inversion that was widely reported as 2005 drew to a close. It is true that when short-term interest rates move

higher than longer-term rates a recession often follows, but there have been exceptions and this is likely to be one. Dan Fuss, manager of Loomis Sayles Bond, and others we respect believe that the overall level of interest rates is too low to constrain economic activity to recession levels. He also believes that the inversion is impacted by the imbalance between long-dated bonds and the demand for them. While the inversion is not a major worry, as always we will be watchful for signs that the big-picture risks that lurk in the background are becoming more threatening. If, for example, the housing market takes a severe and more widespread hit than what we think is likely, the U.S. and global economy would almost certainly fall into a recession and equity markets would suffer a sharp sell-off. Our portfolios would be hit in that scenario, though we believe in most scenarios they would not violate their stated risk thresholds. In general, inflation and interest rates, income growth, spending, and currency relationships will be some of the variables we'll watch. These factors all have the potential to impact earnings. Most importantly we will stick with our core competency and carefully assess asset-class valuations (which are also impacted by many of these variables), for signs of opportunity or increased risk. **Through it all we will patiently wait for the next fat pitch.**

—Lido Advisors Research Team (1/10/2006)

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