Quarterly Investment Commentary | *July 2006*

June Benchmark Returns (Preliminary)	June	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	0.1%	2.6%
Russell 1000 Growth iShares	-0.4%	-1.0%
Russell 1000 Value iShares	0.6%	6.5%
Mid-Cap Benchmarks		
Russell Midcap iShares	0.1%	4.8%
Russell Midcap Growth iShares	-0.4%	2.5%
Russell Midcap Value iShares	0.6%	6.9%
Small-Cap Benchmarks		
Russell 2000 iShares	0.6%	8.1%
Russell 2000 Growth iShares	0.0%	6.0%
Russell 2000 Value iShares	1.2%	10.3%
Other Benchmarks		
Vanguard Total Intl Stock Index	-0.4%	9.5%
Vanguard REIT Index	5.3%	13.2%
Vanguard Total Bond Mkt Index	0.1%	-0.9%
Merrill Lynch High-Yield Bonds	-0.4%	3.0%
Salomon Brothers World Govt. Bond	-1.1%	2.8%
DJ-AIGCI (Commodity Futures)	-1.6%	3.6%
JPMorgan ELMI +	-1.0%	2.3%

The markets bounced around quite a bit during the second quarter, with the S&P 500 reaching a year-to-date high in early May before sliding sharply, then recovering at the end of June to finish the quarter down 1.4% (YTD the S&P 500 was up 2.6% through the 2nd quarter). The small-cap Russell 2000 Index dropped 5%, while foreign stocks managed a slight gain for the quarter. Value stocks continued their dominance over growth stocks in the second quarter. Domestic investment-grade bonds and emerging market short-term bonds were flat, but commodity futures fared better, gaining roughly 6% over the three-month period.

The past several weeks have certainly been a wake-up call to many investors. For a few years now, investors seem to have taken comfort in a number of things: **the fundamentals looked good in most parts of the world; we have gone more than three years without a market correction; and there was lots of money looking for a home.** This money came from many sources, including hedge funds. These vehicles have grown in popularity and influence, and in many cases their managers have been looking anywhere and everywhere for places to eke out some extra return **(We have invested in these vehicles for our clients for many years and still believe there are hedge fund strategies that offer compelling risk/return characteristics).** These funds often use leverage, and with the incredibly low interest rates we saw in 2003 and 2004 (especially in Japan where many hedge funds went to borrow funds) they could borrow very cheaply, then put that money to work anywhere it stood to gain more than the cost of borrowing. Corporate and high-yield bonds, as well as emerging markets securities, were likely big beneficiaries, and it's very possible that commodity futures, and maybe even REITs and small-cap stocks were a part of this strategy as well. We invest in very few single strategy hedge funds, instead we invest most of our assets allocated to hedge funds in well-diversified funds of hedge funds.

We can't say for certain how much of these asset classes' behavior was due to hedge funds' involvement, but we do know that according to an article in *The Economist*, **hedge funds controlled more than $1 trillion in assets as of year-end 2004, and can account for more than half the daily volume on the New York Stock**

Exchange (and can have an equally large presence in every other financial market). Our point here is not so much to dissect hedge funds' impact on the markets, but rather to point out that a collection of factors has lead to an increase in risk-taking in the financial markets, and it has been a few years since something came along and rattled everyone's nerves. Therefore, it is understandable that the market gyrations we have seen in the last month and a half may have caught people's attention, even though these gyrations are not out of line by historical standards.

However, what suddenly caused things to change? Why is the market less "steady" than it was? We were amused to see a headline a couple of weeks ago, "Market Declines on No Economic News." What the author probably meant was that no news had come out that day to provide a clearer picture of where the economy is headed, and right now investors are feeling the need for constant reassurance—and no news meant no reassurance, which was a negative. Of course, the market does not have a mind of its own—it is just the aggregate reflection of many individuals' buying and selling decisions—**but investors' biggest concern seems to be inflation.** And in particular, it is concern over what will eventually happen if inflation persists and the Federal Reserve Board keeps raising rates.

Why Should We Worry About Inflation?

Inflation has many negative effects, and can be very disruptive not only to consumers (by raising the cost of living), but to the financial system and the markets as well. T**he bigger concern with inflation is that it increases the risk that central banks will overshoot in their desire to stamp it out with high interest rates, and that those high rates will tilt us into recession.** The hope among investors has been that the Fed will stop soon and that the economy will slow just enough to bring inflation back to the Fed's targeted range while leaving it healthy enough for decent earnings growth. As economic growth has continued to surprise on the upside—and the Fed has continued to raise rates—the risk of an overshoot (and the ensuing recession) has increasingly been on people's minds. This concern has probably been exacerbated by the fact that central banks have become less transparent about their future plans (probably because they are less certain themselves).

The big question we must ask ourselves is: What are the odds that continued inflation will lead the Fed to tighten to the point that the economy ultimately tips back into recession? **Cutting to the chase, we believe that the longer-term inflation picture is not too troubling.** Given the sizeable rate increases that have already occurred, and signs that the economy is slowing somewhat, our guess is that further rate increases will be limited and a near-term recession is not too likely. The risk is still there, but even if it materialized, we have the benefit of going into that scenario with stocks already at attractive valuations, so a cyclical bear market should not be too bad, and this would actually set stocks up for nice returns going forward.

We Think the Odds Favor a Benign Inflation Environment

There is a potentially large laundry list of counter-inflationary forces at work right now, and among the biggest of them is globalization. **Not long ago, the outsourcing of jobs was the big headline,** and while the media has chosen to focus on other things now, we still live in a very competitive world where 1) cheap labor is readily available in most industries, and 2) it is hard to raise prices when the competition is so stiff. If jobs go overseas, domestic consumers' aggregate wages may temporarily decline; and even if producer prices experience inflation (energy, etc.), any company with overseas competition is going to have a hard time raising prices to offset its higher costs. Their profit margins may get squeezed, but unrestrained price pass-through to consumers would be difficult.

Along with globalization, technology has had a big impact on productivity. Globalization and technology work together, and their combined impact have played—and will continue to play—a big role in keeping inflation in check through increased productivity.

Another force working against inflation—albeit a cyclical one—is a slowdown in the housing market. The counter-inflationary impact here could take many forms. A decrease in housing prices would likely have a negative wealth effect, causing consumers to cut back on spending. Similarly, without the tailwind of rising home prices or declining interest rates, homeowners are less likely to refinance or take out home equity, again leading to lower spending. The construction and financial services industries have grown tremendously in recent years in response to the booming housing market, and a slowdown could lead to layoffs; higher unemployment is usually considered recessionary, rather than inflationary. Also, with fewer families rushing to buy homes, there's less spending on all the goods that come along with a home purchase (furniture, appliances, etc.).

When we weigh all the evidence—both the aforementioned points as well as several others—we find it relatively hard to believe that a broad, dramatic, and sustained rise in inflation is likely in the foreseeable future. **Anything can happen in the short-term, but there are at least as many reasons to be concerned about recession as there are reasons to be concerned about inflation.**

Valuations Revisited

So if inflation is causing the market's problems, but we do not think those concerns are justified, does that mean stocks are undervalued and represent a fat pitch? The short answer is: Not yet. When we go through the math today, we do not feel like the margin of safety is large enough to compensate us for taking on the risk of an overweighting to equities. For us to take on that added risk, we want to feel confident that the market is being irrationally pessimistic by pricing in too much risk, and therefore that there is a very high probability of getting significantly above-average returns over the next five years. Additionally, we would have the expectation that any decline from that level—while possibly pushing us beyond our 12-month loss thresholds in the short-term—would represent an even better buying opportunity. From where we stand today (the S&P 500 is at 1250 as of this writing), we'd need to see a decline in the 5% to 10% range before feeling confident that an irrational level of pessimism was reflected in stock prices.

Having said that, we do believe that valuations—while not in fat-pitch territory—are quite attractive, and this means a couple of things. First, we believe that current prices are already discounting many of the risks. In other words, the market is anticipating a meaningful decline in the fundamentals. So there is already some expectation that a negative scenario—although not a "worst-case" one—will come to pass. The other possibility is that the negative scenarios fail to materialize, or that they are less than the market expects, meaning the market is cheap right now. If this is the case, the market will likely have a nice run-up as investors price in the new information, leading to five-year average returns that are quite good. We believe that there are many legitimate risks out there right now, and our best guess is that reality will lie somewhere in between the two outcomes mentioned above.

If and when the time comes to overweight stocks, we must also decide where the money will come from. Philosophically, we would want it to come from an overvalued asset class that does not add much in the way of diversification or that does not help the portfolio in adverse scenarios. Because of the way our portfolios are positioned—including exposure to emerging market fixed-income, commodity futures, REIT's as well as our alternatives (hedge funds) allocation—the recessionary ballast provided by investment-grade bonds is lower than we would normally have. Convention would have us reduce our bond exposure when increasing equities, but this would further reduce our recessionary protection. In looking at all of the options in a variety of scenarios, we would probably eliminate our commodity futures and REIT's, since our return outlook for these asset classes is not as high today as it was when we first established our positions.

A Brief Recap of Other Asset Classes

Our views on the other major asset classes have not changed much, in spite of the big moves some of them have experienced lately. Investment-grade bonds have performed poorly for several quarters running, which should come as no surprise given the Fed's persistent interest-rate hikes. Inflation has been on the rise as well, meaning that real interest rates are still somewhat low. The real question is what inflation will do going forward, and in spite of all the negative media attention, the bond markets are only implying long-term inflation of 2.7%. In this context, investment-grade bonds are probably in a fair-value range, and continue to play a very important role in protecting portfolios against losses during tough equity markets, especially in a recessionary or deflationary scenario. We continue to believe that emerging-markets short-term local-currency bonds will outperform domestic bonds over a multi-year time frame, in part due to their attractive yields, but more so because of the potential for currency appreciation; the current-account deficit remains a significant risk, and a decline in the dollar over time seems very likely. However, with the last interest rate hike there are now some attractive yields on certain government agency bonds. Some agency bonds with 9 month maturities are paying 5.50% with the interest free from state tax so we are beginning to see more opportunities in certain areas of the bond market.

In the equities arena, we continue to view large-caps as being attractively valued versus small-caps, even after the big drop in small-caps in May. Growth stocks also look good relative to value stocks; foreign stocks have had a significant run-up relative to domestic stocks, and are presently in a fair-value range. The aggregate-level data does not support asset-class shifts in our view, but many of the managers we use have the flexibility to range beyond the confines of their "style box," and we are more than happy to have them opportunistically buy stocks that are unconventional for their style. We think flexibility and opportunism are valuable in the hands of disciplined, thoughtful investors. What we do not like to see are managers who buy particular stocks or industries simply because "that's what's working." To us, that's just speculation and increases the likelihood of getting whipsawed.

Like equities, commodity futures have also been on a wild ride from the competing influences of rising commodity prices and fears over a Fed-induced recession. Futures prices are generally above spot prices, which may suggest somewhat limited return potential going forward, and the return prospects for stocks and bonds have been getting higher at the same time. Right now, we think the odds are good that stocks will outperform commodity futures over the next several years, although this may not be the case versus bonds. This makes commodity futures somewhat less appealing from a tactical standpoint, but they continue to have to value as a portfolio diversifier.

Conclusion

Watching stocks go down is not fun, but we must confess that as valuations have become increasingly more appealing, we are feeling a growing sense of excitement that a good buying opportunity could be occur soon. As long-term investors, we look for the silver lining in a bear market: The potential for better-than-average returns in the future. **By objectively looking at the data and considering what it implies in the real world, we can begin to differentiate between a serious long-term threat to investors and the short-term noise that causes many market participants to react based on emotion or fear.** In recent years, the fundamentals have been generally good or improving in most parts of the world, so there has been little in the way of market-rattling fear and a notable dearth of attractively priced asset classes. But if investors around the globe do act based on irrational fear, bringing markets lower in the shorter term as they demand a greater premium for taking on risk, we will welcome the opportunities it creates for longer-term investors like us.

—Lido Advisors Research Team (7/3/06)