Quarterly Investment Commentary | *October 2005*

The equity markets have generated fairly tepid returns year-to-date, but did relatively well in the third quarter. The S&P 500 rose 3.6% and the small-cap Russell 2000 gained 4.7%. REITs picked up 3.8% on top of a very strong prior two quarters. Among the equity asset classes, foreign stocks were the big star of the third quarter, gaining 11.7%. Commodity futures were also up strongly, as the Dow Jones-AIG Commodity Index climbed 16.6%, due in large part to soaring energy prices. Most investment-grade bonds were slightly in the red, but foreign bonds fared somewhat less well due to appreciation in the U.S. dollar.

September Benchmark Returns (Preliminary)

	Sept	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	0.8%	2.7%
Russell 1000 Growth iShares	0.4%	2.1%
Russell 1000 Value iShares	1.4%	5.6%
Mid-Cap Benchmarks		
Russell Midcap iShares	1.3%	10.1%
Russell Midcap Growth iShares	1.3%	8.2%
Russell Midcap Value iShares	1.3%	11.2%
Small-Cap Benchmarks		
Russell 2000 iShares	0.3%	3.3%
Russell 2000 Growth iShares	0.8%	2.5%
Russell 2000 Value iShares	-0.2%	3.9%
Other Benchmarks		
Vanguard Total Intl Stock Index	4.7%	10.8%
Vanguard REIT Index	0.6%	10.0%
Vanguard Total Bond Mkt Index	-1.1%	1.7%
Merrill Lynch High-Yield Master	-1.0%	2.1%
Salomon Brothers World Govt Bond	-1.9%	-5.1%
DJ-AIGCI (Commodity Futures)	4.7%	25.2%

Market Overview

Stocks — There is no shortage of things to worry about these days: hurricanes in the Gulf Coast, housing prices, massive current-account and federal-budget deficits, strife in Iraq, rising inflation, and others. We share these concerns, and spend much of our time evaluating how these risks could impact the U.S. economy and markets in the near and long term. It's tempting to give in to these fears and assume a conservative investment posture, but this would ignore another—and perhaps more important—variable, which is valuations. Valuations matter because they provide insight into what the market expects to happen, and sometimes those expectations are overly optimistic or overly pessimistic. When these situations occur, we can take advantage of these opportunities and reposition our portfolios to potentially enhance our long-term returns, *without increasing overall portfolio risk*. In fact, in some instances, such as when there is a fat-pitch opportunity, overall portfolio risk may be reduced.

Looking at the current market it appears that the S&P 500 is at the low end of a fair-value range (the range is 15% above or below the fair-value price for the S&P 500), and may even be undervalued. If there are no major blow-ups or there is no major cyclical downturn, we'd expect average annual returns in the high single digits (potentially even low double digits) over the next five years. (Despite the short-term economic impact of Hurricanes Katrina and Rita, we don't think a cyclical downturn is likely in the near term, though it is a real possibility at some point over a five year time frame. This risk is something we will continue to assess.) We have seen other valuation assessments that suggest the market is not undervalued, but the methodologies in which we have the most confidence suggest that the market is either attractively valued or is pricing in a higher-than-average level of risk. The latter may indeed be the case, and that impacts our conviction level in assessing the overall market and our tactical positioning.

The market always prices in risk to some degree, but it seems likely that the market is presently pricing in a somewhat greater-than-average level of risk. We too believe that there is a higher-than-average level of risk, but this apparent valuation buffer gives us some comfort that investors are not ignoring these risks. If one or more of the risks come to pass, it would be bad for stocks, and losses could be material over a 12-month time frame (perhaps as much as 20%, or even more in an

extreme situation). However, the fact that valuations are already reasonably attractive suggests that a big drop from current levels would lead to a buying opportunity. In the short-run, valuations seldom come into play as a backstop against losses; investors get scared and head for the exits, valuations be damned. However, the trade-off for that short-term pain would be that it would create an opportunity for better-than-average long-term gains.

Within the equity universe, we aren't seeing any attractive tactical opportunities. Small-cap stocks look a bit less attractive than large-caps. We have had an overweight to small cap stocks the past 2 years and have done very well for our clients. We are going to begin to unwind this overweight as small cap stocks are beginning to look less attractive of late. We have also seen data that suggests that growth and value stocks are within a fair-value range relative to one another (there is some evidence pointing to the attractiveness of growth stocks, but we do not find it compelling enough to warrant an overweighting). International equities have several things going for them: improving fundamentals in some areas such as Japan and emerging markets, and higher dividend yields and slightly better valuations than in the U.S. We increased our allocation to International stocks in the 1st quarter and have been rewarded with double digit returns thus far. REITs have had a good year but most measures suggest that they do not offer attractive valuations, and as such we are not adding to this position.

The continued strong upward move in commodity futures prices has probably reduced some of their return potential (at least over the short term). However, the primary structural elements of total return for the commodity futures index remain, and there are many plausible scenarios where commodity futures will perform either as well as or much better than a 60/40 mix of stocks and bonds. Commodity futures would likely do poorly in a deflationary environment, but over the long-term we still believe this investment will add value.

Fixed Income — Investments in the fixed-income world can be very tricky. For example, rising oil prices stoke fears of inflation, which is bad for bond prices, but at the same time there are concerns that high oil prices in conjunction with other factors (such as a slowing housing market) could slow economic growth, which is good for bond prices. Many statistics suggest the economy is going great, but the structural imbalances in the U.S. pose risks that could, at some point, cut the legs out from underneath the expansion. Economic forecasting is difficult, and calling turning points is even tougher. Even among the investors we hold in the highest regard there are diverging opinions about the direction of the economy. But while bonds are heavily impacted by the economic environment, fortunately we don't have to be able to forecast that environment to intelligently factor fixed income into our portfolio weightings.

In deciding how to allocate to bonds it is important to think about their purpose. Is it to provide income? Provide big returns to the portfolios when tactical opportunities present themselves? Our view is that most of the time bonds' most important function is to help offset equity losses when the markets are in flux. Obviously we are aware of—and sensitive to—the return prospects for different bond sectors, and this plays into our decision-making process, but the key driver is in assessing how they can help us "play defense" when times are tough for stocks. Right now, real yields on investment-grade bonds are very low, which suggests to us that they may be overvalued on a long-term basis (which is why our fixed income allocation to investment grade bonds has been minimal). However, if we experience a significant economic slowdown, bonds would experience some appreciation at a time when equity markets wouldn't be performing well.

So bonds are an important diversifier that help us manage risk. Even with their relatively low yields we expect them to generate returns in the 4% to 5% range, which would equal or outperform cash returns over the long run in most scenarios, including a "steady-state" environment in which we don't see any huge changes in economic conditions. We also continue to believe in foreign-currency denominated bonds and Emerging Market debt as prudent investments, and we are still heavily invested in a Municipal Bond Arbitrage strategy as an alternative to Investment Grade Bonds.

Scenario Analysis Review

Scenario analysis is an important step in our asset allocation process and one of the things we do on a regular basis. It helps us envision the investment consequences of many different events. The value of the exercise isn't so much in coming up with exact numbers, but rather in getting a better

appreciation of the risks and opportunities we're exposed to and how we might address those exposures.

In general, we focus on negative scenarios: How bad will a particular type of portfolio get hit if scenario A, B, or C comes to pass? Our loss thresholds are based on 12-month periods, so we usually frame our analysis over that horizon. However, we also consider multi-year time frames, and think about positive environments as well, which is important in assessing how much money we could leave on the table if we were defensively postured. Often, history serves as our guide, but we're careful not to put too much weight on the past since secular changes can make historical data obsolete. Our ultimate goal is to put together a portfolio with the best long-term expected returns, but that is unlikely to violate its loss thresholds. Coming up with a realistic set of return (or loss) expectations for a range of asset classes in particular scenarios, and then calculating how that would play out at the portfolio level, is the nuts and bolts of how we approach the project.

In our most recent analysis, we came up with a long list of scenarios. The ones we considered in depth included the steady-state scenario we mentioned earlier, a normal cyclical recession, a severe recession (where it is both long and deep), stagflation, a dollar crash, and U.S. economic resurgence (where the U.S. economy grows nicely and the rest of the world trails behind). Obviously these are not all of the scenarios that could come to pass, and there are some seemingly obvious ones that are not explicitly listed: a collapse in housing prices, a worst-case Katrina/Rita situation, a major terrorist attack, a hard landing for China, a financial crisis precipitated by the problems with huge financial institutions such as Fannie Mae and Freddie Mac. But as we considered these additional scenarios, we came to see that—to varying degrees—they each ended up having outcomes resembling one of the other scenarios we had already explicitly evaluated. For example, several of these event-driven calamities would have an impact on financial assets that looks like our severe recession scenario, where we assumed a 20% drop in equity prices (this has happened rarely in the past, especially in the absence of high valuations). A worst-case Katrina/Rita-driven economic outcome could look very much like our stagflation scenario. And so forth. The most important thing is to understand what can happen to our portfolios, and we believe the scenarios we examined achieve this goal.

In a couple of cases, the scenarios we studied resulted in portfolios violating their 12-month loss limits, but generally not by large amounts, and most of the other negative scenarios saw declines that were less than our loss thresholds. While we don't explicitly assign probabilities to any of these outcomes (there is ample evidence that even good analysts are poor at assigning probabilities) we think these are not high-probability scenarios. There are even less likely worst-case scenarios that could last more than 12 months, perhaps a couple years. Obviously this means that they are still possible, and would be very, very bad from an investment perspective, but we want to be careful about confusing severity with probability. The likelihood of having two consecutive 12-month loss threshold violations is remote, but not impossible. Also, in the event of such a situation, we would be carefully assessing a wide range of information, including valuation levels, and could make changes that either 1) reduce our risk exposure if we had a high conviction that things were going to get worse and that valuations weren't good, or 2) valuations might be attractive enough that we start overweighting certain asset classes with the goal of enhancing long-term returns when the markets eventually recover.

We cannot fully protect ourselves against every kind of risk and there is always some chance of a sizable equity market loss. In a worst-case scenario, we would violate our loss thresholds. The problem is that the only way to completely hedge this risk is to have very low allocations to volatile investments such as equities. But even bonds are not a perfect solution (we can imagine bonds losing 5% or more in a dollar crash or stagflation scenario, and they could even lose money if the economy did unexpectedly well). We have increased our allocation to alternative investments investing in Oil & Gas Drilling projects, long/short hedge fund managers and Opportunistic Equity managers which we believe offer much better risk/return characteristics then other asset classes. These investments still have risk, but we understand the risks and are confident in the managers' ability to make money in all types of environments. Trying to protect against all possible risks would result in a permanent, ultra-conservative asset allocation. That level of excessive pessimism can be just as detrimental to long-term returns as market disruptions: missing big up-moves can seriously reduce long-term average returns. This is why we own things like bonds, commodity futures, Municipal Bond Arbitrage, long/short funds, Opportunistic managers and foreign bonds to help us in the event that some of these risks come to pass, but we have always been willing to

accept a small chance that risk thresholds could be violated by what we believe would be a small amount in certain very severe scenarios. As always it is very important to make sure you are in the right type of portfolio for your level of risk tolerance.

Lido Advisors Investment Team (10/3/2005)

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