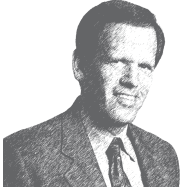

LETTER FROM THE PORTFOLIO MANAGER

December 2, 2005

Bah Humbug



Eric M. Kobren

November was a nice month for the financial markets, with the domestic equity market (as defined by the S&P 500) posting its largest gain of the year. In fact, it was the S&P's second largest one-month gain in two years (second only to last November's gain). However, despite some positive factors for the stock market, we are not so keen on joining the increasingly bullish consensus.

A Santa Clause Rally?

Frequently, the equity market enjoys a year-end rally, often referred to as "The Santa Claus Rally." In fact, for the Dow Jones Industrials going back to 1900, December is the month with the highest percentage of positive months: 73%. December also has the highest average gain: 1.5%. November is also typically a strong month, with an average gain of 1% and with 62% of the months since 1990 being positive. Looking at more recent history, the last ten years have mostly witnessed very strong finishes in the last quarter of the year, with the exception being 2002.

There are a variety of reasons for this seasonal effect. Many people get paid bonuses in December and that money often finds its way into the market. Money managers may take more risk (allocate more to stocks) at the end of the year, either to play the very seasonal effect we are talking about, or to make a last try to improve their relative performance, and thus their paychecks. None of these is completely convincing in itself, but a combination of factors, is probably the answer.

Sentiment Too Bullish For Comfort

So, given the seasonal trends why are we not getting more bullish? For starters, as long-term investors, these short-term considerations based on liquidity (that bonus money coming into the market) or sentiment (investors becoming more positive on the market due to the seasonal factors) have little impact on our strategic decision-making. Valuations, earnings growth, and interest rates are more meaningful variables in the positioning of our overall asset allocations.

That said, liquidity and sentiment are factors we look at when making shorter-term tactical assessments about entering or exiting longer-term positions. In that sense, investor sentiment which was negative a month plus ago (preceding the sharp run-up in prices), is at a bullish extreme. All else being equal, this is a contrarian sell signal that offsets the strong seasonal pattern.

Earnings — Less Than Meets The Eye

Another reason we are not quite so bullish is earnings. At first glance, earnings would seem to be a strong positive. At the end of September, year-over-year earnings growth for the S&P stood at 16%. That is more than twice the long-term average of 6-7% and earnings are expected to accelerate from

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here. The consensus market expectations for earnings growth six months out is 22%.

Again, however, we need to offset this outlook a touch. First, based off the table at right, it can be seen that from an historical perspective, the best stock market returns are generated when earnings growth is actually negative to slightly positive (between -20% and 5%). The reason, as we have noted in this space before, is that the market is a discounting mechanism concerned about what it expects to come, not where things are now.

In any event, we are not as positive on future economic growth as the consensus view. We do acknowledge the positive economic momentum currently in place but there are plenty of factors that would plausibly suggest a slowdown in 2006. First, higher short-term interest rates may finally begin to pinch. Second, energy prices are still well above year-ago levels. Energy costs do not have the same impact on the economy as they once did, but they still matter. Consumer debt levels are high and the housing boom that has supported consumption in recent years appears to be slowing, creating a recipe for slowing consumer spending.

S&P 500 Gain per Year When:	
Year/Year Earnings Growth is:	Gain/Year
Above 20%	1.20%
Between 5% and 20%	5.30%
Between -20% and 5%	13.10%
-20% and Below	-14.80%

The Market has done best when earnings are rebounding from losses (-20% to 5%). When earnings are growing between 5% and 20%, as they have been this year, the market has averaged a 5.3% gain - roughly in line with the market's gain in 2005.

Source: Ned Davis Research, Inc.

On Balance, Valuations And Interest Rates Are Neutral

Price/earning ratios have come down in recent years, but still remain elevated compared to long-term averages. Long-term interest rates are low, which can be a good explanation why we have seen above-average returns in recent years, but low interest rates also generally suggest lower returns moving forward. We remain with our long-held view that the primary backdrop to the market is that financial market returns will generally be lower in the coming years (3-5 years out and beyond) compared to historical averages.

Given these considerations, our strategy remains grounded in a fundamental investment discipline:

- We will continue to build diversified portfolios with exposure to multiple asset classes — including some unconventional ones (commodities, emerging markets, etc.)
- We will tactically adjust our asset allocations when we think we see “fat pitches” based off relative attractiveness.
- We will continue to search out active managers that we think are superior.

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- And we will remain firmly focused on keeping costs low.

New Research On Investor Behavior

We came across a recent survey presented by AllianceBernstein (the survey was conducted by the Advisor Institute and Financial Planning magazine). In the survey, nearly 600 advisors were interviewed (we were not among them) and 1000 clients (56% with advisors and 44% without). The questions were primarily centered around asset allocation and investor behavior.

Let me summarize a few key findings. First, approximately 75% of the investors surveyed felt that they understood asset allocation, could create a proper asset allocation plan, and had the discipline to stick with their plan. For those investors who used advisors, 25% felt that allocating and re-balancing a portfolio was the most important thing their advisor did for them. Another 41% felt that a thorough on-going personal interaction was the most important value.

However, the professional advisors surveyed felt that the actual *behavior* of their clients was very different. For instance, 88% of advisors felt that the media's attention to top-performers makes it hard to get clients to focus on core planning issues; 93% believe that few investors rebalance as often as they should; and 77% reported that it was hard to get clients to stick to their plan when markets were moving strongly up or down.

Perhaps the most heartening finding of the survey, however, was that only 12% of clients felt that the most important thing that advisors do is select specific investments. As the tag line of the AllianceBernstein presentation states (and we concur):

“It’s not about the right stock, the right fund, the right time to buy or sell, it’s about the right plan and, just as important, the right mix of investments.”

Sincerely,



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Co-Portfolio Manager