

2006 INVESTMENT COMMENTARIES: 4th Quarter, In Review

Most equity asset classes did well in 2006, with smaller-caps once again leading large-caps for the year, continuing their run of out performance that began in 1999-2000. The small-cap Russell 2000 index was up 18.2% for the year, while the large-cap S&P 500 was up 15.6%. I reduced small cap exposure in the 4th quarter, expecting that the large cap stocks will outperform. The "value" indexes vastly outperformed their "growth" counterparts across all market caps, large, mid and small. As a group, the broad universe of diversified equity fund managers underperformed their benchmarks. International stocks had another year of outperforming domestic stocks.

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 bonds (in which you likely have a tactical position) gained 12.3%.

Generally speaking, your portfolios lagged the S&P 500. Now this is to be expected in a bond heavy portfolio, but lagging the S&P 500 is not normal for most of you. The difference this year was that too many of our domestic fund manager's had a bad year, both individually and collectively. Bill Miller, manager of Legg Mason Value Trust had beaten the S&P 500 for 15 years in a row. Not in 2006. His return was 5.9% vs. the S&P 500's 15.5%. Does that mean we want to jump out of the fund? Absolutely not, he's a proven and highly respected manager. To have one bad year in 16 is still a great record. TCW Select Equities had a bad year from start to finish, underperforming its Russell Growth 1000 index by 15%, similar to Bill Miller. TCW holds 20-30 stocks and when a third of your holdings are significantly down for the year, as in their case, your whole portfolio (or in their case, mutual fund) suffers mightily. Am I selling it? No, because the reasons of why they own the companies that they do have not changed. This segment of the stock market (heavy in tech stocks) has underperformed the S&P 500 for at least the past six years. Sooner or later it will have a breakout year and it could be 2007, who knows.

With the S&P 500 putting up good numbers in 2006, and some market indexes reaching record levels, stocks may "seem" like they should be getting expensive. In truth, though, 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, my research company's valuation model showed the S&P 500 as being approximately 18% undervalued (the model showed the market at a 15% discount to fair value at this time last year). When something is undervalued by 18%, it means the prices are lower than the values and good deals present themselves. It's worth remembering that the new highs reached by some indexes are only now eclipsing levels that were first seen nearly seven years ago. If the S&P 500 is undervalued, growth stocks are undervalued even more.

With the Lehman Aggregate Bond Index yielding better than 5%, intermediate-term investment-grade bonds are likely to generate 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 I expect bond returns going forward to be generally in line with their long-term historical average.

I expected the commodity futures asset class to be volatile, and it lived up to expectations in 2006, with big quarterly swings in returns. Admittedly, as of early January, I am reevaluating my tactical rationale for owning PIMCO Commodity Real Return because it does not appear that it will outperform the stock market in the near-term and although it may return what the bond market returns, it will be at much greater risk. No one has more than a 3% position in it, but nevertheless I am looking at this right now.

If you have bonds, you likely have PIMCO Developing Markets Bond Fund. It returned 11.95% in 2006. In addition to the overall decline in the dollar that I think is likely over coming years, I 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. Additionally, because these are bonds in the countries of our trading partners, they are not as subject to the currency swings of the dollar.

In summary, at current valuation levels, I think return prospects for your portfolios over the next five years are reasonably good right now under the scenarios I consider most likely—in a range from mid- to high-single-digits for our most conservative

portfolios to perhaps low double digits for portfolios with 100% stock funds. (Past performance is no guarantee of future results.) I can't predict the timing of those returns, except that it is highly unlikely that they will be smooth from year to year. I am 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 me, and using managers I believe to be highly skilled, I can earn above-average long-term returns while keeping the shorter-term downside risk within a reasonable loss threshold.

Happy New Year! Thank you for your business and your trust.

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