

2006 INVESTMENT COMMENTARIES: 1st Quarter

Stocks had a good first quarter in 2006, with the S&P 500 gaining 4.2%, but the real standouts were smaller-cap and foreign stocks. The Russell 2000 shot the lights out, gaining almost 14%. Foreign stocks rose 9.5%, with just over one percentage point coming from currency appreciation. In the face of steadily rising interest rates, the Lehman Aggregate Bond Index struggled to stay in the black, and a tough month in March resulted in a quarterly loss of 0.7%. Commodity futures struggled as well. Most of your portfolios did very well this past quarter. If your overall quarterly returns were above 4%, it was because you have a high percentage in stocks or stock funds. If you were in the 3% range you likely have 30-50% in bonds, which were low, if not down for the quarter. If you were in the 2% range, you likely have more than 50% in bonds and money market.

Rising interest rates, fear that the housing market may be starting to roll over, a growing current-account deficit, volatile commodity prices, ongoing turmoil in the Middle East—all of these concerns have been on investors' minds lately. Looking past short-term noise is important in making good investment decisions, but many of these issues are more than noise, and require that I evaluate and try to put them into an investment context. As always, I think in terms of scenarios and probabilities as I try to weigh both the likelihood that any given event(s) might occur, and what the magnitude of its impact on the investment portfolios might be. An important piece of this puzzle is valuations, since valuations impact how well we might do in a more positive scenario and how much of a cushion we have against a more negative scenario.

My view continues to be that stock risk levels are above average, but that valuations appear to be reflecting at least some of that risk. An almost endless list of positives and negatives can come into consideration, and my goal is to make a realistic assessment that weighs optimism and pessimism fairly. I give more weight to factors that are material and knowable, and then try to evaluate how they might relate to a clear, high-conviction argument for making a move in your portfolios. This approach can be applied to all asset classes, but in the tables that follow are some of the specific issues I believe are worth thinking about in the context of the U.S. stock market.

Factors Supporting Optimism: 1) Attractive valuations by several measures; 2) General health of corporate balance sheets; 3) Low core inflation;

and 4) Below average returns based on past history.

Factors Suggesting Caution: 1) Imbalances such as current account deficit and low savings; 2) Impact of a housing slowdown; 3) Likely deceleration in rate of earnings growth; and 4) Length of economic expansion.

So, as always I face a balancing act of pros and cons, and when I weigh good valuations based on current fundamentals against the probabilities and magnitude of future risks and fundamentals, I need a larger margin of safety—in other words, larger undervaluation—as compensation for taking the portfolio-level risk that would come from overweighting equities.

Among the sub-sectors of the U.S. market, large-cap and growth stock valuations are favorable versus small-caps and value stocks, respectively, but not sufficiently so to warrant a tactical change in your asset allocation; In looking at foreign stocks, there are some similarities and some differences in the analysis of the fundamentals relative to domestic stocks, but a big part of my thinking with this asset class is influenced by valuations relative to the U.S. market. Right now, developed foreign markets appear to be within a broadly defined fair-value range relative to the U.S.

Intermediate-term bond prices have finally started reflecting the Fed's tighter interest rate policy, and the yield-to-maturity of the Lehman Aggregate Bond Index stood at 5.3% as of this writing. With yields at this level, it's likely that bond returns going forward will both beat inflation and equal their historical long-term average performance. Returns can and will be higher and lower over shorter time periods (anything less than three to five years), but on balance the prospects for bonds are better than they were a year ago, and I'm comfortable saying they're within a fair-value range. In addition to an improved outlook in a steady-state scenario, bonds could generate fairly attractive returns should a recession (or worse) come about—conceivably even double-digit gains over a 12-month timeframe—and this would provide an important counter-balance to what would be an ugly environment for stocks.

With no exciting investment opportunities, it can be a frustrating time for some. However, a few great investors that I respect have commented that sometimes the big money is made in the waiting. I believe this. There will be times when investor fear will present us with some clearly great opportunities. The key is having the discipline to wait. The good news is that right now, equity

valuations are somewhere between average and good, which gives me confidence that even if we don't get a great buying opportunity, returns on average over the next several years are likely to be at least decent. Rising interest rates have brought investment-grade bonds back into fair-value territory, so their future contribution to your portfolios

should be better than it has been over the last year. I have your money invested with great fund managers who I believe can add significant value over their benchmarks over the long-term. These are all good things to focus on while we patiently wait for the next compelling opportunity to come along.

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