

2006 INVESTMENT COMMENTARIES: 2nd Quarter

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 first six months +2.7%. The small-cap Russell 2000 Index dropped, but still leaving it +8.2 YTD, while the EAFE (foreign stocks) managed a slight gain for the quarter and remain positive for the year at +10.2%. On the bond side, the Lehman Bros. Aggregate Bond Index remains under water for the year at -.7%.

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'd gone more than three years without a market correction; and there was lots of money looking for a home. What suddenly caused things to change? 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.

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, I 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, my take is that further rate increases will be limited and a near-term recession isn't too likely. The risk is still there, but even if it materialized, we have the benefit of going into this environment with stocks already at attractive valuations, so a cyclical bear market shouldn't be too bad, and this would actually set stocks up for nice returns going forward.

There are several forces working against inflation and one of them - albeit a cyclical one- is a slowdown in the housing market. Without the tailwind of rising home prices or declining interest rates, homeowners are less likely to refinance or take out home equity, leading to lower spending. With fewer families rushing to buy homes, there's less spending on all the goods that come along with a home purchase. Weighing all the evidence, I think it is unlikely 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 a recession as there are reasons to be concerned about inflation.

So if inflation is causing the market's problems, but I don't think those concerns are justified, does that mean stocks are undervalued and represent a buying opportunity? The short answer is: not quite. I don't feel like stocks are cheap enough to compensate us for taking on the risk of increasing your exposure to equities. For me to take on that added risk, I want to feel highly confident that the market is being irrationally pessimistic, resulting in significantly above-average return potential over the next five years. From where we stand today (the S&P 500 is at 1250 as of this writing), I'd need to see a further decline in the 5% to 10% range before feeling confident that an irrational level of pessimism was reflected in stock prices and therefore presented a "buy low" scenario.

Having said that, I do believe that valuations are quite attractive and already discount much of the risk. If a negative scenario fails to materialize, or is less than investors expect, 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. (How's that for giving bad news a "good spin?" I could work for the government!)

If and when the time comes to overweight stocks, I must also decide from where to find money. Convention would have me reduce your investment-grade bond exposure when increasing equities, but this would further reduce your recessionary protection. Considering all of the options in a variety of scenarios, I would probably eliminate your commodity futures positions, since this asset class would be of little help in a recession, and my return outlook for the asset class is not as high today as it was when I first established our positions. These positions are relatively small, so I would need to take money from another area in order to establish a full 5% overweighting in equities, and Loomis Sayles Bond Fund, whose bonds are not investment-grade, would probably be my next source of funds. It is likely that this fund would under perform a Managers Fremont Bond, for instance, in a recessionary scenario, and from a risk-management standpoint, I do not currently want to reduce our exposure to Managers below its current levels.

Watching stocks go down isn't fun, particularly when interest rates are rising and causing bonds to be in negative territory, but I must confess that as valuations have become increasingly more appealing, I'm feeling a growing sense of excitement that a good buying opportunity could

be near. Because you are long-term investors, I look for the silver lining in a down market: The potential for better-than-average returns in the future. I realize that my presenting a scenario of possibly increasing stocks during an environment of negative returns is scary. Heck, it's scary to me too,

but I think it is the right way to view what might be happening and to take action should the scenario present itself. I will need your trust on this one.

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