

2006 INVESTMENT COMMENTARIES: 3rd Quarter, 2006 in Review

Your portfolio returns so far this year generally lag the S&P 500, although there are parts that are doing great. In the 3rd quarter, some stock indexes are finally reaching record levels first touched over six years ago (though the NASDAQ remains far below its peak). The larger-cap S&P 500 index ended up 5.6% for the quarter. Small caps were nearly flat, gaining 0.4%. Value outpaced growth across all market caps. Domestic investment-grade bonds and international stocks were each up about 4%, while short-term local currency emerging-markets bonds gained almost 3%. Commodity futures had the worst quarter by far, losing 6.5%.

It is entirely possible that the U.S. economy will have a soft landing from the strong economic growth it has been experiencing and continue to expand for several years. I am always pleased when stocks are priced with a big valuation cushion, since this reduces the downside risk, as most bear markets, for example, start from a point of high valuation.

Last month I reduced the small-cap exposure in your portfolios and moved the proceeds into large-caps, specifically the iShares S&P 500 (symbol IVV), an exchange traded fund which you can find the NYSE stock tables, not the mutual fund tables. In reaching this decision, I looked at data presented to me and it showed small-cap valuations at or near the high end of their historical range relative to large-caps. Right now, this data shows that small-caps are expensive relative to large-caps. In fact, they are nearly as expensive as they have ever been, an observation supported by other data sources as well.

I also believe that cyclical considerations favor a lower small-cap weighing. We are well into the economic cycle, (which is not the same as the stock market cycle) and small-caps' best performances generally come in the beginning, after a recession, and continuing through some sort of mid-point. I believe we hit that point last quarter, which is why I shifted a major part of your small-cap exposure to the large-caps. I think it is very likely that large-caps will out-perform small caps for the next 5 years. However, your overall stock vs. bond exposure remains unchanged. I also caution that there is no way to know for sure how long it will take for this move to pay off. My confidence is based on a longer time frame, one that could be as long as five years, (and here comes the hedge) but it is impossible to successfully predict the short term.

Thanks to slowing earnings, dropping oil prices and a deteriorating real estate market, as I mentioned last newsletter, the Federal Reserve has finally put on hold what has turned out to be one of the sharpest cycles of interest rate increases on record. If the economy does not have a soft landing and falls into recession, I need to manage your portfolios with an eye towards this risk. High-quality bonds are generally the best-performing asset class during recessions, and as such I believe bonds still have an important role to play in balanced portfolios, because bonds help mute the volatility of equities in other scenarios as well. When we are pointed at a recession (and that is inevitable) you can expect me to reduce or eliminate the Loomis Sayles position, and increase it with high-quality bonds.

You also own emerging-market short-term local-currency bonds as a tactical hedge against a dollar decline. At almost 6% of GDP, the U.S. current account deficit remains near its worst level in history. To us, this suggests that on a long-term basis, the dollar is likely to experience further declines. This is the most important argument underlying your position in emerging-market short-term local-currency bonds, i.e. PIMCO Developing Market Fund. These bonds have higher yields than U.S. bonds of similar maturity, which is an additional argument in their favor, along with the improving fundamentals in many emerging-market countries. These bonds are also limited to the governments of our trading partners, which helps reduce currency risk.

You continue to own small positions in commodity futures in your balanced accounts. At present, I believe the return prospects for commodity futures are not as good as equities, but are better than bonds (and they provide a valuable diversification benefit when mixed with stocks and bonds). As a result your small positions in this asset class are coming out of your bond exposure.

I am pleased that there are tactical opportunities in short-term emerging markets bonds, commodity futures, and larger-caps versus smaller-caps in your portfolios. I am confident these moves will modestly improve your return prospects while helping mitigate certain risks over coming years. The fact that several of the fund managers (i.e., TCW, Legg Mason and Harbor Capital) have trailed their benchmarks at the same time has not helped, and as a result your portfolio performance has lagged this year after a long stretch, going back

to 2000 of generally outperforming the S&P 500, particularly in the down years. The shorter-term underperformance of some of the managers does not impact my confidence in their ability to beat their benchmarks over the long term. Over the years I have often observed that even top managers occasionally have lengthy and sometimes significant stretches of underperformance. The managers I use are chosen based on extensive due diligence, and my research company follows up with them frequently.

As long as my original thesis remains intact, and there are no material issues that impact my confidence in their investment edge, I know that underperformance is not by itself a reason to make a change. Even the greatest managers will at times test their investors' patience, but as in all investing, patience and discipline are keys.

Thank you for your business and your trust.

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