



Q3 2006 Quarterly Commentary

Author: Mark Duvall, Principal and Chief Investment Officer, CFA®

Like autumn weather, investment markets are subject to sudden changes that can catch people by surprise. For much of the last several years, the prices of oil and other commodities have increased sharply. As we moved into fall, however, the price of oil dropped from a high of nearly \$78 to a range of \$58-\$60, while overall commodities declined 6.5% for the quarter as a whole. Conversely, with the help of declining oil prices, the US stock market as represented by the S&P 500 ended Q3 with a solid 5.7% gain, and as of September 30th is up 8.5% for the year. Large Cap Value stocks continued outpacing growth stocks, up 6.2% for the quarter versus Large Cap Growth stocks up 3.9%. Small company stocks lagged their larger brethren with a 2.5% rise, developed market international companies rose 4.8%, and commercial real estate continued its stellar run, increasing 9.1% in just the 3rd quarter. With concerns on inflation moderating, bond yields fell. Since bond prices move inversely to yields, declining yields was good news for fixed income prices, resulting in bonds returning 2.5% for the 3rd quarter.

The large variation in quarterly returns reminds us that markets move quickly and without warning, while our diversified investment strategy helps us take advantage of the differential in asset class returns to build our client's wealth with minimized volatility. Additionally, staying invested when the economic news seems discouraging is important when the market quickly moves up.

Much has changed in the Global Economic landscape since our last quarterly letter. Not only has oil fallen almost \$20 per barrel, but the Federal Reserve has paused in its campaign of interest rate increases, and a number of key rates have fallen. During the quarter, the 10 year Treasury bond hit nearly 5.25%, then fell as low as 4.5% before moving back up to today's 4.7%. This good news (combined with a rising Dow Jones Index) fueled optimism in the U.S. consumer and offset ongoing concern about softness in the housing market. We are cautiously optimistic, expecting the housing slowdown to cut growth and slow the economy by 1% from the otherwise achievable growth rate, but not produce the hard landing many were expecting. Although housing is slowing the economy, lower



interest rates and fuel costs are acting to stimulate the economy. Net result: U.S. Gross Domestic Product at an annualized rate between 2.0% and 3.0% would not surprise us for the upcoming 12 months.

On a global and longer term basis, we are still bullish and continue our overweight of developed and emerging markets. We are tilted slightly towards large capitalization stocks which have lagged small caps and offer attractive valuations. With real estate equities (REITS) having enjoyed more than a five year run of out performance that has driven valuations up and yields down to multi year lows, we have moved to underweight real estate a bit. Given last quarter's REIT performance, we were clearly early, but we see greater risk to the downside than continued strong returns in this asset class.

Since a major change to our retirement laws was signed this last quarter, we wanted to highlight the most important provisions of the Pension Protection Act for you, legislation that combines boosts to and tighter limits on actions that we may all take regarding our retirement and taxes.

Non-spousal beneficiaries can now roll over assets inherited from a retirement plan, and pay taxes only when the funds are withdrawn. This provision now extends to domestic partnerships an option only available previously to married couples. IRA contributions can be \$5,000 in 2008, with catch-up contributions for individuals age 50 or older an extra \$1,000 for IRAs and \$5,000 for 401k plans. The new law also permanently allows for Roth 401k and Roth 403b plans.

For those clients with children or grandchildren, the new law makes permanent the tax free status of 529 plan withdrawals. In most cases, 529 plans are the preferred way to save for college, and an estate tax efficient way for grandparents to move assets from their estates while still maintaining control of the funds to assure they are only used for college.

The Pension Protection Act now allows taxpayers to make tax-free distributions up to \$100,000 to



charity directly from their IRA accounts. Since the IRA is money never taxed, there is no additional tax deduction for this contribution. The Act also toughens the tax laws for charitable donations by requiring taxpayers to keep records of all cash donations. Donated items, such as cars, clothing, and household goods, must now be in “good condition.”

The new law also affects employers and their employees covered by Defined Benefit plans, making funding requirements more stringent. Our assessment is that this legislation’s affect will be to continue the corporate trend away from guaranteed income pension plans and towards employee contributory plans that create incentives for employees to save and take responsibility for their own retirement. Our firm is built on the premise that individuals need to save and invest on their own in order to prosper in a future where many others will not be prepared. We are happy to help interpret how the Pension Protection Act affects your individual situation.