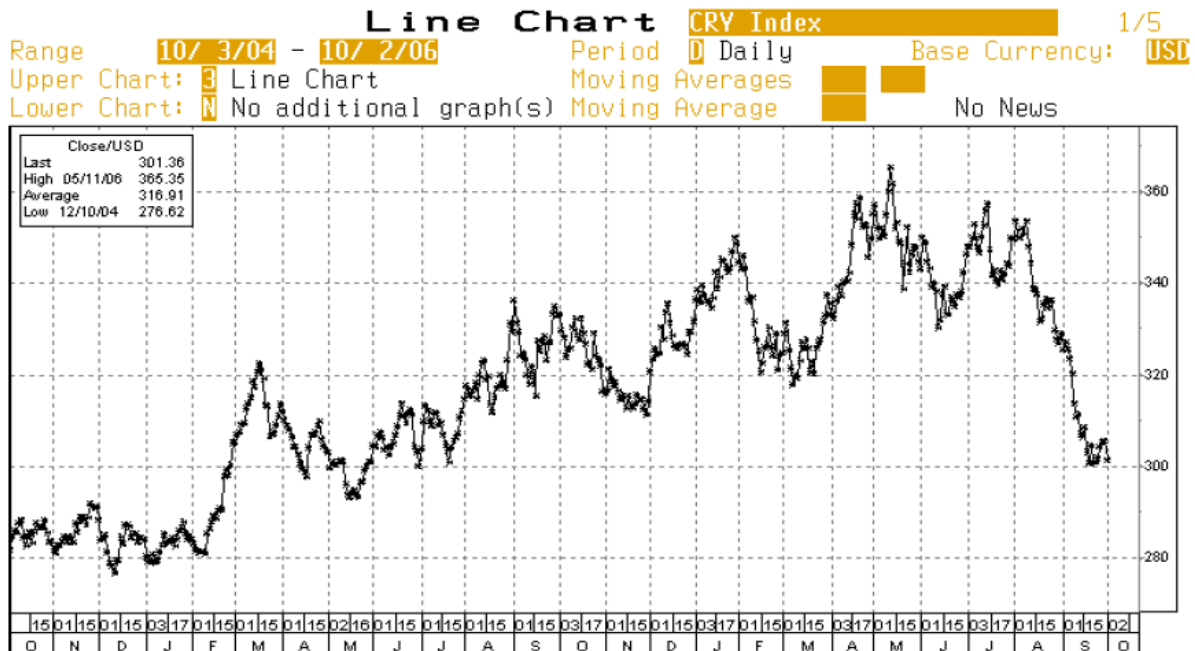


Commentary - 3rd Quarter 2006

The baseball playoffs are here, football season is in full swing, and the stock market is close to all time highs. Could things get any better? Unfortunately, we must endure a mid-term election season with all the mud slinging and empty promises. Energy prices declined during the third quarter, the Federal Reserve stopped raising interest rates, and we dodged a major hurricane. All in all, the markets enjoyed a very good quarter with the stock market gaining over 5% and the bond market appreciating more than 3%.

The main themes of the third quarter that investors encountered were the weakness in the housing market, falling energy prices, and the surprising drop in long term interest rates. Last quarter we discussed the relationship between these three economic variables. The Fed's relentless raising of short term interest rates over the last twenty-four months has finally succeeded in slowing the housing sector and containing commodity prices. We suggested last quarter that if commodity prices did not moderate, we could see more interest rate increases and a potential hard landing for the economy. Now that commodity prices have declined, as shown in the graph below, the Fed can wait to see if the housing sector's weakness is going to require an interest rate cut. Lower commodity prices, especially energy costs, have reduced inflationary pressures, so we should see pleasant inflation reports in the fourth quarter.

Graph 1. Commodity Research Bureau Commodity Price Index, Source: Bloomberg



The CRB Index graph shows the price of a basket of commodities over the last two years. The index has dropped by 17% over the last three months. The bond market anticipated this slowing in economic growth and weaker commodity prices by rallying strongly in the third quarter. Long term interest rates on Treasury bonds dropped half of one percent in the third quarter, setting the stage for the stock market to attempt new highs. The headwinds that the stock market faced previously, increasing interest rates and higher energy costs, have now dissipated. Now the question is whether the weak housing sector drags down the rest of the economy. Home sales have dropped 14% year-over-year. The inventory of unsold homes has reached historically high levels of almost seven months supply. We know that housing prices reached unrealistic levels on the coasts and in Las Vegas. Will this year's weakness in housing be mitigated by lower mortgage rates and growing personal incomes or will the dropping real estate prices cause over-leveraged homeowners to walk away from their mortgage obligations. We have a difference in opinion in that I do not think the housing market will deteriorate that badly- but it is an outside possibility to consider, while Mr. Kramer believes the housing sector will fall hard enough to take the rest of the economy into a recession.

The gradual increase in interest rates prior to the third quarter occurred in most of the developed countries. Central banks were cautious not to raise rates too quickly and cause another financial crisis like the Long Term Capital Management hedge fund fiasco of 1998. Surprisingly, the sharp drop in energy prices caught a few hedge funds off guard (read: unhedged) resulting in fund liquidations, and in the case of Amaranth Advisors, losses of billions of dollars. The strength of the financial system was evident in the fact that these huge hedge fund losses did not translate into wholesale liquidations in other sectors. With central banks easing off of the monetary brakes, the global economy appears to be on track for another year of sustainable growth with China and India leading the way. The American consumer may be giving up the leadership role in the global economy for a short time, but we do not expect her to give it up for long.

Here is a look at the sectors we cover:

Large Cap Stocks: Our Blue Chip Strategy gained 4.78% in the third quarter versus a gain of 5.65% for the S&P 500 Index. For the first nine months of 2006, the Blue Chip Strategy is up 10.67% versus 8.56% for the S&P 500. The portfolio company with the best return in the third quarter was Pfizer, rising 21.9%. Pfizer had a management shakeup in late July, replacing their CEO. The worst performer in the Blue Chips during the third quarter was Alcoa, dropping 12.9%. The basic materials companies struggled during the third quarter as commodity prices declined. Our outlook for large cap stocks remains positive as the global economy maintains a reasonable growth rate. Since interest rate levels are generally higher than last year and there is more risk in the market, we expect large caps to attract capital flows as a safer way to invest in equities. Corporate balance sheets are in good shape and mergers and acquisitions activity indicates that corporate executives still have a positive

outlook. The last few trading days of the quarter saw the Dow Industrials approach their all time of 11,722 set in January, 2000. As of this writing, we are setting a new high that only took six and a half years to reach.

Small Cap Stocks: Our Small Cap Value Strategy rose 5.87% in the third quarter versus a 0.13% gain in the Russell 2000 Index. For the year-to-date period, the Small Caps are up 6.21% versus 7.78% for the Russell 2000. We have closed the performance gap considerably since the first quarter of this year. The biggest gain in the strategy was provided by Talk America Holdings as a takeover battle for the company was launched in the last two weeks of September. The stock gained 53% for the quarter, but we think the takeout price is still too low relative to other deals that have been announced in the competitive local exchange telecom space. The weakest performer during the quarter was Meridian Resources, which fell 12.5% as the whole energy sector was pounded in the third quarter. Natural gas prices fell 30% during the quarter while oil prices declined 22% from their highs. For a change, we had no turnover in positions during the quarter. We expect to sell our Talk America position in the fourth quarter when their bidding war ends and replace it with another company on our watchlist. Considering the weakness in the housing sector, could there be an attractive candidate there?

Convertible Securities/High Yield: The Convertible Securities/High Yield Strategy appreciated 1.95% in the third quarter versus the Merrill Lynch High Yield Index gain of 4.04% and the Merrill Convertible Index gain of 2.78%. Since the beginning of 2006, the Convertibles strategy is up 13.48% versus 7.17% for the Merrill High Yield Index and 7.38% for the Merrill Convertible Index. Our exposure to the energy sector hurt the strategy during the quarter as Callon Petroleum fell 30% and our Toreador Resources bonds fell 5.8%. The position providing the biggest boost to the strategy was our Ford Motor convertible preferred that was up 24%. We added a position in United Airlines convertible bonds to the strategy that yields 7.16% to its put date in 2011. One position in the strategy matured in July, the Lucent Technology bonds. We are cognizant that an economic slowdown could hurt the high yield bond sector if credit quality deteriorates. At this point credit spreads are not reflecting any weakness in debtors' ability to pay. This is one reason we have confidence that the economy is merely experiencing a temporary slowdown.

Intermediate Bonds: The Intermediate Bond Portfolio was up 2.62% versus the Citigroup 1-10 Year Government/Corporate Index gain of 3.24%. For the year-to-date period the strategy is up 4.27% versus 3.09% for the index. Our Intermediate Tax Exempt Bond Portfolio was up 1.65% in the third quarter versus a 2.57% gain in the Merrill 3-7 Year Insured Muni Index. Since the end of 2005, the tax exempt bond strategy is up 2.26% versus 2.67% for the Merrill Index. Our long term puttable corporate bonds boosted the taxable bond strategy as interest rates fell during the quarter. With ten year Treasury yields now trading 50 basis points (half of one percent) below the Federal Funds rate, we do not see much value in long term bonds. For bonds to appreciate substantially from these levels, the housing sector would have to

continue deteriorating and cause the Fed to start lowering interest rates in the near future. The stock market is telling us that corporate earnings should be positive and the economy is in decent shape, a completely different forecast than the bond market is predicting.