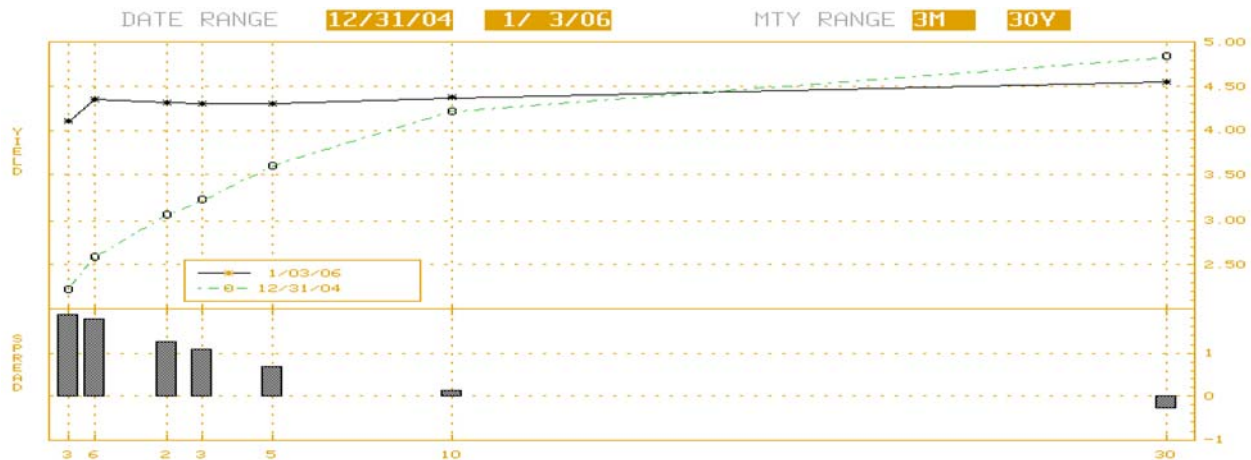


Commentary - 4th Quarter 2005

The stock market experienced a pretty uneventful close to the year 2005. The hoped-for Santa Claus rally turned out to be more like a year-old fruit cake from Aunt Edna. The broad market did turn in a gain for the fourth quarter of about 2%, but that all came in November. The strong November momentum was dashed by higher energy prices, more Fed tightening, worries over an inverted yield curve, and a perceived slowing in the housing market. Overall, we were pleased with our performance for our asset class strategies versus their respective benchmarks. We made a few poor decisions last year, but they did not hurt us too badly, and we had enough good decisions that offset the poor ones or set us up for good returns in the future. We'll go over our report card in a minute.

In our opinion, the dominant theme for the first half of 2006 is the predictive strength of the yield curve inversion. An inverted yield curve occurs when short term interest rates are higher than long term interest rates. The last week of 2005, two-year Treasury yield traded slightly higher than 10-year Treasury yields. Usually an inverted yield curve, as shown below in Figure 1, portends a slowing economy or potential recession. And a slowing economy or recession most likely leads to a stock market decline. So the big question is: Will the economy slow in 2006 and cause the stock market to fall? We can find many economic statistics to show that the economy is in good shape with solid momentum going into 2006: Fourth quarter GDP should increase around 3.5%. The unemployment rate is 4.9%. Retail sales are strong. Personal income is growing. Global economic growth is improving. Most economists are predicting another year of moderate growth in the U.S. economy. What could upset this picture? Energy prices are still much higher than they were a year ago and if they continue rising, they could hurt the consumer. The housing sector could weaken further, causing a decline in home values and subsequently a more pessimistic consumer. Inflation could rise faster than anticipated by the Federal Reserve, leading to higher interest rates and their restrictive effect on the economy. Or, if the Federal Reserve decides that their operation to increase interest rates at a measured pace over the last year and a half has reached its goal and announces they are finished raising rates, the dollar could lose value against other currencies.

Figure 1. U.S. Treasury Yield Curve, December, 2004 versus December, 2005, Source: Bloomberg



The predictive power of the bond market/yield curve has been suspect over the last year anyway. Usually, long term interest rates are influenced by two factors, inflation expectations and confidence in the central bank. Long term interest rates actually declined slightly last year as the Thirty Year Treasury yield fell from 4.82% to 4.55%. This happened at the same time that energy prices skyrocketed and inflation increased to a 4% rate. Either the bond market is ignoring the increase in inflation or bond investors expect the Federal Reserve will not let inflation get out of control. Unfortunately, once inflation infiltrates the economy, it is very difficult to exorcise. We think the bond market is giving the Fed too much credit for its inflation fight so far. The price of gold is suggesting that the Fed is way behind in the battle to limit commodity price increases and that interest rates will have to move higher. Figure 2 shows the price of gold over the last five years. Gold prices were low coming out of the global economic slowdown of 2001-2002, but they have climbed dramatically with the synchronized global expansion of the last two years. This move in the price of gold suggests that central banks across the globe are too easy in their monetary conditions. The value of gold has risen not just against the dollar, but against other major currencies as well. For over two thousand years, gold has been a common store of value. Currencies are only as good as the government that issues them. When the price of gold rises versus paper currencies, it suggests that investors are losing confidence in the will of central governments to maintain the value of their currencies. Maybe this is a symptom of the profligate spending tendencies of most major democratic governments. The U.S., Japan, and most of Europe

stock in this strategy during 2005 was Hewlett Packard rising 38%, followed closely by Boeing. HP hired a new CEO and his initial efforts to improve operations at the company have met with investor approval. Boeing benefited from strong international demand for its commercial aircraft and increased defense spending on its military hardware. The worst performing stock in the Blue Chips was General Motors, down 47%. GM's stock hit a twenty-year low due to falling market share, higher labor costs, and a surge in gasoline prices hurting the sales of its most profitable products - SUVs. Ford and GM are battling the same problems. They must figure out a way to reduce labor costs and improve market share without having to offer substantial price discounts on their vehicles. Both of them are in decent financial shape, with considerable liquidity. Both are selling off non-core operations or raising capital through joint ventures. These are stop-gap measures to buy them time for gasoline prices to moderate or to renegotiate their labor contracts. But in the end, it will come down to their ability to produce vehicles that consumers want to buy. It can be done, look what Chrysler did in the nineties after it avoided bankruptcy in 1990. Chrysler is holding its market share currently by offering bold new products. Nissan Motors executed the same kind of turnaround in the late nineties. The potential for recovery at GM is there, but management will have to be aggressive and so far the market is not impressed with their moves.

Another point to make on the large cap sector is that if the Fed decides that they have raised interest rates enough, the dollar should weaken. A weaker dollar makes our goods more competitive in the global marketplace. Typically a weaker dollar should benefit big companies more than smaller ones because they receive a greater proportion of their revenues from overseas. We believe the outlook for large cap stocks is still positive. They have reasonable price to earnings ratios and generally they have strong balance sheets. The resilient economy supports our outlook for large company earnings growth and higher stock prices.

Small Company Stocks: Our Small Cap Value Strategy rebounded 6.05% in the fourth quarter versus a 0.81% gain for the Russell 2000 Index. For the year, the Small Caps rose 6.18% versus 3.32% for the Russell 2000. Shouldn't beating the index by almost 3% be worth an A+ on the report card? We took gains on Spinnaker Exploration and Coinstar in the fourth quarter. Spinnaker was acquired by Norsk Hydro, a Norwegian oil and gas company. Coinstar

jumped after reporting higher earnings for the third quarter and raising guidance. We were apprehensive about their ability to continue growing profitably after they made sizeable acquisitions in the last year outside of their core coin-counting business. We also took our lumps on Metro One Telecommunications after they lost too many directory assistance contracts from the major cell phone providers. We recently added two new positions to the strategy, Synagro and Genco Shipping. (Research summaries on each company are enclosed for those clients participating in the strategy.) Synagro provides organic waste treatment services primarily to municipalities. It exhibits characteristics similar to the publicly traded master limited partnerships we hold in our Convertible Securities/High Yield Strategy; i.e. it offers a high yield over 9% with growth potential in the five to ten percent range. Genco Shipping is a dry bulk carrier that mainly transports commodities. With global trade increasing and commodity demand escalating, especially in China and India, Genco can grow its cash flow accordingly. It came public last summer and under its current dividend policy we expect a dividend yield over 13%. Both of these companies have reasonable debt levels and we like their high payouts.

Convertible Securities/High Yield: Our Convertibles strategy fell 3.00% in the fourth quarter versus a 0.48% increase in the Merrill Convertibles Index and gain of 0.68% in the Merrill High Yield Index. For the year, the strategy rose 3.86% versus a decline of 0.34% for the Merrill Convertibles Index and an increase in the Merrill High Yield Index of 2.83%. Considering the turmoil in the convertible bond market in April through June when some convertible arbitrage hedge funds had to close due to losses, we think our performance rates an A. We were hurt in the fourth quarter by the underperformance of one of our biggest holdings - Callon Petroleum and our exposure to Ford and GM convertible preferreds. Master limited partnerships in taxable client accounts also were weak during the quarter. Surprisingly, one of our strongest performing positions was our convertible bond on Continental Airlines, which gained 77% in the fourth quarter, even in the face of high fuel costs.

We sold our position in CP Ships, earning a nice gain, as they were acquired by a German shipping company. We recently added two positions - Toreador Resources and Echostar Communications. The Toreador bond yields 8.17% to a put option in October, 2010. We were attracted to Toreador because part of their management team is from a former Small

Cap Value position in Triton Energy that was very successful. They are developing oil and gas fields in Romania, Turkey, France, and Hungary. They recently announced that they expect to double production annually between 2006 and 2010. Echostar Communications (symbol: DISH) is one of the major providers of satellite television. The bond yields 6.31% to a May, 2008 maturity. Echostar is rapidly increasing earnings and cash flow as most of their capital expenditures are behind them.

Intermediate Bonds: Our Intermediate Bond Portfolio declined 0.41% in the fourth quarter versus a rise of 0.52% in the Citigroup 1-10 Year Government/Corporate Index. For all of 2005 the portfolio declined 0.12% versus a gain of 1.65% for the Citigroup Index. Our grade in this strategy is Unsatisfactory, or C-. Our biggest disappointment for the year was purchasing General Motors bonds too early. We bought GM bonds in January, 2005 to yield 8.18%. Unfortunately, GM's situation worsened and they were downgraded by the ratings agencies. They now yield 13.70% to maturity in 2023. We believe that GM has many options to raise liquidity and shrink their balance sheet before they have to attempt a restructuring in bankruptcy court. Their current liquidity provides them a few years to turnaround their labor situation and come up with some popular products. We will be watching them closely.

The Intermediate Tax Exempt Bond Portfolio rose 0.04% in the fourth quarter versus an increase of 0.35% in the Merrill 3-7 Year Insured Muni Bond Index. For the year, the strategy rose 1.25% versus 1.15% for the Index. Maybe we earned a B- on the report card in this strategy. We continued to purchase AAA rated short term tax exempt bonds with maturities less than two years. Our bond portfolios are positioned for interest rates to rise further. We think there is a good possibility that longer term interest rates will rise when the Fed says they are finished raising short term interest rates.

This should be an interesting year in the financial markets as the bond market is forecasting an economic slowdown that most economists and the Federal Reserve do not expect. If there are no shocks to the economy, corporate earnings should grow nicely and we should see attractive returns in the stock market. If energy prices and other commodity prices continue climbing, interest rates will probably go higher than many forecasters expect and put a damper on stock market gains, much like 2005. The Federal Reserve cannot afford to monetize the increase in commodity prices or inflation will get out of hand.