

Commentary - 4th Quarter 2006

Rewarding! Very, very rewarding! (Any similarity to the Citibank credit card commercial is purely intentional.) 2006 turned out to be a very rewarding year with the broad market gaining over 6.5% in the fourth quarter and approximately 16% for the year. Considering the anxiety most investors experienced in mid-summer, the end result was very pleasing. Our proprietary strategies substantially out-performed the market last year, alleviating any discontent from 2005's mediocre market. We would like to take time to celebrate, but now we have to face a new year and the "what have you done for me lately" mentality.

The stock market enters the new year under similar circumstances it faced in the second half of 2006. The economy is growing at a moderate pace, approximately 2% annualized GDP growth, interest rates are stable at relatively low levels, energy prices are behaving, global economic growth is healthy, and most stocks have reasonable valuations. This backdrop supports continued gains in the stock market if nothing upsets it. Of course, we are always on the lookout for what can upset a rosy scenario.

The overwhelming theme of the recovery from the bursting of the stock market bubble has been liquidity. The Federal Reserve lowered interest rates through 2003 and raised them at a very moderate, predictable pace through the first half of 2006. They were careful not to raise rates too fast and trigger a liquidity crunch. The Fed's cautious approach was offset by the increase in global liquidity from foreign central banks, especially the Bank of Japan. A few examples of this financial liquidity are the historic low yield spreads on high yield bonds versus risk free bonds, the surge in private equity activity (a.k.a. leveraged buyouts), low market volatility, and the abundance of corporate mergers and acquisitions. The Bank of Japan has provided financial system liquidity to the world through their 0.0% interest rate policy since the mid-1990s. The deluge of petrodollars has contributed to the availability of risk capital. We recognized the overbought situation in the housing sector in 2005, which is currently being corrected. But right now we do not see any other sectors that exhibit "bubble" valuations indicative of speculative activity which would cause the central banks to dramatically raise interest rates.

One area of the financial markets that has blipped on our defense radar is the proliferation of financial derivatives. From exchange traded funds, index notes, collateralized mortgage obligations, collateralized debt obligations, interest rate swaps, credit default swaps, to financial futures, commodity futures, options, and portable alpha, the explosion of ways to slice and dice security cash flows has overwhelmed the basic tenets of financial analysis. In their desire to manage risk through structuring new types of financial vehicles, most investors have lost the ability to analyze credit risk, interest rate risk, and business cycle risk. They rely on others to hedge their risk with new products. This sounds great in theory but

the practical application has not been tested since the Long Term Capital Management meltdown in 1998. The amount of leverage in the financial system from these new types of risk management tools is enormous. Early in 2005, when General Motors' credit ratings were downgraded, severe dislocations occurred in the convertible bond market. A few convertible bond shops had to close their doors. Somehow, they guessed wrong in their approach to hedging risk. When auto parts maker Delphi declared bankruptcy in 2005, the amount of credit default swaps outstanding was three to four times the maturity amount of their outstanding bonds. In our experience, when investors believe they are safely hedged, and a hedging strategy is very popular, an unforeseen event can cause major volatility. (Portfolio insurance was a very popular product prior to the stock market sell-off in 1987.)

So we acknowledge that a blow-up in some form of derivatives could cause a system-wide problem. Other than that, we are cognizant of the potential for continued dollar weakness, turmoil in the Middle East affecting energy prices, dislocations in a rapidly growing Chinese economy, and the housing sector weakness dragging down the rest of the domestic economy. Sure there are other risks that could hurt the stock market this year, but right now our cautiously optimistic outlook anticipates a prosperous 2007.

Here is why we were so excited about the 2006 results for each of our proprietary strategies:

Large Cap Stocks: The Blue Chip Strategy gained 6.76% in the fourth quarter versus a 6.66% rise in the S&P 500 Index, and 18.16% for the year versus 15.80% for the S&P. IBM was the best performer, up 18.82% in the fourth quarter. Pfizer dropped 8.25% in the fourth quarter as one of their highly anticipated new drugs was pulled from the FDA approval process. The best performing Blue Chip in 2006 was General Motors, up almost 63%, as their restructuring efforts gained investor confidence. Intel was the weakest holding in 2006, falling almost 18%. Intel faces strong competition from AMD and weak personal computer sales. We expect PC sales to pick up now that Microsoft has finally released their new Vista operating system. Large cap stocks did not outperform small cap stocks last year as we projected (if you compare the S&P 500 to the Russell 2000), but they held up better during the mid-year sell-off. Since we recognize that there may be too much liquidity in the financial system and there is potential for central bank tightening to reduce excess liquidity, large cap stocks will be a good place to have equity market exposure with lower risk. Additionally, if the economy does experience a mild recession, large cap stocks should be more resilient than small- and mid-cap stocks.

Small Cap Stocks: Our Small Cap Value Strategy rose 19.40% in the fourth quarter versus 8.55% for the Russell 2000 Index. For the full year, the Small Caps gained 26.81% versus 17.00% for the Russell 2000. This is the second year in a row that our Small Cap portfolios trounced their benchmark in the final quarter of the year. Leading the performance in the fourth quarter was Markwest Hydrocarbons, rising 74%. Investors recognized the potential for Markwest to raise their dividend at a rapid rate over the next few years and their newest

project in the Woodford Shale area of Southeast Oklahoma should exceed estimates. Only one position declined in the fourth quarter, Talk America Holdings, which was taken private in November at a price that was lower than a bidding war in September suggested. We added one new position to the portfolio in December, Winn Dixie Stores. Winn Dixie emerged from bankruptcy in November after closing unprofitable stores and reducing debt. The current valuation of the company is much lower than other publicly traded grocery store chains, and with very little debt we see potential for the company to appreciate to multiples similar to its peers with less risk because they do not have any material long term debt. (A Research Summary for Winn Dixie is enclosed for clients in this strategy.) As we mentioned above, we expect large cap stocks to outperform small cap stocks when liquidity in the market is reduced. We have positioned our small cap portfolios for this situation by increasing our exposure to high dividend paying small companies. Our experience tells us it is better to own income producing securities when risks are increasing.

Convertible Securities/High Yield: Our Convertible Securities/High Yield Strategy enjoyed an outstanding fourth quarter, gaining 9.22% versus 5.00% for the Merrill Convertible Index and 4.17% for the Merrill High Yield Index. For the full year our strategy rose 23.95% versus 12.75% for the Merrill Convertible Index and 11.64% for the Merrill High Yield Index. Our airline positions led the way with Continental convertible bonds up 36% and United Airlines convertible bonds up 25% in the fourth quarter. The Continental position was the best performer for the full year, gaining 78%. Penn Treaty American Insurance Company, a long term insurance provider, was the weakest performer for the full year, falling 23%. Penn Treaty is one of our older positions and we converted our Penn Treaty bonds last year into the common stock when the bonds were called. The stock trades at a discount to book value and the company has growth potential. It recovered late in 2006 after heavy insider buying supported a positive outlook for them. We did not add any new positions to the strategy in the fourth quarter, but we expect opportunities to arise in the current quarter. We know that yield spreads for high yield bonds are very low from an historical standpoint. This reinforces our efforts to conduct thorough credit analysis prior to adding any new positions. Default rates on junk bonds have been very low. When financial system liquidity is reduced, default rates will rise and we must be defensive in our approach.

Intermediate Bonds: The Intermediate Bond Portfolio strategy rose 1.35% in the fourth quarter, exceeding the 1.06% gain in the Citigroup 1-10 Year Government/ Corporate Index. For the full year, our bond strategy gained 5.67% versus the benchmark return of 4.19%. Our long term corporate put bonds benefited from the decline in long term interest rates, while our short maturity positions benefited from higher short term interest rates. The Intermediate Tax Exempt Bond Portfolio rose 0.65% in the fourth quarter versus 0.60% for the Merrill Insured Bond Index. For the trailing twelve months, the tax exempt bond strategy gained 2.92% versus 3.29% for the benchmark. The inverted yield curve that is usually dependable in forecasting an economic recession may be wrong this time. We have experienced slower

economic growth in the third and fourth quarters of 2006 as the impact of a weak housing sector and lower auto productions was felt. We may have weak growth in the first quarter of 2007, but right now it does not appear likely that we will have any quarters of negative GDP in 2007. Once the housing sector stabilizes, we should return to the more normal 3% GDP growth range. Our approach over the last six months has been to opportunistically extend our bond maturities. Given our current outlook of slow to moderate economic growth, moderate inflation, and the potential for tighter monetary conditions in the global financial system, we will continue to manage our bond portfolios in a similar manner.

Other reasons for our satisfaction regarding 2006 included the performance of our private funds and the growth in our business. Our funds of MLPs gained approximately 35% last year while our high yield/distressed fund rose almost 60%. Our firm now manages approximately \$300 million, which is a long way from where we started almost eleven years ago. We think we have a strong team at Pinnacle, but based on last year's performance it is fitting we recognize Brett Kramer, who is our unofficial chief investment officer. Way to go Brett. (Of course, please direct all future complaints to Brett too.)