Altamont Capital Management

First Quarter 2006 Performance

"With globalization the big [countries] don't eat the small, the fast eat the slow."

Thomas A Friedman (Op-Ed Columnist New York Times)

The Quarter

Stocks picked up in the First Quarter of 2006 where they left off in 2005, posting solid gains in the face of economic uncertainty and potentially setting the stage for a fourth straight year of equity gains following the brutal bear market of 2000 through 2002.

Large Cap U.S. Stocks had a good first quarter in 2006, with the S&P 500 gaining 4.2%, but Smaller-Cap U.S. and foreign stocks took the prize. The S&P 600, Small Cap index, hit a home run gaining almost 13%. Large Cap Foreign stocks rose 9.3%, with just over one percentage point coming from currency appreciation.

The story for bonds is radically different. In the face of steadily rising interest rates, bonds struggled to stay in the black, and a tough month in March resulted in a quarterly loss of 0.7%. Commodity futures struggled as well, losing more than 2%. Emerging-market short-term bonds, however, fared better with a 2.6% gain. Senior Floating Rate bonds earned 2% for the quarter. The Secured Floating rate bonds, international bonds and commodities futures are all part of my investment strategy to add return while mitigating risk. I call this my "Core-plus strategy," whereby you invest in standard investments but pursue alternative strategies that will offset risk while adding return.

First Quarter 2006 and the Year Benchmark Returns

	First Quarter	Last 12 Mos.
Large-Cap Benchmarks		
S&P 500 iShares	4.2%	11.6%
S&P 500 Growth iShares	2.6%	8.2%
S&P 500 Value iShares	5.8%	14.8%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	7.7%	21.5%
S&P 400 Midcap Growth iShares	6.3%	20.0%
S&P 400 Midcap Value iShares	9.0%	22.5%
Small-Cap Benchmarks		
S&P 600 iShares	12.8%	12.4%
S&P 600 Growth iShares	14.2%	24.1%
S&P 600 Value iShares	11.3%	22.7%
Other Benchmarks		
MSCI EAFE Int'l iShares	9.3%	25.0%
Vanguard Total Bond Mkt Index	-0.7%	-0.4%
Dow Jones AIG Commodities Index	-3.0%	5.7%

Investors are holding on to hopes for a prolonged "Goldilocks" economy with steady growth, moderate interest rates and benign inflation. This optimism has kept stock returns positive during the First Quarter of 2006. Underlying this fairy tale economy are some significant chinks in the armor. It could be a bumpy ride this year with some significant ups and downs as the outlook for interest rates and corporate profits become less clear.

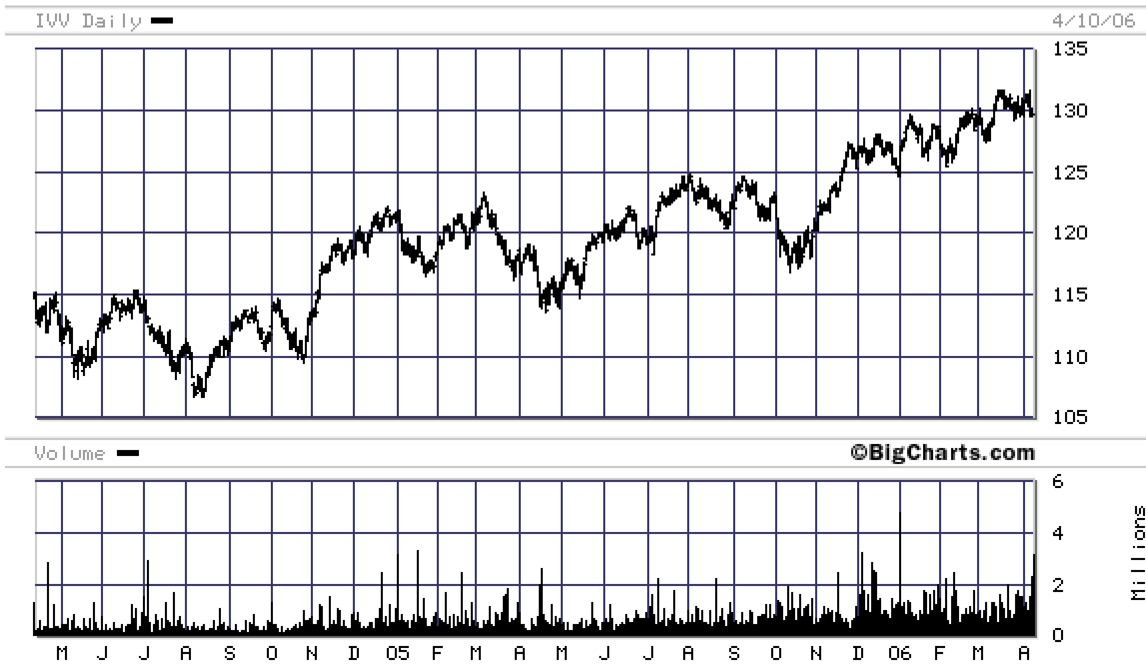
What risks are we facing right now? Rising interest rates, uncertainty surrounding the housing market (this may be starting to correct), a growing current-account deficit, volatile commodity prices, ongoing turmoil in the Middle East—all of these concerns have been on investors' minds lately. Looking past short-term imbalances is important in making good investment decisions, but many of these issues will have long term impacts on the economy and stock market.

New Federal Chairman Ben Bernanke will have to guide a slowdown in residential housing delicately, taking care not to send prices down precipitously as he manages inflation. What happens this year with interest rates may very well guide the financial markets here and abroad.

The Federal Reserve, Interest Rates and the Market

Turning to the length of the current economic expansion, our economy has been growing for a little over four and a half years, which is the average length of a post-World War II expansion. The last expansion (defined as the period between recessions) lasted almost 10 years, so it's possible that things could continue to be good for a while, but the odds are that we'll have another recession sometime in the next several years. The pull back will happen as the full impact of the Federal Reserve's interest rate hikes are felt throughout the economic system.

My view continues to be that risk levels are above average. This can be seen in the volatility of the S&P 500 ishares (IVV) for the last two years. Each new high is a struggle and is tested over and over again. During the first quarter it was difficult for the market to keep any gains. My hunch is we will see the market lose ground during the year. In fact we could have a major pull back to lows experienced last year and in 2004.



An important piece of this puzzle is interest rates. When will the Federal Reserve stop raising interest rates and will that permit stock prices to climb faster this year? Remember that the Fed can only raise ultra short rates (that's the rate that one bank can loan another bank money overnight to meet its reserve requirements) , this is like having a canoe paddle to steer a super tanker. The Fed's goal is to eventually force longer term rates to rise in order to slow down the economy and avoid rising inflation (and a subsequent recession). At the end of this quarter, the Fed raised rates a quarter point (0.25%). This marks its 15th consecutive increase to 4.75% since it started raising rates in June of 2004. The new Fed Chairman, Bernanke, has indicated that they will only stop raising rates when he is sure inflation is under control. The Fed will carefully follow the inflation indicators like the Consumer Price Index (CPI) and employment data (such as job creation and unemployment rates). The market currently has one to two more interest rate hikes built in to current stock and bond pricing. If the Fed does not begin to tone down its rhetoric regarding future interest changes over the summer, then the market will fall as it begins to price in additional interest rate increases into stock price valuations.

I am not a market timer—as tempting as it can be at times— because research has shown that huge market bets just increases the odds of being wrong. However, given the probability that a recession is statistically likely to occur somewhere in the next twenty-four months, creating an investment plan that recognizes this risk is essential. To try to mitigate some of the risk facing the U.S. market I have concluded that its time to give greater weight to the alternative strategies, especially international stocks and bonds.

There's an Elephant in the Room

Actually there is more than one elephant in the room and the room is getting a little crowded. Some of the elephants are the emergence of Asia (China, India, etc.), structural problems with the U.S. dollar, and the looming commodities shortages. I have discussed the emergence of Asia in the last few newsletters. It is by far the biggest elephant in the room. Think of China and the rest of Asia as comparable to the U.S. after WWII. Every family wanted a car, a washing machine, furnishings, an oven, refrigerator…. It was an age of consumption. The citizens of China and all of Asia want everything that we wanted plus more. They are motivated to pull themselves out of the rural 19th century and into the 21st century. Their economies will be growing at an astronomic rate compared to the developed world (U.S., Europe, and Japan). Emerging markets are also very volatile and now vulnerable to a correction. It is best not to make a huge play into emerging market equities at this time. Most of the diversified international funds I have invested you in have an exposure to emerging markets. For the risk associated with emerging markets the exposure you have through these mutual funds is more than enough. It is very possible that these fast growing markets will experience some retrenchment in the next twelve months.

Another elephant in the room is the growing instability of the U.S. dollar. Our economy is currently facing some structural problems which are of particular concern to the rest of the world. What structural problems? Our low savings rate, the large current account deficit and now also the large budget deficit are familiar issues that we've discussed before. Why would the rest of the world care? Well we are the reserve currency of the world.

Wikipedia describes reserve currency as:

> A **reserve currency** (or **anchor currency**) is a currency which is held in significant quantities by many governments and institutions as part of their foreign exchange reserves. It also tends to be the international pricing currency for products traded on a global market, such as oil, gold, etc.

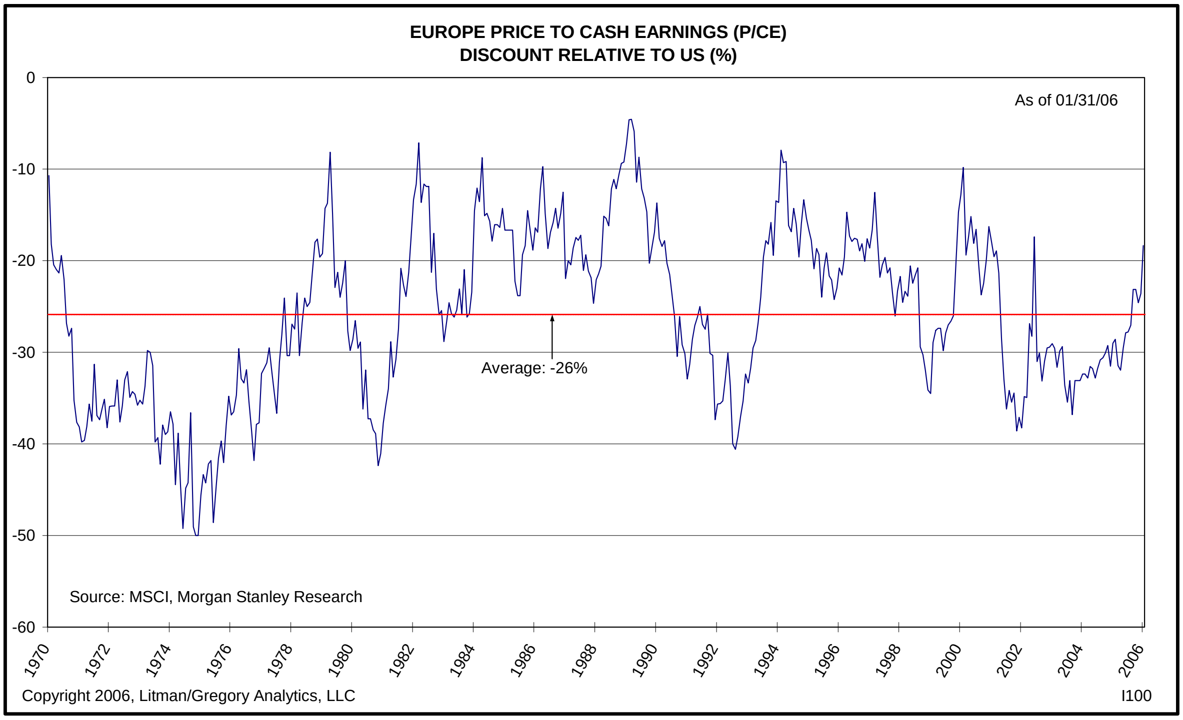
As the reserve currency, the US Dollar is currently the lynch pin of the modern global financial system. It has evolved to be that way for good reason. Through the 1900's the US was the most stable capitalist economy in the world, and after the win in WWII, enjoyed the benefits of rapid growth due to technological innovation, a solid manufacturing base, plentiful natural resources, a stable political system and an asset backed currency. In terms of a vehicle for the storage of wealth, it has been and continues to be the pre-eminent asset.

Over a decade, the proportion of U.S. government debt held overseas has more than doubled from 20 per cent to about 45 per cent. Underpinning this massive expansion of overseas borrowing has been an inadvertent and undeclared currency pact between U.S. and Asian economies.

Desperate to prevent their currencies from rising against the dollar and undercutting their booming exports to the US, Asian nations have bought up billions of dollars and US Treasury bonds to shore up America's greenback and keep their exchange rates pegged (some are loosely tied to the dollars and others are directly tied) against it. The accidental quid pro quo has been that Asia has been able to continue selling its goods to Americans at highly competitive exchange rates, while the U.S. has been able to run up ever-increasing debts to pay for them — helpfully financed by the Asian central banks. Until recently, there seemed no limit to the foreign appetite for US dollars. But now the appetite of Asian banks for the U.S. dollar is waning. As these banks slow their accumulation of U.S. dollars and diversify into other currencies (a survey of central banks last year showed that 70% had increased their exposure to the euro and were thereby decreasing their exposure to the dollar.) the impact will be important. If this trend continues, the U.S. dollar will have to fall in value. My hope is that any dollar devaluation will be gradual and I doubt that a crash in the U.S. dollar is imminent.

The best way to protect a portfolio against a falling dollar is to own international bonds and stocks (mostly in developed countries) valued in their local currencies. Based on the dollar potentially weakening, I will be recommending that a larger percentage of your stock and bond portfolios be allocated abroad. Think of it as a hedge against the dollar falling in value.

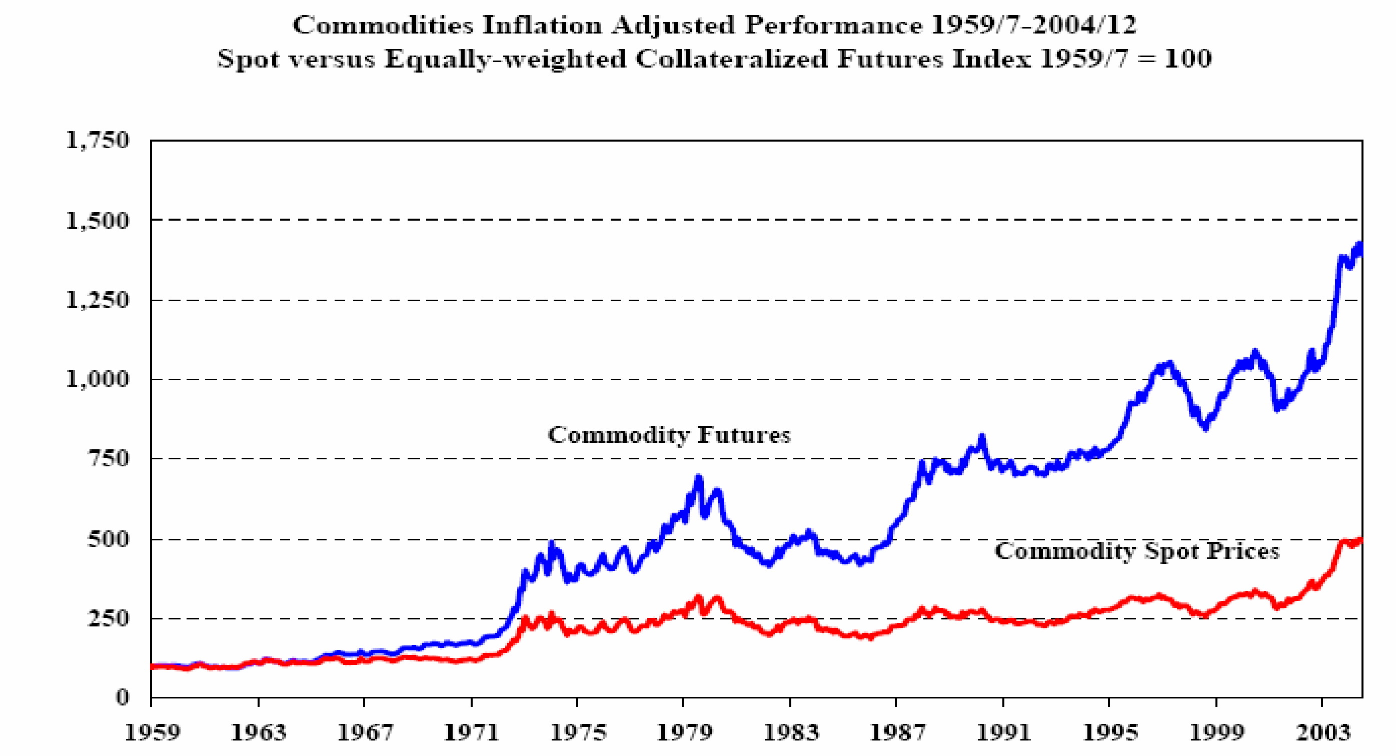
I would like to make another point regarding international markets. Traditionally, developed countries' stocks have traded at a discount to U.S. stocks based on most metrics. European stocks historically traded on average at a 25% discount to U.S. stocks, based on stock price to cash earnings. A consensus is building in the investment market that this historic discount may begin to evaporate. In other words, European stocks will be valued more on par with U.S. stocks. If this discount were to decline, investing in European stocks could represent an opportunity to gain higher returns than the U.S. market.



The third elephant is the world's increasing demand for commodities. As Asia and the rest of the developing world demand more metal, wood and oil the price will have to rise. Commodities are sticky in the face of rising demand, because new sources are not quickly found, developed and brought to market. The result is that it can take years before supplies can be increased to meet rising demand. So commodities tend to outperform over long time periods (usually ten to twenty years). We are just at the start of a long cyclical bull market for commodities. So if commodities fall, like they did last quarter, it is only a long term buying opportunity. Since commodity prices are incredibly volatile, I still believe it is best to keep your exposure to only 3% to 5% of the portfolio.

It is important to remember that when I talk about commodities I'm talking about owning commodity *futures* not actual commodities. This is an important distinction, because as the chart on the next page shows, owning commodity futures is different from owning "commodities." In fact, over the long-term, the return to commodities (based on their spot prices) has been much lower than the return from owning commodity *futures*. The chart on the next page demonstrates this relationship. The blue line shows the *inflation-adjusted* performance of commodity futures. The red line is the performance of commodity spot prices.

Commodity futures returned about 11% annualized versus about 7% for commodity spot prices (*with* annual rebalancing). Without rebalancing, spot prices only gained 3.5% annually, which is below the rate of inflation during this time period – so commodity spot prices did not keep up with inflation. One of the reasons I selected PIMCO Commodity Real Return Strategy is that it owns the commodity futures. Most natural resource funds own the stocks of companies that produce and sell commodities. As the chart below demonstrates this is not the same as owning the commodity futures.



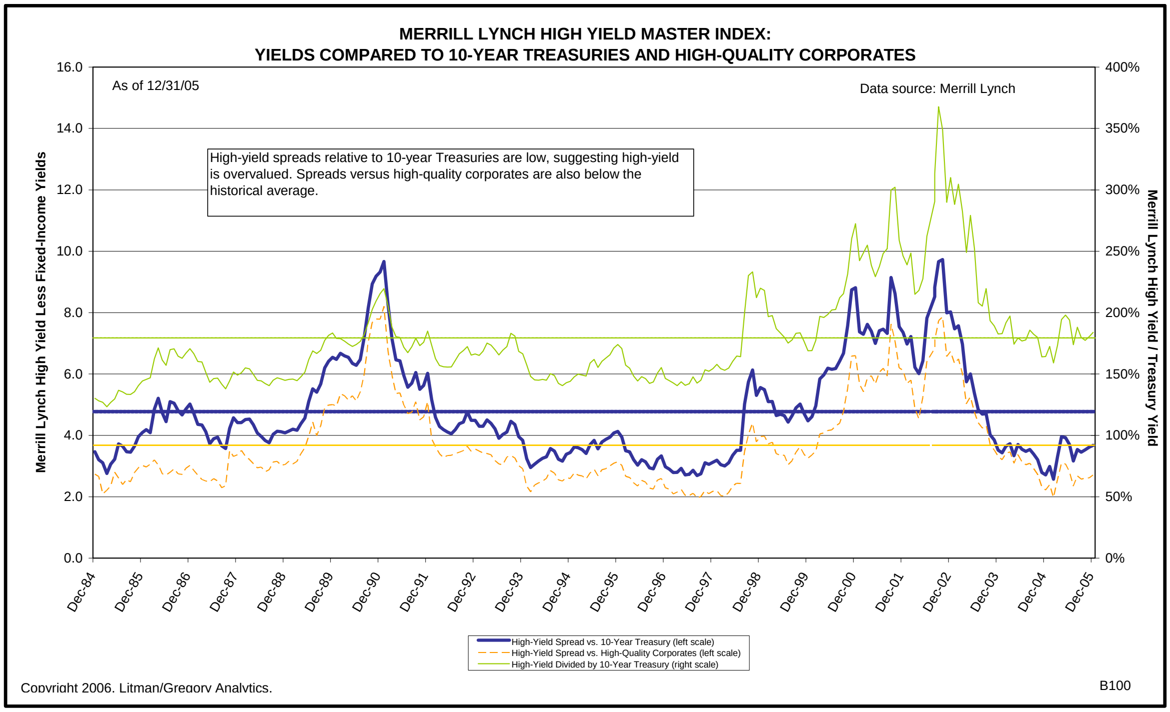
The chart was created from data presented in *"Facts and Fantasies About Commodity Futures,"* Gary Gorton and K. Geert Rouwenhorst, Yale ICF Working Paper No. 04-20, February 2005.

The other reason to invest in commodity futures is its correlation benefits. There is essentially a zero or a slightly negative correlation between commodity futures and stocks and bond returns. That means they don't perform in lock step with stocks and bonds. This lack of correlation is a consistent finding across numerous academic studies. It doesn't matter if the study is based on a different commodity futures index or analyzes a different time period (as long as it was a reasonably long time period) the results are the same. So although commodities are volatile by themselves, when added to a portfolio of stocks and bonds, they reduce the overall portfolio volatility and increase risk-adjusted returns. That's the beauty of Modern Portfolio Theory.

Interestingly, commodity futures are positively correlated to inflation. In other words during significant periods of inflation, commodities futures perform well. More importantly, commodity futures are positively correlated to unexpected *changes* in the rate of inflation. So if inflation unexpectedly increased, commodity futures have historically performed well.

In summary, commodity futures are volatile but historically over the long run they protect your portfolio from inflation and the underperformance in stock and bond markets usually associated with inflationary periods. So I plan to keep the 3% to 5% allocation to commodity futures in your portfolio stable but increase your international stock and bond exposure during the next quarter.

Here is an interesting observation on the state of the U.S. bond market. Investors are not being compensated for taking risk in the bond market. They are blindly chasing yield without regard to risk. The yield on the Merrill Lynch High Yield index currently stands around 8%, which is low by historical standards. The spread over the 10-year Treasury (considered the risk-free rate) is just 310 basis points (1 basis point is equal to 0.01% so 100 basis points is 1.00%) for high yields. This represents a dramatic decline from a peak in late 2002 when spreads were over 900 basis points (9.00%). The current level is well below its historical average, indicating that high-yield bonds are overvalued. High yield bonds are currently not competitive with other asset classes. They have a relatively low probability of achieving a large upside surprise in returns, and a risk profile that is higher (or potentially worse) than alternative bond and stock investments. I believe that high yields bonds are overvalued and therefore are not included in your portfolio.



Financial Planning Issues: Did you get ensnared by Alternative Minimum Tax (AMT) this year? We can help our ongoing investment management clients with tax planning and maybe help you reduce or avoid AMT. It is all a part of the service we offer you as ongoing clients. So if you would like us to help you with your tax planning please give us a call and schedule an appointment.

Everyone is very focused on current value of their real estate. Please remember that as your assets increase in value so does your exposure to loss and theft. As part of our ongoing service to our investment management clients we would be happy to review your property insurance and make recommendations. We just need copies of your home and auto insurance declaration pages. Remember that we are fee-only and do not sell insurance so you can be sure that we are offering you our unbiased opinion.

The 401(k) and 403(b) contribution levels have increased for 2006. As an employee, you can contribute $15,000 to your plan in 2006 and an additional $5,000 if you are age 50 or over. IRA contributions are $4,000 but those who are over age 50 you can contribute an additional $1,000. If you need additional help managing your employer sponsored retirement accounts please give us a call; as usual it is part of our ongoing management service. This is also a good time to review all of your beneficiaries on your retirement accounts (IRAs, 401ks, etc.) and make sure they are up to date. We would of course be happy to help you with this as well.

Other News: We finally have our website up and running. The address is www.altamontwealth.com Altamont's quarterly newsletter and articles are posted on the site for easy access. We also have our SEC forms such as the ADV available for download in Adobe. So check out our site and let us know what you think.

Happy Spring,

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