Altamont Capital Management

Second Quarter 2006 Performance

"There are intelligent ways to go about investing and less intelligent ways. ….Even pursuing the sensible, time-honored policies of conservative investing is no guarantee of financial enrichment. The most intelligent plans often go awry…So know yourself, educate yourself, determine the financial plan best suited to your objectives, and have the wisdom, patience, and emotional discipline to stay the course." ***John Bogle (Founder of Vanguard)***

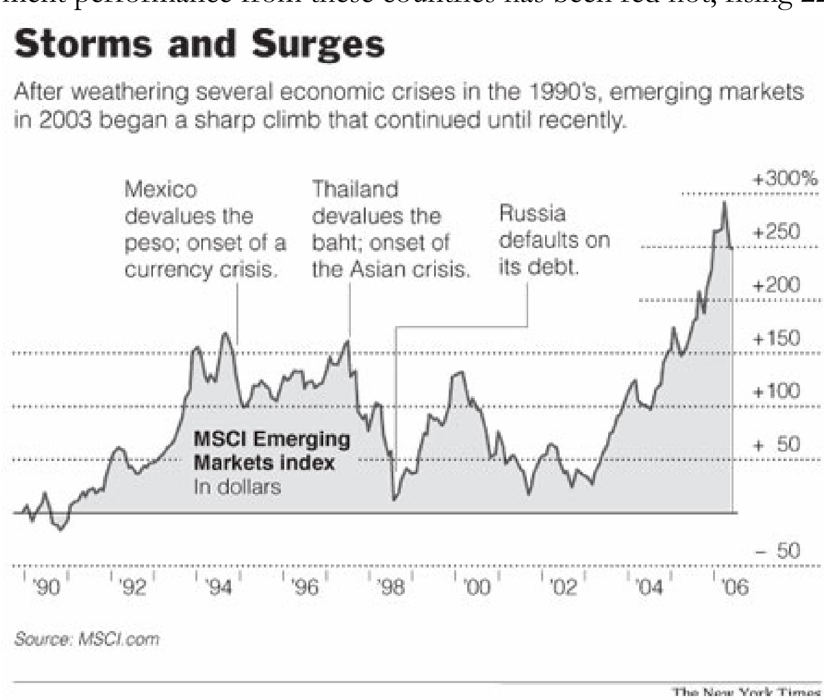
The market suffered through a disappointing Second Quarter as investors' anxiety about rising inflation and interest rates dragged stocks and bonds lower on Wall Street and around the globe. The markets bounced around quite a bit during the second quarter, with the S&P 500 reaching a year-to-date high in early May before sliding sharply, then recovering at the end of June to finish the quarter down 1.5%. Up. Down. Down. Up. The market's mood swings this year have been enough to give even the most seasoned investor motion sickness. So is the sky falling? Not even close. In fact, the major indices for the year are still positive.

Second Quarter 2006 and Year-to-Date Benchmark Returns

	Second Quarter	Year-to-Date
Large-Cap Benchmarks		
S&P 500 iShares	-1.5%	2.6%
S&P 500 Growth iShares	-3.5%	-1.3%
S&P 500 Value iShares	0.6%	6.4%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	-3.2%	2.7%
S&P 400 Midcap Growth iShares	-4.4%	0.2%
S&P 400 Midcap Value iShares	-2.1%	5.6%
Small-Cap Benchmarks		
S&P 600 iShares	-4.6%	6.0%
S&P 600 Growth iShares	-5.2%	4.1%
S&P 600 Value iShares	-4.1%	7.9%
Other Benchmarks		
MSCI EAFE Int'l iShares	0.7%	9.1%
MSCI EM Int'l iShares	-5.8%	5.5%
Vanguard Total Bond Mkt Index	-0.2%	-0.9%
Dow Jones AIG Commodities Index	6.1%	3.6%

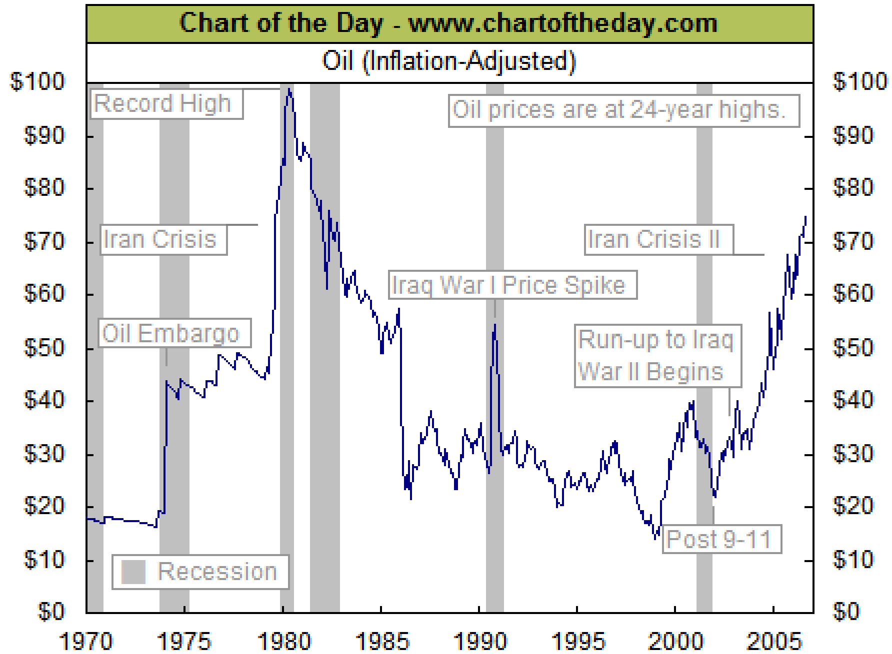
The two sectors of the market that gained the most over the last year fell the most and they were small cap domestic stocks and emerging market stocks. The S&P 600 (U.S. Small Cap Stocks Index) fell 4.6% during the quarter while the S&P 500 (U.S. Large Cap Stock Index) fell 1.5%. Year-to-date, small caps are still trouncing large cap stocks, with S&P 600 returning 6% versus the S&P 500 return of 2.6%.

The second major story was about emerging markets - third world countries like India and China. The investment performance from these countries has been red hot, rising 22% in 2004 and 30% in 2005. In spite of falling almost 6% in the Second Quarter, the MSCI Emerging Markets Index is still up 5.5% for the year. This is a typical boom-bust pattern; a huge ride up is followed by a correction. The volatility in the emerging markets sector is not going away, and will in fact become more amplified over the next year. Due to the volatility in emerging markets, your portfolio is not directly invested in this sector. Instead your portfolio has a minor exposure to this asset class through your more traditional developed-markets international mutual fund investments.



Value stocks continued their dominance over Growth stocks in the Second Quarter. We'll discuss the continued dominance of value over growth and small caps over large caps later in this newsletter.

Domestic investment-grade bonds and emerging market short-term bonds (local currency) were flat, but commodity futures fared better, gaining roughly 6% over the three-month period. The rising cost of oil and other raw materials is causing commodity futures to rise. The price for a barrel of crude oil has just surged above the $77 level. While oil is currently at 24-year highs, it is still significantly below the inflation-adjusted highs of 1980. It is also interesting to note that most oil price spikes were a result of Middle East crises and often preceded or coincided with a US recession. Stay tuned….



Risk Reasserted Itself with a Vengeance – Why is Everyone Worrying About Inflation?

The past several weeks have certainly been a wake-up call to many investors. For a few years now, investors seem to have taken comfort in a number of things: the fundamentals looked good in most parts of the world; we'd gone more than three years without a market correction; and there was lots of money looking for a home. This money came from many sources, including hedge funds. These vehicles have grown in popularity and influence, and in many cases their managers have been looking anywhere and everywhere for places to eke out some extra return. These funds often use leverage (meaning they invest borrowed money), and with the incredibly low interest rates we saw in 2003 and 2004 they could borrow very cheaply, then put that money to work anywhere it stood to gain more than the cost of borrowing. Corporate and high-yield bonds, as well as emerging markets securities, were likely big beneficiaries of this aggressive strategy, and it's very possible that commodity futures, and maybe even REITs and small-cap stocks, were impacted by hedge fund investing.

It is impossible to prove definitively that the behavior/performance of these asset classes was due to hedge funds' involvement, but two things are certain: 1) most hedge fund managers' incentive-based fees create a very strong incentive for risk-taking, and 2) according to an article in The Economist magazine, hedge funds controlled more than $1 trillion in assets as of year-end 2004, and can account for more than half the daily volume on the New York Stock Exchange (and could very possibly have an equally large presence in every other financial market). The point is not to slam hedge funds or dissect their impact on the markets, but rather to highlight that a collection of factors have led to an increase in risk-taking in the financial markets, and it has been a few years since something came along and rattled everyone's nerves. So it is understandable that the market gyrations we've seen in the last month and a half may have caught people's attention, even though these gyrations are not out of line by historical standards.

What suddenly caused things to change and for volatility to increase? Investors' biggest concern seems to be inflation and what could eventually happen if inflation persists, causing the Federal Reserve Board to keep raising rates.

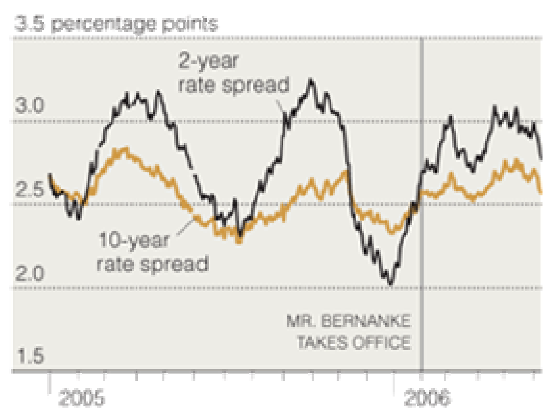
Investors are worried that the Fed will overshoot in trying to choke off inflation and that higher rates will push the country and the world into a recession. The hope among investors has been that the Fed will stop raising rates soon and that the economy will slow just enough to bring inflation back within the Fed's targeted range while leaving the economy healthy enough for decent earnings growth. As economic growth has continued to be surprisingly strong—and the Fed has continued to raise rates—the risk of an overshoot (and the ensuing recession) has increasingly been on people's minds.

Our new Federal Chairman Ben Bernanke did a horrible job managing the messages disseminated by various Federal Reserve members during the quarter. Different Fed members gave speeches with contradictory signals about inflation, job growth and the Fed's stance on future rate hikes. The market doesn't like uncertainty and reacted poorly to these diverse inputs. The adjacent chart shows the bond markets reaction to the uncertainty surrounding Bernanke replacing Alan Greenspan as Federal Reserve Chairman. I think the Fed corrected this problem in July, when it last raised interest rates, by clearly stating its position. The market has since stabilized but the damage was already done. I didn't think I would ever say this, but I miss ex-Chairmen Greenspan's convoluted way of turning a phrase. He was deliciously boring but never contradictory.

The Bernanke Factor

The differences between rates on regular Treasury securities and Treasury inflation-protected securities, or TIPS, are a closely watched indicator of inflation expectations. Those spreads continued to increase in Ben S. Bernanke's first days as Federal Reserve chairman.

Yield spread between regular Treasury securities and TIPS, for 2- and 10-year bonds.



Source: Macroeconomic Advisers

The New York Times

So what are the odds that continued inflation will lead the Fed to tighten to the point that the economy ultimately tips back into recession? The longer-term inflation picture appears temperate. Further rate increases should be limited since sizeable rate increases have already occurred, and the economy is showing signs of slowing. A near-term recession isn't too likely given the economy's current vital signs. Even if a recession were to occur, stocks have recently corrected to attractive valuations, so a cyclical bear market wouldn't be too bad. All-in-all inflations should stay under control.

Why Inflation Could be Benign

There are numerous counter-inflationary forces at work. Globalization is among the strongest of these counter forces. Production has moved around the world to where it is least expensive. The result: it has become a very competitive world where cheap labor is readily available in most industries. Cheap labor costs keep the price of finished goods low. When jobs go overseas, domestic consumers' aggregate wages may temporarily decline. Even if producer prices (e.g., oil) experience inflation, any company with overseas competition is going to have a hard time raising prices to offset its higher costs. Their profit margins may get squeezed, but unrestrained price pass-through to consumers would be difficult.

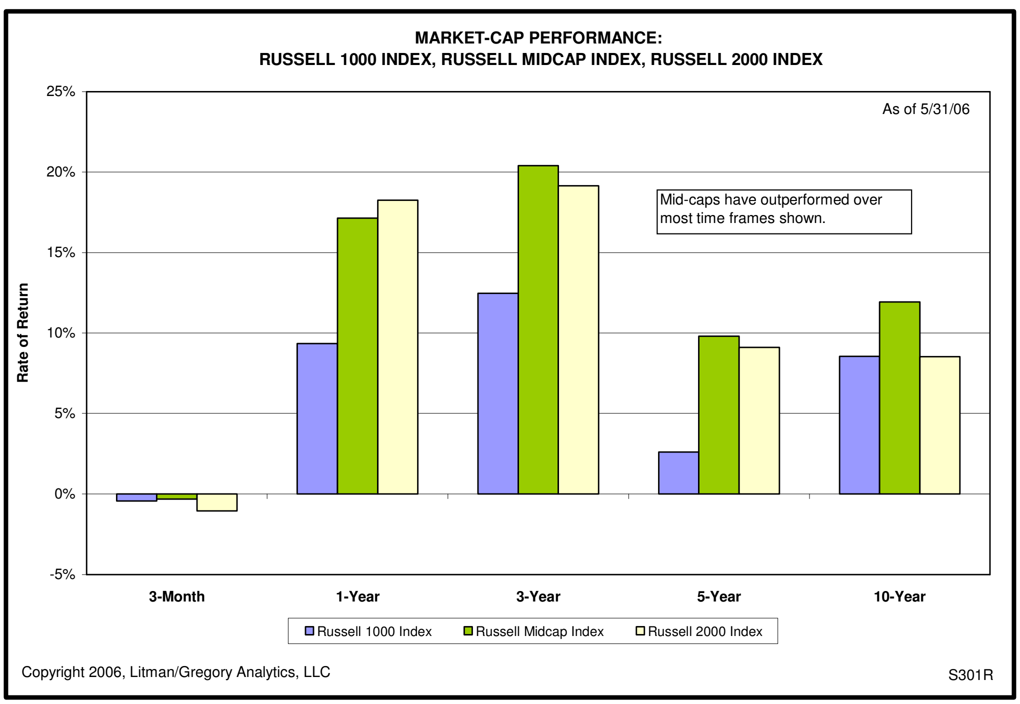
Along with globalization, technology has had a big impact on productivity. Globalization and technology work together, and their combined impact have played—and will continue to play—a big role in keeping inflation in check through increased productivity. The so-called "productivity miracle" is a big part of the reason why profit margins are high, even in the face of rising commodity prices and a lack of pricing power. This is a secular force that is likely to dominate a temporary cyclical rise in inflation.

Another force working against inflation is a slowdown in the housing market. Without the tailwind of rising home prices or declining interest rates, homeowners are less likely to refinance (taking out home equity) to increase their spending. The construction and financial services industries have grown tremendously in recent years in response to the booming housing market, and a slowdown could lead to layoffs; higher unemployment is usually considered recessionary rather than inflationary. Also, with fewer families rushing to buy homes, there's less spending on all the goods that come along with a home purchase (furniture, appliances, etc.).

Weighing all the evidence, it is unlikely that a broad, dramatic, and sustained rise in inflation is likely in the foreseeable future. Anything can happen in the short-term, but there are at least as many reasons to be concerned about a recession as there are reasons to be concerned about inflation.

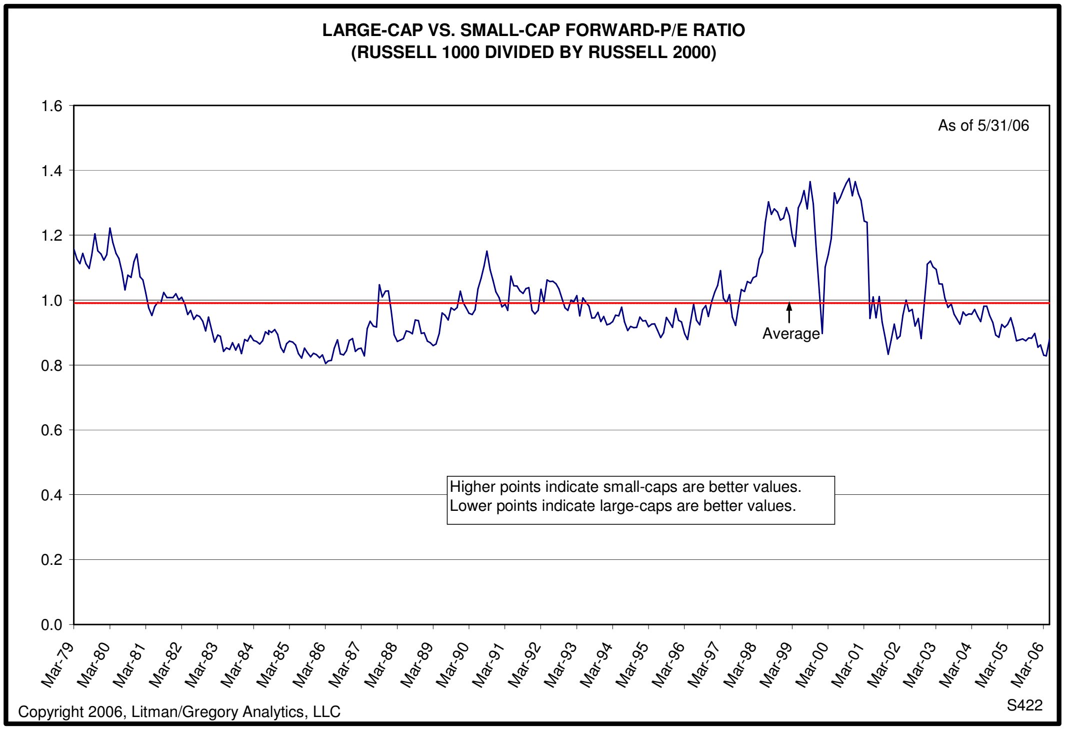
Valuations Revisited

So if inflation is causing all the market's problems and those concerns are likely unjustified, does that mean stocks are undervalued? The short answer is: Not quite. In order to take the risk of overweighting stocks (versus bonds) there would have to be a significant chance for above average returns over the next five years. To feel comfortable that above average returns were achievable, I'd need to see the S&P 500 fall to below 1,100 before feeling confident. Below that level I could feel confident that an irrational level of pessimism was reflected in stock prices. However, with the S&P 500 currently around 1,240, valuations are quite attractive and already discount much of the risk.



Is it Large or Small, Value or Growth?

What do valuations look like between different sectors of the U.S market? Well, small-caps' domination of large-caps may finally be nearing an end. For the five-year period from 2000 through 2004, the Russell 2000 Index (Mid Cap Stocks) outperformed the Russell 1000 Index (Large Cap Stocks) by an average of more than 800 basis points (or 8%) per year, but in 2005 these asset classes were more or less on par with one another (Large Caps tended to do better in down months, and Small Caps did better in up months, November being the lone exception). This pattern has persisted in 2006, and while Small Caps are ahead year-to-date, the euphoria surrounding them appears to have mellowed considerably. While Small Caps' big run may be over, their huge outperformance in the first part of the decade represents a rebuke to the ill-conceived perception in the late 1990s that investors should own only Large Cap stocks, and underlies the importance of diversification.

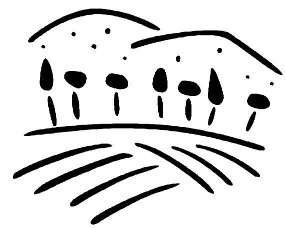


The huge outperformance of Small Caps over the past five years has eliminated the valuation gap that existed at the end of the 1990s bull market. According to Leuthold's data series, Small Caps are now selling at a P/E premium relative to Large Caps; historically, Small Caps have tended to sell at a discount to Large Caps. Russell data also shows Small Caps selling near historically high multiples relative to Large Caps. Overall, most measures suggest that Small Caps are probably somewhat overvalued relative to Large Caps, although not clearly overvalued in their own right. Since Large Caps are marginally undervalued, this suggests that Small Caps are probably still in a fair value range.

With respect to style, neither Growth nor Value offers clearly superior opportunity relative to their historical relationships with one other. There is some evidence pointing to the attractiveness of Growth stocks, but it is not enough of a valuation differential to warrant overweighting them.

Conclusion

Watching stocks go down isn't fun, but it does make valuations increasingly more appealing. In recent years, the fundamentals have been generally good or improving in most parts of the world, so there has been little in the way of market-rattling fear and a notable dearth of attractively priced asset classes. But if investors around the globe act based on irrational fear, bringing markets lower in the shorter term as they demand a greater premium for taking on risk, the opportunities it creates for longer-term rational investors may be significant. So stay tuned….



We thank you for your confidence and trust.

Libby Mihalka

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