Altamont Capital Management

Third Quarter 2006 Performance

"The only difference between life and the movies is that a script has to make sense, and life doesn't."

Joseph L. Mankiewicz (Film Director)

The third quarter was triumphant for stocks. Not only did the Dow Jones Industrial Average flirt with its record high — thanks in part to falling energy prices and a pause in interest-rate increases — but the Standard & Poor's 500-stock index had its best third quarter in nine years. On the flip side, the tech heavy NASDAQ still remains far below its peak. In fact, the NASDAQ composite index is still down a stunning 55 percent from its record high.

The third quarter also marked a change in leadership with large caps substantially outperforming small and mid caps. The larger-cap S&P 500 index ended up 5.5% for the quarter. Small caps were nearly flat, losing a mere 0.9%.

For the last several years, investors made money by making big bets on shares of risky but fast-growing small companies. In fact, small-cap stock funds have been Wall Street's leaders since the bear market of 2000. Now that seems to have changed.

Over the last three months it has been the large, stable blue-chip companies that have delivered the best performance. Until this past quarter these large mega stocks traded at a discount to the overall market because they have been overlooked for several years. Historically, stable blue-chip stocks are what investors tend to cling to in the later stages of an economic cycle, when growth is harder to come by and when risks are rising.

Year-to-date, value stocks have outpaced growth across all market caps. Domestic investment-grade bonds and international stocks were each up about 4%, while short-term local currency emerging-markets bonds gained approximately 2%.

Third Quarter 2006 and Year-to-Date Benchmark Index Returns

	Third Quarter	Year-to-Date
Large-Cap Benchmarks		
S&P 500 iShares	5.6%	8.5%
S&P 500 Growth iShares	6.0%	4.9%
S&P 500 Value iShares	5.2%	12.0%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	-1.1%	3.0%
S&P 400 Midcap Growth iShares	-1.7%	-0.2%
S&P 400 Midcap Value iShares	-0.6%	6.0%
Small-Cap Benchmarks		
S&P 600 iShares	-0.9%	5.9%
S&P 600 Growth iShares	-2.5%	2.9%
S&P 600 Value iShares	0.5%	10.1%
Other Benchmarks		
MSCI EAFE Int'l iShares	3.9%	14.3%
MSCI EM Int'l iShares	3.9%	9.8%
Vanguard Total Bond Mkt Index	3.9%	2.9%
DJ-AIG Commodities Index	-7.8%	-3.2%

The Federal Reserve ended its long streak of interest rate increases as long-term rates fell, enhancing the overall performance of bonds. Bonds outperformed most of the stock market during the third quarter. The market shift toward safe (less volatile), blue-chip stocks and bonds could be an indication that investors think the economy is coming in for a landing. This is an about-face from the first half of this year, when inflation — not an economic slowdown — was the biggest issue worrying investors.

Technically, the economy has already begun to slow, with growth in the second quarter coming in at an annual 2.6 percent, versus 5.6 percent in the first quarter. By the third quarter, this slowdown was certainly reflected in commodity prices, as crude oil fell to about $60 a barrel from nearly $80. The oil price decline dragged down energy stocks, which had been among the market's big winners in recent years. According to Morningstar, the average natural resources fund, which invests heavily in the energy sector, lost 9 percent in the last three months. Precious-metals funds also lost ground, tumbling 6.6 percent. Commodity futures fell 7.8% during the quarter.

Investor sentiment improved in September as investors reacted to a more favorable inflation outlook. Despite this improved psychology in the market, the fundamental questions remain unanswered. 1) How much corporate earnings will slow in a moderating economy? And, 2) will this result in the economy having a soft landing; in which it slows but avoids recession, or a hard landing; with a painful recession?

The answer is unclear but an environment of increased uncertainty surrounding earnings expectations, usually keeps the market from becoming too speculative allowing the market to slow gently yet continue expanding for several more years.

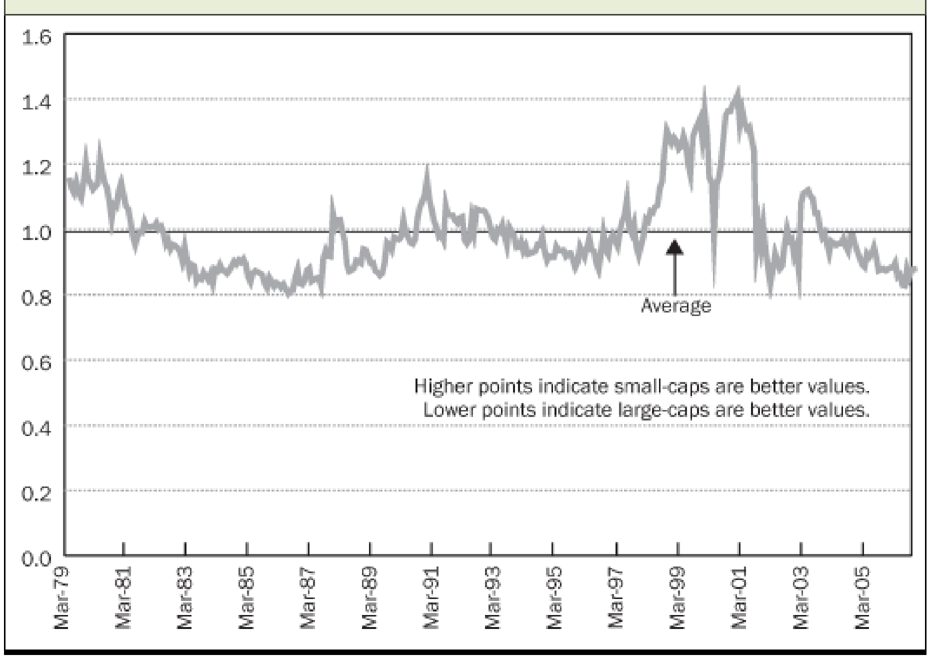
Explanation of Our Smaller-Cap Reduction

You may have noticed that we have reduced your small-cap exposure in your quarterly rebalancing worksheets over the last two quarters. If you haven't had a chance please review and sign your rebalancing so we can implement our recommended changes.

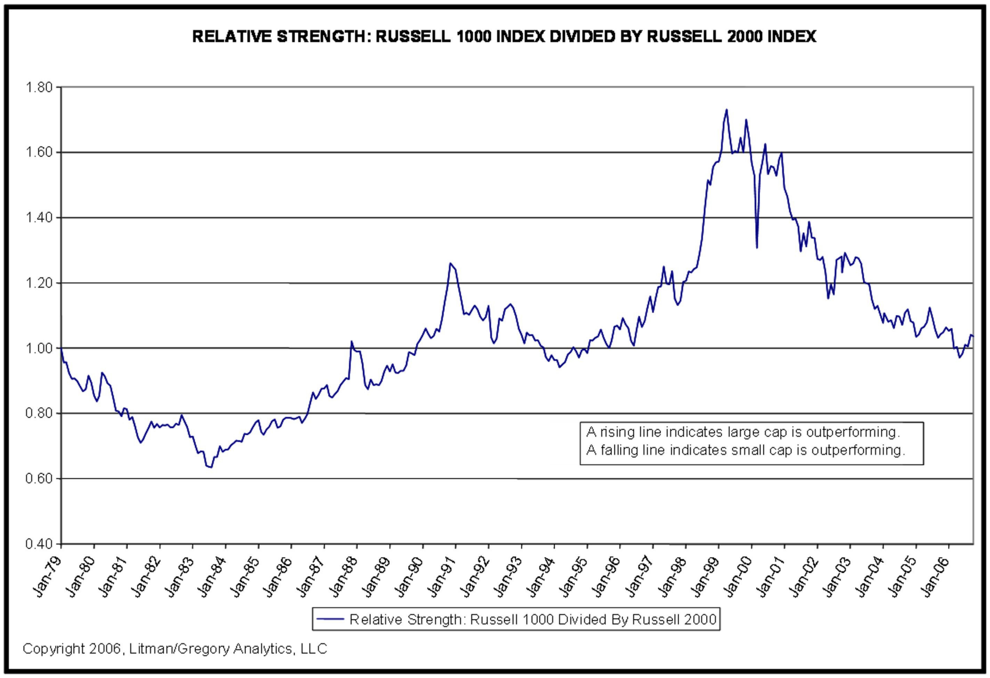
The decision to reduce small-cap exposure was driven by data from several sources. In every case these metrics showed small-cap valuations at or near the high end of their historical range relative to large-caps. The chart below shows the historical relationship between large-cap and small-cap P/E ratios. A ratio of ratios may be difficult to get one's arms around, but it's worth understanding. A P/E ratio on its own tells us how much it costs to buy a dollar of earnings: a higher P/E ratio means you are paying a higher price for that dollar of earnings, and a lower P/E ratio means you are paying a lower price for each dollar of earnings.

This chart is nothing more than a way of comparing the "costliness" of large-caps and small-caps to one another based on their stock price and company earnings. As an example, if a dollar of earnings from the average large-cap company cost \$18 (which is a P/E of 18x) and a dollar of earnings from the average small-cap company cost \$20 (a P/E of 20x), then the "ratio of ratios" would

Large-Cap vs. Small-Cap Forward-P/E Ratio (Russell 1000 Divided by Russell 2000) (8/31/06)



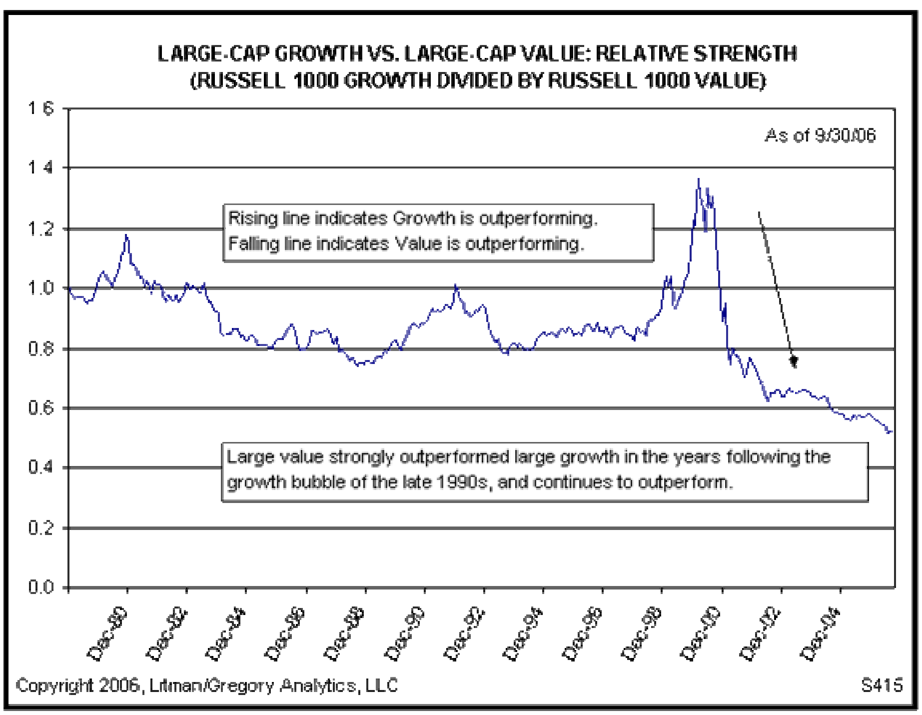
show that large-caps cost 90% of what small caps cost (18 divided by 20 is 0.9). Right now, this data shows that small-caps are expensive relative to large-caps. In fact, they are nearly as expensive as they've ever been, an observation supported by several other data sources as well.



Cyclical considerations also favor a lower small-cap weighting. The U.S. economy is well into its current economic cycle, and small-caps usually perform best (relative to other asset classes) early in the cycle. Combined with the valuation backdrop, the odds are very good that large-caps will beat small-caps on average over the next five years.

Please note that the rationale for underweighting smaller caps is relative. Larger-caps are not necessarily a compelling absolute return opportunity on their own, but smaller-caps are clearly less attractive than larger-caps, and so a shift in asset allocation is warranted. Your overall equity exposure will in most cases remain unchanged.

I would like to interject a note of caution that there is no way to know for sure how long it will take for this move to pay off. History is full of examples where an asset class stayed overvalued for years at a time, then took years to return to a normal valuation level. While history can be used as a guide in valuing small caps, it does not guarantee future performance. This re-allocation is based on my expectations of market performance over a longer time frame (approximately the next five years) but it is impossible to successfully predict what will happen in the market over the short term.



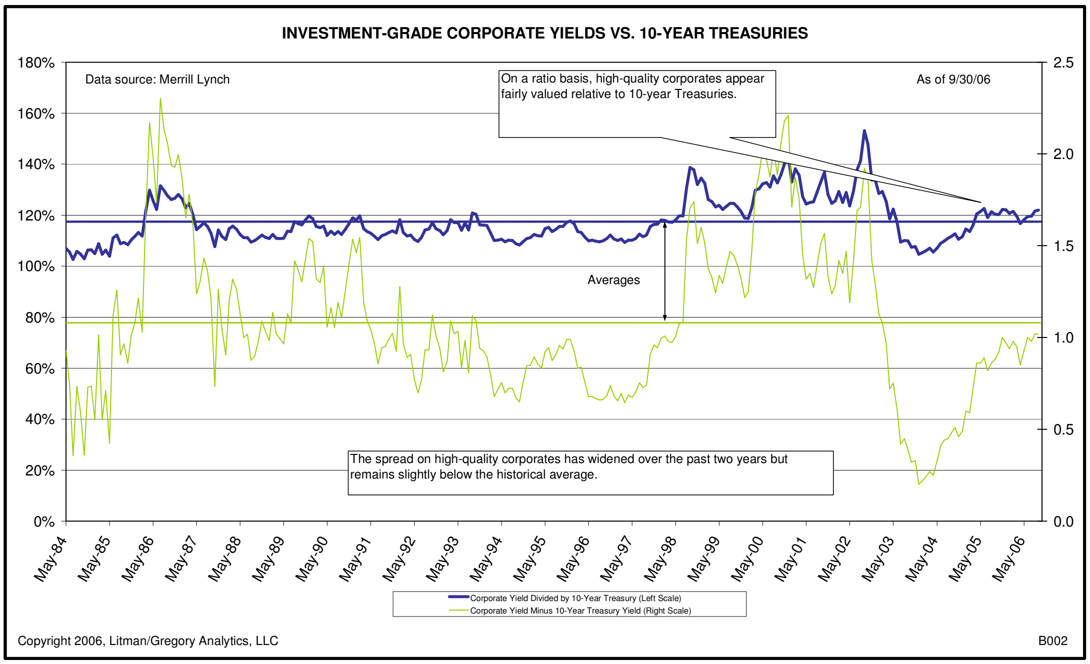
Growth vs. Value: Which will the Market Favor?

The bursting of the tech bubble in early 2000 caused growth stocks to fall and ever since, value stocks have outperformed growth. The strong relative performance of value stocks from 2000 through today has resulted in growth stocks appearing undervalued compared to value stocks. In four out of the past six calendar years, the Russell 1000 Value has massively outperformed the Russell 1000 Growth, after beginning that period hugely undervalued. In the other two years, 2003 and 2005, value still beat growth, but by narrower margins (20 bps and 180 bps respectively), and value is far outpacing growth in 2006. Some value managers have commented that the best stock-picking opportunities right now are in names that are more traditionally associated with the "growth" universe, which adds to the argument that growth is becoming attractive relative to value.

It is quite possible that the value-stock universe may continue outperforming the growth-stock universe until "value" is significantly overvalued on a relative basis. This has happened in the past after growth stock over-exuberance has been unwound. This scenario has only happened a few times (growth exuberance to bust and then value stock over-domination) so it is impossible to extrapolate

The Economy and Hedging Your Portfolio

Thanks to slowing earnings, dropping oil prices and a deteriorating real estate market, the Federal Reserve has finally put on hold what has turned out to be one of the sharpest cycles of rate increases on record. Economic forecasting is extremely difficult, but it's pretty clear that the risk of recession is increasing. It is essential that this risk and its impact be incorporated into your portfolios allocation. Hence the inclusion of asset classes other than equities (stocks) in your portfolio.



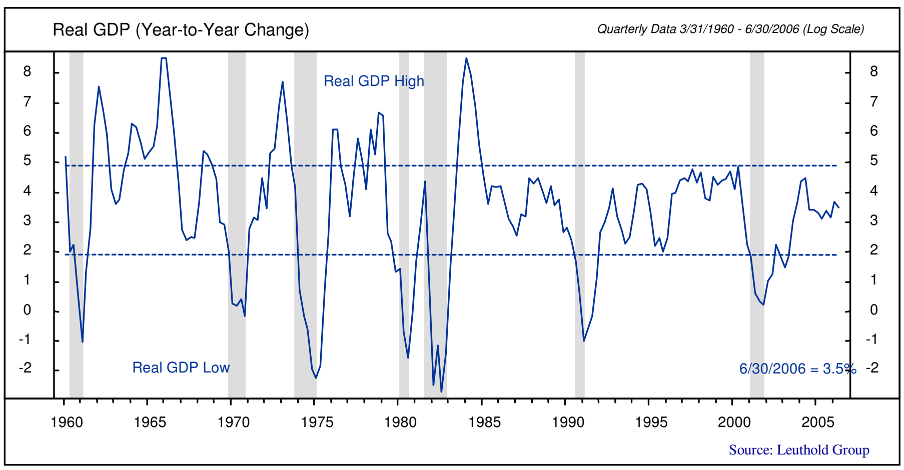
High-quality bonds are generally the best-performing asset class during recessions (bonds help mute the volatility of equities in other scenarios as well). The bottom line is that we don't need to be able to forecast the economy with precision in order to make sound portfolio decisions. High quality bonds have a low correlation with the stock market. In other words they don't usually perform in lock step so when one is down the other is up. Diversification within a portfolio reduces risk and enhances returns over the long run.

Emerging-market short-term local-currency bonds were added to most portfolios as a tactical hedge against a dollar decline. At almost 6% of GDP, the U.S. current account deficit remains near its worst level in history. Foreigners' demand for our financial assets has, to some degree, offset our demand for their goods and services, and that has mitigated the dollar's decline over the last several years. The dollar did decline a significant amount between 2002 and 2004 against a basket of major currencies, so a partial correction of this imbalance has started, but the dollar has declined far less relative to "other important trading partners," a group defined by the Fed that includes China, Mexico, and much of Latin American and Asian emerging markets. The fact that the current-account deficit, which is mostly driven by our trade deficit, remains at an all-time high is further validation that the dollar's declines thus far have been insufficient to correct this imbalance. On a long-term basis, the dollar is likely to experience further declines. For this reason emerging-market short-term local-currency bonds were added. In addition, these bonds have higher yields than U.S. bonds of similar maturity. Another argument in favor of emerging market bonds is the improving economic status of many emerging-market countries.

In the event of a sharp and disorderly decline in the dollar, emerging market currencies could come under selling pressure because of their closer ties to the dollar and a broad move away from riskier economies. Developed-market foreign bonds could certainly do better in that situation, and that is why they are being added to most client portfolios. However, developed country bonds are considerably less attractive in a base-case scenario for several reasons. They have lower nominal yields. In addition, most of their currencies, with the exception of the yen, have already had big upward moves versus the dollar; and that as a group they don't represent some of the countries with which our largest trade imbalances exist.

When Will the Current Economic Cycle End?

The current expansion is mature but could continue. Grey bands show recessions.
The line shows real GDP change.



It's a balancing act between which to investment will yield the highest return, emerging markets short term bonds or developed country bonds. Including both types of international bonds in a portfolio provides valuable diversification and the potential for very good long-term returns relative to domestic bonds.

Commodity futures have also been on a wild ride from rising and falling commodity prices and fears over a Fed-induced recession. Oil and natural gas—two of the biggest component of the index—have been particularly volatile. Futures prices are generally at or above spot prices, which may suggest somewhat limited return potential going forward. This makes commodity futures somewhat less appealing from a tactical standpoint, but they continue to have value as a portfolio diversifier. If oil and natural gas were to soar, then the stock market will surely fall. The small position in commodity futures would yield a significant return that would help offset any stock market losses.

One of the key variables for commodity futures is the Fed's interest-rate stance. Historically, a good time to sell commodity futures is when the Fed starts cutting rates. The Fed isn't ready to cut rates yet, but it is something I'm monitoring.

Tactical opportunities in short-term emerging markets bonds, commodity futures, larger-caps versus smaller-caps and growth versus value will modestly improve our return prospects while helping mitigate certain risks over coming years. The goal is to generate the highest risk adjusted returns for our clients.

Thank you for your confidence and trust.

Libby Mihalka

P.S. Remember to check out our website www.altamontwealth.com