Altamont Capital Management

Fourth Quarter 2005 Performance

"The real test of the earnings power…of an operation is what it achieves after operating for an extended period in a no-growth mode. You only learn who has been swimming naked when the tide goes out."

Warren Buffet (2004)

The Year the Market Moved Erratically Nowhere

The lessons of 2005 reflect the importance of discipline and patience. The market reacted to lots of macro-level worries by moving in "fits and starts" back to where it began with the Dow Jones Industrial Average losing 0.6%. For much of the year markets were flat or falling, but there were short periods when returns came in bunches. Timing these short bursts of performance would have been difficult. It was also a year when diversification away from most mainstream asset classes paid off. In addition, committing to a fundamentals-based asset allocation paid off. So in the end, even though 2005 didn't feel like a very good year for investors, it wasn't too bad.

Stocks, as measured by the S&P 500, returned a boring but respectable 4.8%. But foreign stocks delivered a downright exciting 13.4% return thanks mostly to the performance of stocks in Japan and emerging markets. Overall, investors with global equity exposure had the opportunity for a reasonably good year. Within the U.S. stock market, based on most benchmarks, value-type stocks out-performed growth-type stocks for the sixth consecutive year (though in the second 1/2 of the year growth began to outperform). Value's out-performance was largely due to energy stocks, which were far and away the year's strongest sector. Small and Mid Cap stocks trounced Large Cap stocks for the third year in a row. Outside of the equity markets, fixed income (bonds) offered only small nominal returns and non-dollar bonds delivered slightly negative returns due to a stronger dollar, which resulted in currency losses. Other asset classes did better, including commodity futures (up 21.4%). In short, in 2005 investors were rewarded for diversifying beyond domestic stocks and bonds.

Fourth Quarter 2005 and the Year Benchmark Returns

	Fourth Quarter	2005
Large-Cap Benchmarks		
S&P 500 iShares	2.1%	4.8%
S&P 500 Growth iShares	1.9%	3.8%
S&P 500 Value iShares	2.2%	5.7%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	3.3%	12.5%
S&P 400 Midcap Growth iShares	5.0%	13.3%
S&P 400 Midcap Value iShares	1.5%	11.5%
Small-Cap Benchmarks		
S&P 600 iShares	0.3%	7.5%
S&P 600 Growth iShares	0.4%	9.0%
S&P 600 Value iShares	0.2%	5.9%
Other Benchmarks		
MSCI EAFE Int'l iShares	4.1%	13.4%
Vanguard Total Bond Mkt Index	0.7%	2.5%
Dow Jones AIG Commodities Index	-3.0%	21.4%

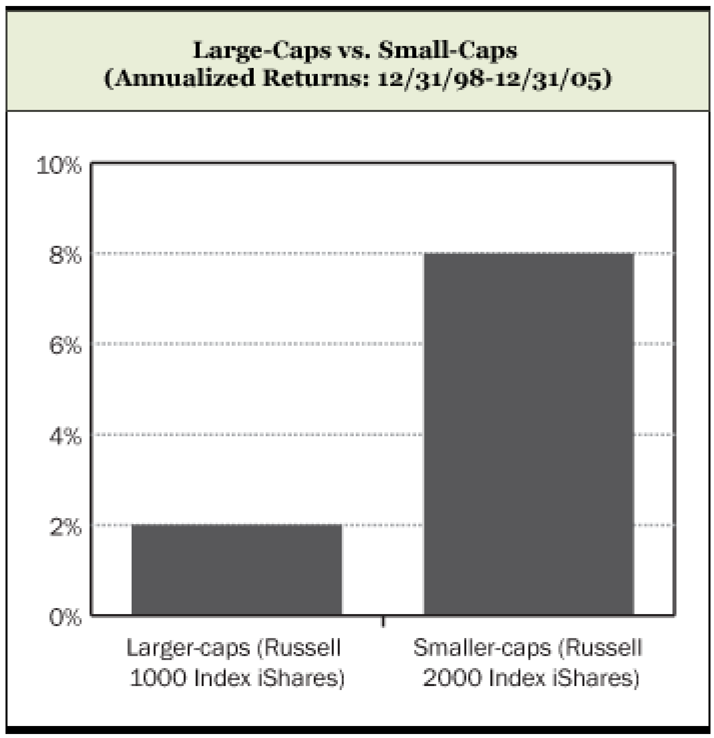
I would love to deliver fantastic performance to you (our clients) every year. However, I've learned through experience, from study, and discussions with many great portfolio managers that pursuing greatness year in and year out is not only unrealistic, it is not wise. Even the best are wrong sometimes and miss out on some opportunities. Eventually, for virtually all investors the experience is humbling at some point. Acknowledging this, I focus on the more realistic goal of having a good consistent performance. I do this by following a disciplined investment approach and only deviating slightly from each client's portfolio target asset allocation when there is a clearly compelling opportunity. These opportunities do not present themselves very often. I have to strongly believe they either raise the portfolio's return potential without materially increasing the risk, or lower the portfolio's downside risk level without lowering return potential. Pursuing only high-conviction opportunities greatly increase the odds of being right more often than wrong, which in turn can lead to good performance most of the time. Reasonably good performance most of the time can result in a very good performance over a very long time. Growing your retirement portfolio isn't about one big win followed by big losses the next year; instead it's about consistent performance.

Consistent performance is not achieved by only owning what's considered hot and shunning what's not. When any investment or asset class is universally loved, investors should beware. But when an investment or asset class is hated, investors are often presented with great opportunity. Back in early 2000 it was easy to see what was loved and what was hated.

Today most asset classes are neither loved nor hated. The hated asset classes of 2000—value stocks, small cap stocks and real estate—have hugely outperformed, while growth has been pummeled. Most asset classes are now priced about right, and while there are some potential opportunities, there are no clear return-based opportunities.

Growth stocks: With a sense of history it is perhaps not surprising that some of the best stock-picking opportunities probably now lie in the large-cap growth universe. After almost six years of huge underperformance and losses that are not yet close to being recouped (despite a strong rebound since late 2002) many companies are at least reasonably priced.

Since the technology stock bubble burst in March 2000, consumers have fueled the economy. While Corporations have held onto their cash, consumers spent more than they earned by pulling billions of dollars from their home equity. This is the first time consumers have spent more than they earned since the Great Depression. In addition, a greater percent of consumers' income is going to necessities (53%) than any time in the past 25 years (44% in 1980). Consumer spending has propped up the economy, but increased interest rates, rising energy prices, and skyrocketing medical costs will dampen consumer spending in 2006.



Many strategists think businesses will pick up the slack by investing in technology and equipment. Many companies have delayed any technology upgrades or capital spending until the business environment stabilizes. Years of delayed capital upgrades, large stashes of cash and strong earnings growth could prompt firms to begin spending. Growth stocks would benefit the most from corporations investing the $2 trillion in cash they have accumulated the last few years. Then again, I expected this to happen last year. There is no historical evidence to support increased corporate spending in the next year. If Corporations don't step up and start spending while consumers spend less, then the economy and the stock market could have a down year. I think it is likely that we will see a gradual change from consumer driven growth to corporate driven growth.

Based on this scenario and the current investment climate it is time to slightly overweight to growth.

Large-Caps: After a lengthy period of stronger-than-expected earnings growth, it is likely that growth will slow but remain positive. At this point S&P 500 earnings are forecasted to grow by over 10% once again.

However, with a recent (and unusual) history of underestimating earnings growth, I believe the bias may now be for analysts to again overestimate growth. If so, earnings will disappoint rather than surprise to the upside. What leads me to this conclusion? – Well, rising borrowing costs, a topped-out housing market, already high profit margins and the age of this earnings cycle could lead to a disappointing year. But even if earnings growth slows, the overall large-cap stock market looks somewhat undervalued and reasonably attractive. So despite a plethora of potential longer-term risks, I would maintain a healthy exposure to large cap stocks because stock prices suggest some margin of safety (the risks are at least partly reflected in stock prices) and returns should be better over the next few years than most of the alternatives.

Mid Caps and Small-Caps: Small-cap stocks look less attractive than they did a few years ago and less compelling than large-caps. Given their significant outperformance since the late 1990s, they now look slightly pricy relative to large-cap stocks. They also tend to perform best early in the economic cycle. Though it is hard to say how much of this cycle is left, it is not early. So limiting exposure in small-caps to the lower end of the allocation range would be best.

Mid-caps are still enticing. Last year mid-caps generated the strongest return with the S&P 400 Mid-Cap Index by delivering an 11.6% return. Most of the institutional investment world ignores mid-caps as the poor cousin of small-cap stocks but that is precisely what makes them so enticing. Based on valuation, mid-caps are just as compelling an investment in 2006 as large-caps.

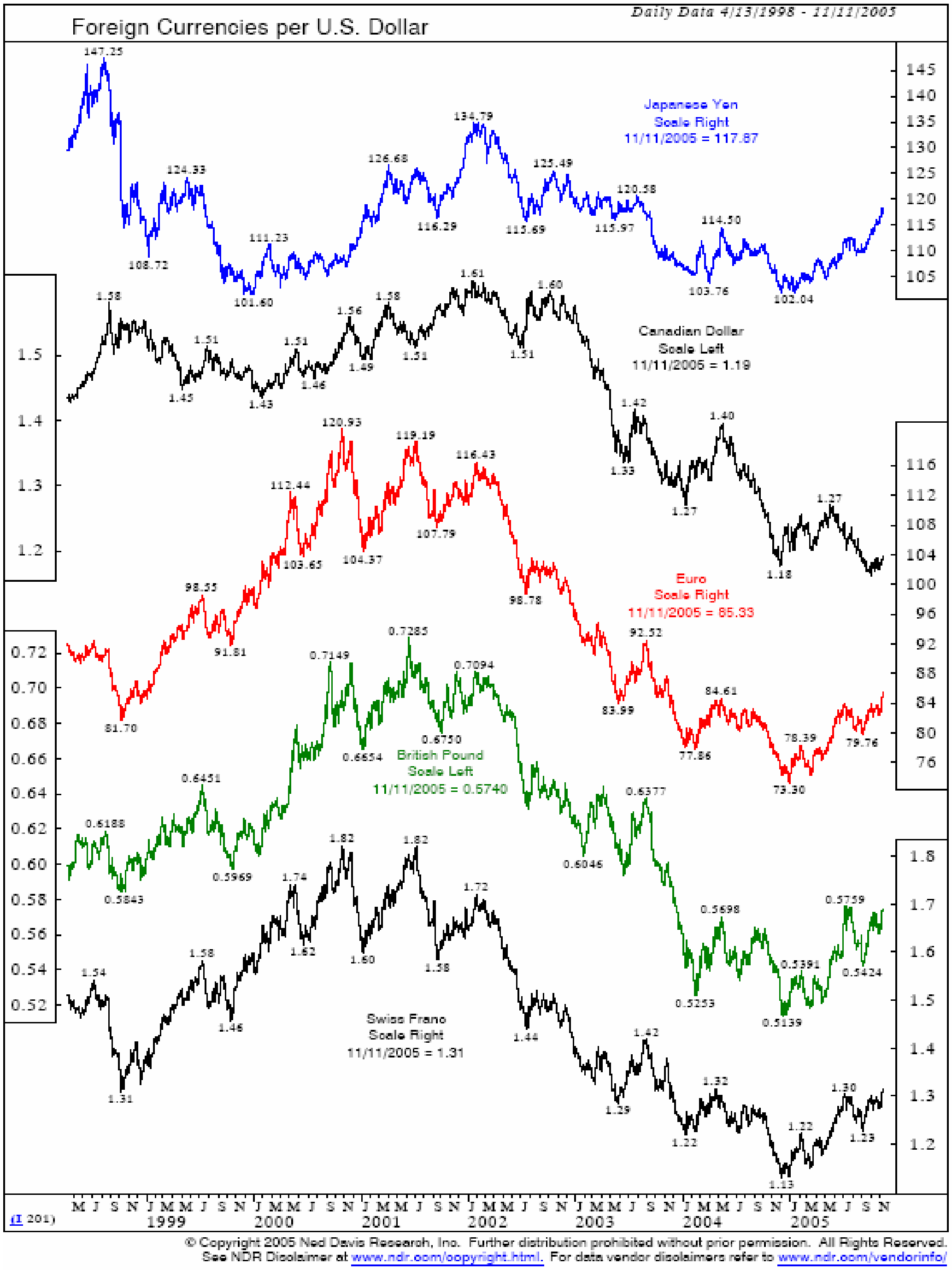
Foreign Stocks: 2005 was a big year for foreign equities. While momentum could very well result in continued strong performance for some time, the data suggest that foreign stocks are in a fair-value range compared to U.S. stocks. The Japanese market was particularly strong in 2005 and this reflected continued and important improvements in the health of the banking sector and corporate restructuring. But while the prospects for Japan look better than they have for more than 15 years, the country is still experiencing price deflation and the population is both shrinking and aging. Still, it all nets out to a more positive outlook than we've seen in close to a generation and explains the highest allocations to Japanese stocks in international funds I've seen in 15 years.

Emerging markets look cheap, selling at a P/E of just over 12x trailing earnings. However, on a price-to-book basis, emerging markets look historically pricy. A key question is whether the valuation metrics of emerging-markets deserve to be upgraded due to the significant structural improvements in many of their economies (e.g., current-account surpluses, reduced debt levels, improved disclosure, and higher foreign currency reserves). India and China are considered emerging market countries and they have been coming on strong. Their newly created middle class wants to own everything we have here in the U.S. This has led to an amazing economic growth spurt in these countries. Latin America has also been improving.

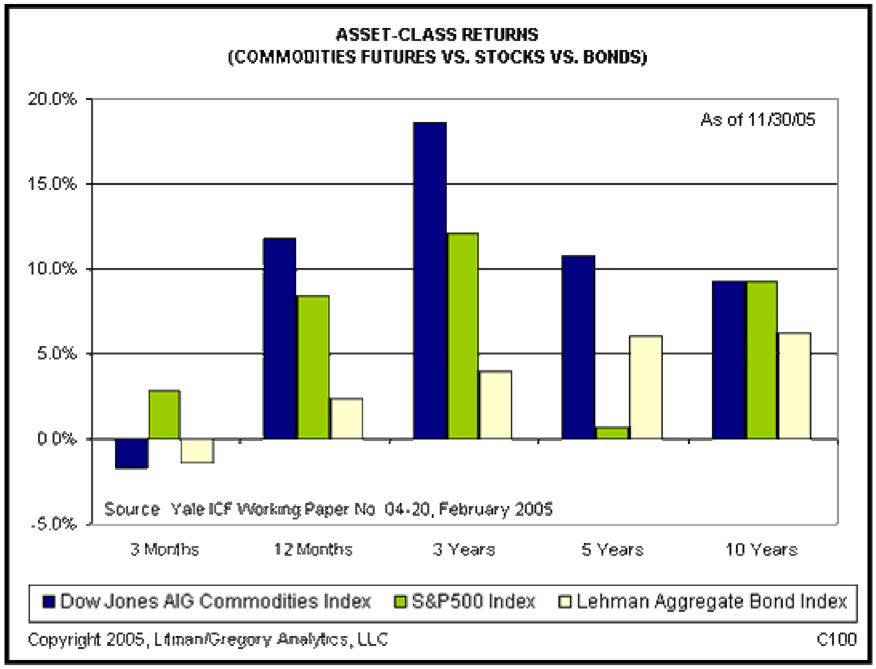
I am reluctant to buy a dedicated emerging markets international fund since your diversified international funds are invested in emerging markets. The portfolio managers allocate the investments across country and region and currently they have a very healthy exposure to emerging markets. Making a separate investment in emerging markets is a duplication of their efforts resulting in over-exposure to them.

However, I made significant investments in small cap international stocks, which were very successful last year. MSCI EAFE (International) Small Cap Index generated an amazing 26% return in 2005 while the MSCI EAFE (International Large Cap) Index yielded a very healthy 13.4% return. Small Caps stocks in developing and emerging markets will continue to outpace large-cap international investments since their performance is more closely tied to the local economy. Overall, given current valuations we remain over-weighted in foreign stocks with a healthy allocation to small cap international.

Emerging Markets Short-Term Bonds: This is a investment that I hope I will be adding in 2006. The catalyst for our analysis of this asset class was the launching by PIMCO, the respected fixed-income manager, of the first public mutual fund to offer dedicated pure-play exposure to this asset class. With vastly improved fundamentals in many emerging markets, this asset class gives your portfolio diversified exposure to a variety of currencies, a higher interest yield than other fixed-income vehicles, and minimal interest-rate risk since the maturities are very short—almost money-market-like. This investment is worthwhile because the currency exposure offers some protection against a sharp sell-off in the U.S. dollar (thus reducing portfolio risk in that event) and offers the potential for long-term currency gains versus the dollar. The dollar has been gaining against most currencies since last summer (see graph). The U.S. dollar will begin to decline against other currencies as soon as the Federal Reserve stops raising interest rates. The Fed Reserve is expected to stop raising rates in April. At that point I'll begin to add this to your portfolio.

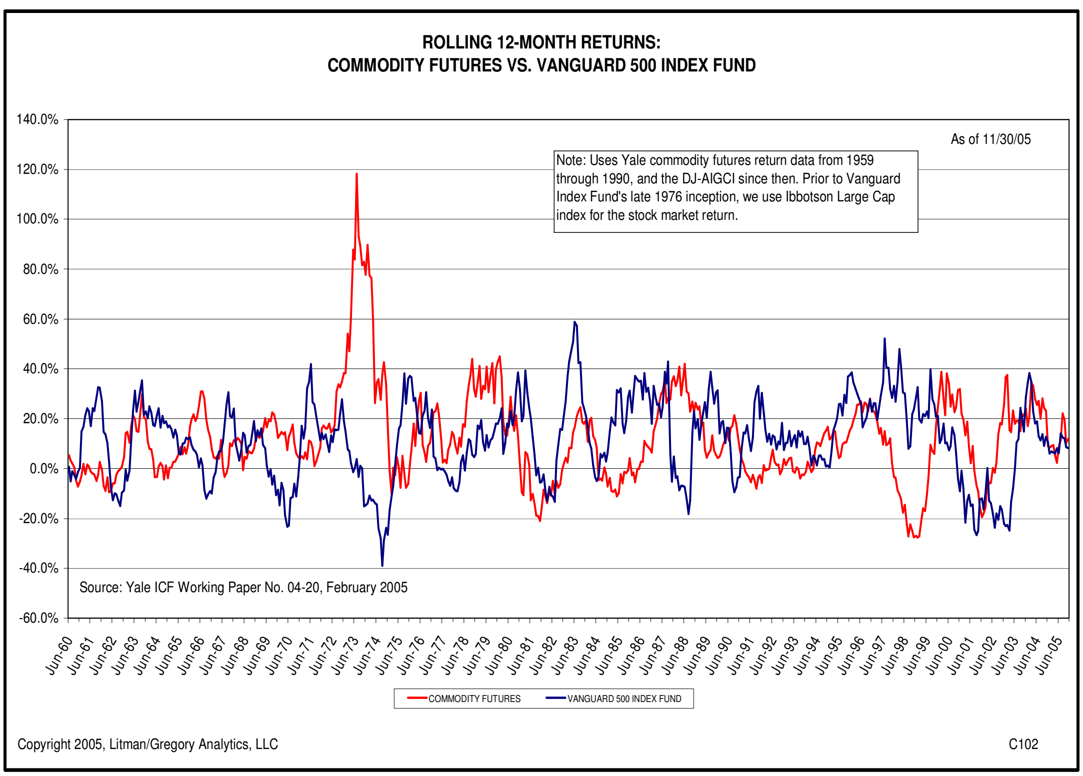


It is important to note that in a typical recessionary environment, domestic investment-grade bonds would probably perform better. However, the return potential of short term emerging bonds is materially better than U.S. bonds and provides some protection against one of the big economic imbalances - the current account deficit and related dollar-crash risk. Adding short term emerging market bonds to your portfolio will expose it to more cyclical risk, but your other bond positions should provide an adequate defensive and keep losses to a minimum if the economy were to go into a recession.



Commodity Futures: In 2005 I added a small exposure of 3% to 5% in commodity futures to many clients' portfolios using the PIMCO Commodity Real Return Fund. This fund tracks the total return of the Dow Jones-AIG Commodity Index. Commodity futures have valuable investment characteristics that include long-term return potential on par with stocks (and clearly better than bonds) and diversification benefits since they are often negatively correlated with stocks and bonds.

I spoke with both PIMCO and Credit Suisse about the recent IRS ruling regarding the tax treatment of income and gains from indirect investments in commodities indexes like those used by PIMCO Commodity Real Return, and Credit Suisse Commodity Return Strategy, which is an alternative. In short, the IRS ruled that the returns from swaps is not qualifying income for mutual funds and therefore not eligible for the favorable tax treatment funds usually receive. This would effectively prevent these commodity futures funds from investing in these instruments. Very shortly, we expect PIMCO to release additional details regarding their plan of action for the fund. It seems likely that over the next six months (until the new IRS ruling takes effect) the fund will transition from using commodity futures-linked swaps to using "structured notes" to track the performance of the DJ-AIG Commodity Index (if the IRS doesn't reconsider their ruling in the meantime, which they are both hoping and working for). A downside to structured notes is that they may be a slightly more expensive than swaps to implement and



another is that their tax treatment is also not certain (i.e., the IRS has not ruled on structured notes yet). PIMCO's fund should still be able to maintain exposure to TIPS. I will continue to be in touch with PIMCO and Credit Suisse as events unfold, but in the meantime, I recommend continuing to hold PIMCO Commodity Real Return.

Domestic Fixed Income a.k.a. Bonds: Investment-grade bonds did not perform particularly well in 2005 as a wide variety of factors (including but not limited to the Federal Reserve rate hikes, foreign capital inflows, oil prices, and inflation) contributed to the almost nonexistent rise in intermediate-term rates. Overall the return potential from investment-grade bonds is not exciting; with expected returns over extended time periods fluctuating around their current low yield. In this environment, bonds serve one purpose—providing a hedge against recession and deflation—and this is why I continue to maintain bond exposure in your portfolio.

In the middle of 2005, we added Eaton Vance Floating Rate Bonds to most portfolios to offset the low returns generated by investment-grad bonds. This fund generated a 5% return last year which is twice the return of Vanguard Total Bond Market Index (2.5%). This fund invests in senior floating rate loans. These loans are made by U.S. Banks and other financial institutions to large corporations. Floating rate funds are less susceptible to interest rate risk than fixed rate bonds because rates are periodically reset to the prevailing interest rate. So if interest rates increase slowly this fund is less apt to generate a negative return. In order to minimize the negative impacts of rising interest rates, the Eaton Vance Institutional Senior Floating Rate Fund was added to most portfolios. Once again it is the special asset classes that we added last year that added the most value to your portfolio.

In Summary: From a valuation standpoint, I'm not excited about any asset-class opportunities. But I'm not overly worried about that the markets will perform badly. Current valuations throughout the equity markets suggest that over the next few years returns, while not spectacular, will be reasonably good compared to inflation. The trick in this type of environment is not to try too hard to find something that isn't there. It is time for patience. At some point there will be a shock to the global economy and markets. When that happens, your portfolios will feel some pain but hopefully it will be buffered from severe loss by the diversified asset classes you hold.

Other News: For the first time ever Altamont Capital Management is also offering tax preparation services. Both Nicole Hanson and Jerrilynn Krebs are licensed tax professionals. In addition, Jerrilynn Krebs has earned the prestigious EA (Enrolled Agent) designation. They can help you with your tax return preparation needs at very reasonable rates. You can mail or drop off your tax documents and then set a time to go over your completed return with us. Please call our office for more information.

During the coming year, I will finally get that website I've been talking about forever up and running. I'll post my quarterly newsletter and articles for easy access. I'll also have my SEC forms such as the ADV available for download in Adobe. I will let you know when I have my site up and running. In the meantime, if you would like a copy of a past newsletter or of my ADV please let me know by emailing or calling the office.

I thank you for your confidence and trust.
Best Regards,

Libby Mihalka, CFA, MBA
Altamont Capital Management