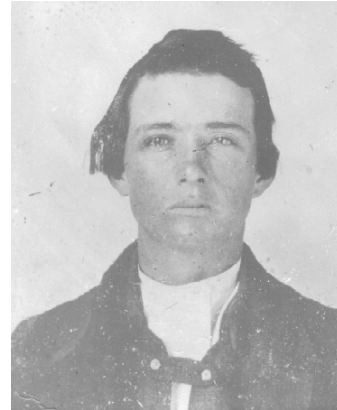


FIRST QUARTER 2006

I've always been interested in my family heritage. As an American, I've known that somewhere in the past, an ancestor was willing to risk everything – to leave the comfort if not at least the familiarity of the home country (England, on my father's side and Alsace on my mother's) to make a perilous journey to a new land of hope and promise. Once here, the perils continued. I've read the accounts of my maternal ancestors less than pleasant encounters with both Indians and British soldiers in the 1700's.

I found one of my ancestors particularly intriguing – my great-grandfather, David Almond. When I was growing up, some family member had found an old tin-type photo and distributed it with the barest of facts about him: dates of birth and death, his wife, where he was buried, and the most fascinating tidbit of all: he was a Civil War veteran, serving in the 28th North Carolina Infantry, Company K. The photo is typical of those from the period – a dark haired man with an obvious home hair cut and a near expressionless steely gaze into the camera. Who was this man whose genes I carry?



My son and I set out two years ago to find out more. The National Archives gave some puzzle pieces, such as enlistment, pay, medical, and service records. The battle record of his unit could be researched on several Civil War web sites. Piecing together the clues give a picture of an ordinary man caught up in the extraordinary events of his time. We then took a trip to gain more insight by visiting the places that figured in his military career.

He did not enlist until April 1862, well into the conflict. Was it lack of enthusiasm for the Confederate cause? Was it the birth of his first child in 1861? We do know that he found himself at Fredericksburg in December 1862. While the most famous part of the battle was the gallant, futile Union charges against the stone wall at Marye's Heights so vividly depicted in the film *Gods and Generals*, his unit was deployed at the southern end of the battlefield, where a railroad grade was the only cover. A strong Union attack there smashed into his unit and broke through the Confederate lines. (By hiking about a mile up the railroad grade, my son and I found the location.) In the melee, David Almond found himself a prisoner. This lasted only a few days – a prisoner exchange sent him back across the lines. The experience must have taken a toll, as he was then hospitalized in Richmond for two weeks.

The individual record becomes sketchy, although we know his unit was in the thick of battle at Chancellorsville, Gettysburg, Petersburg, and finally made the last, bloody retreat to Appomattox. There, my son and I found his name on the official roster of the surrendered Confederates. What followed for him must have been a long, hungry walk home.

Regardless of how one feels about the side he fought for, you must admire the gallantry and courage of David and others like him. In the face of indescribably horrible conditions, they marched, fought, and persevered until the very end. In a phrase, he and his generation showed incredible strength of character.

Visits with David's grandson, my Uncle Hubert, are always tinged with emotion for me. You see, Uncle Hubert is the last living family member of my father's generation. They have been called "The Greatest Generation" and I will not argue with that. At age 21, Uncle Hubert was tail gunner on a B-25 bomber, completing 70 missions over Italy and France. He's credited with downing a Me-109 fighter attacking his formation. On his wall is a case containing his service medals and, curiously, a jagged piece of metal. The metal fragment is shrapnel from a German 88mm flak round that exploded beneath his plane and embedded itself in the armor plate directly below him. Even today, Hubert's eyes fill with tears when he recalls being with his buddies in the evening and the next day seeing them shot down. In the face of death, Hubert and countless others like him did their duty with courage and determination to secure a world free from totalitarianism. In a phrase, he and his generation showed incredible strength of character.

I highlight these men from my family simply because their stories are familiar to me. I am proud to say we have veterans and even a former POW among our clients. I'm sure you have similar examples among your family and friends as well.

We owe our present way of life to men and women such as these. Not only because of their bravery, gallantry, and patriotism, but also due to their values in other areas that allowed the United States to become the world's pre-eminent nation and economic force. One could write worthwhile books on how their moral, spiritual, ethical, family, and social values contributed to the rise of the United States as a world power. The focus here will be on the role of their *economic* values and how the demise of those values in present and future generations (among other forces) may eventually dethrone the United States from its place in the sun.

Delayed gratification – perhaps when we were a more agrarian

"Patience is a virtue." – William Langland (1377)

economy, we better understood the advisability, if not necessity, of waiting on something. It took time for a crop to mature. With credit far less available than it is today, there was usually little choice – if you wanted something, you waited until you had saved enough to buy it. (There were also fewer things to want and far less advertising.) I could not help but notice the new neighbor a few months ago – a recent college graduate moving into his new \$197,000 four bedroom, 2½ bath home. I didn't think too much about that until we saw the new 42" plasma television being delivered. While I could be all wrong, my guess would be that the home was purchased with a minimal down payment and the TV was on a no-payments-for-a-year plan. Don't misunderstand me - there is nothing wrong with having a nice home and nice things in the home. However, it seems that many people

*"I need a new credit card. My first two are maxed out!"
– Heather, UNCC student*

(especially Gen X'ers) see nothing wrong with buying whatever their credit limit will

permit with little thought about making the eventual repayment or how costly it may be. Saving up to make a major purchase? Get outta here!

Avoidance of debt – my parents grew up in the Great Depression and that experience undoubtedly shaped their concept of debt. They saw the absence of personal debt as one of the factors that allowed their families to make it through those times. Debt was almost viewed as a moral failure. People who were “in debt” were looked down upon. Borrowing was seen as a last resort. As financial planners, we can see debt a bit more objectively and believe there is both “good debt” and “bad debt”. Judiciously using debt to help acquire appreciating assets can make economic sense. Tax advantages (the deductions for home mortgage interest and property taxes) make purchasing a home a compelling move for most people as soon as one can. Given reasonable interest rates, the mortgage payment for a modest home is similar to the monthly rent for an apartment. Given the choice of making equal rent or mortgage payments, we’d normally prefer the mortgage payment.

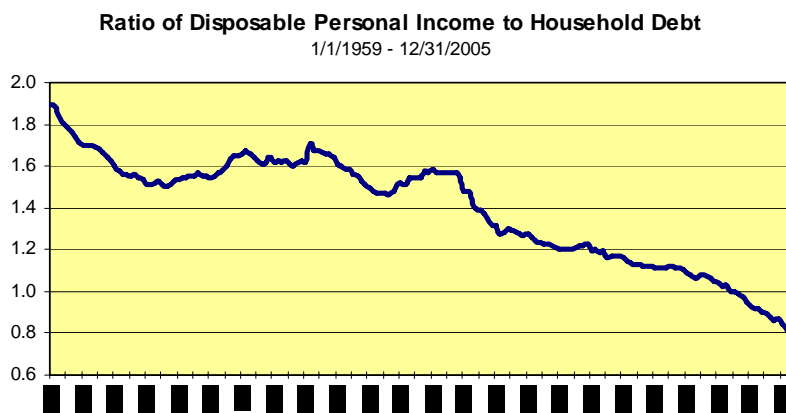
Another form of “good debt” can be student loans. It’s an established fact that a college education is a good investment. Despite the rising costs, the increased income resulting from a four year degree provides an excellent return. So if loans are necessary to obtain an education, we see it as investing in an appreciating asset: yourself.

Last year “the average college graduate was carrying over \$8,000 in personal credit card debt.” - *National Council of Economic Education*

What is the definition of “bad debt”? We would say any debt that is used to finance current consumption or a depreciating asset. With the exception of zero percent financing, the interest charges simply add to the cost of the purchase.

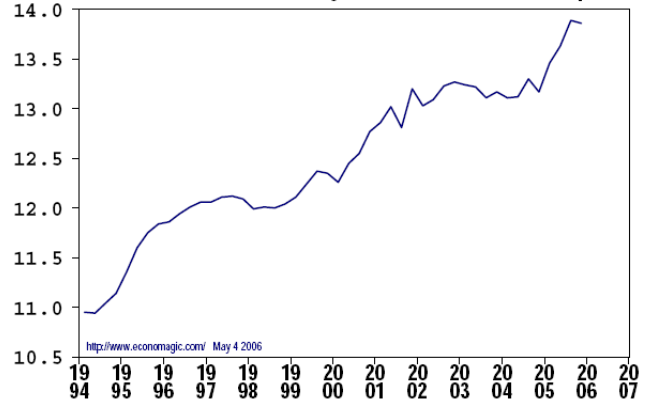
Debt financing creates accelerated gratification versus the delayed variety. It results in consumption now and a claim on future earnings. Like government deficit spending, it artificially stimulates economic activity now by borrowing from future economic activity.

How much debt are we generating? The numbers are sobering. Total US personal debt (consumer and mortgage) was almost \$11.5 trillion at the end of 2005. That sounds like a huge number (and it is) but what can we relate it to? One measure might be to calculate a ratio with household income:



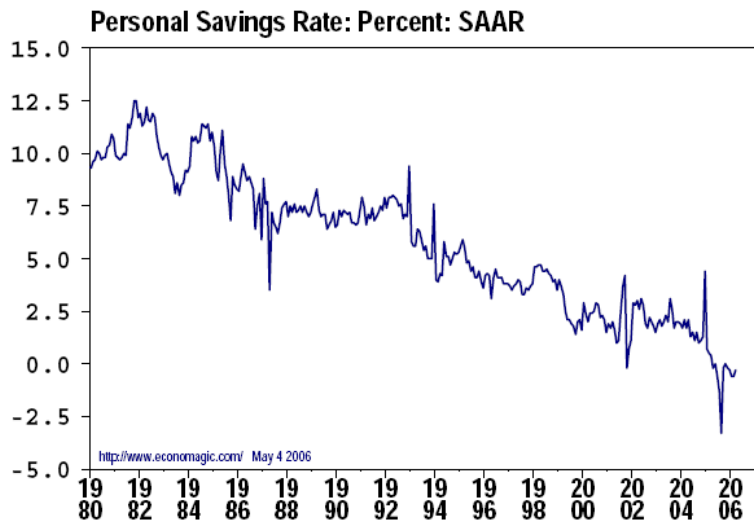
What the chart shows is that households are accumulating debt faster than incomes are increasing. The trend is unmistakable and disturbing. The implication is an ever-increasing debt burden

on the average American household, with less income available for saving and investment. The amount of disposable personal income that is required for debt principal and interest payments continues to rise, now up to almost 14 % of household income: As households increasingly leverage their balance sheets, credit scores will drop, and the well of easy credit will dry up. Discretionary spending must ultimately be reduced with predictable consequences on overall economic activity. Remember that of the world's major economies, ours is one of the most dependent upon consumer spending?



Thrift and saving and investment – the impending transfer of wealth between the generations is one of the most significant macroeconomic events of the current century. But how was the wealth accumulated in the first place? Luck? Shrewd investments? The older generation understood the inherent wisdom in putting money aside for the future. Perhaps they learned by observation that after the harvest, there was canning, freezing, or otherwise storing things for future consumption. You enjoyed some of the fruits of your labor now, but a significant portion was put aside for the future. It was less important whether you saved (utilizing only bank accounts or CD's) or invested (buying stocks, bonds, real estate, mutual funds, etc.) versus how much was put aside at the beginning. As we have said before, the rate of saving is more important than the rate of return.

Sadly, our country has crossed a milestone in our national economic history – our savings rate has declined to below zero. This means we are consuming more personal capital than we create. To compare our national consumption binge to drunken sailors maligns the character of drunken sailors – we should know better.



The long term effects of a national economy with no personal savings are difficult to predict with precision, but we can't see anything positive from this trend. The US currently has the world's largest supply of capital, but without new capital availability through savings and investment, the cost of capital must inevitably rise. Alternatively, the capital needs must be supplied by external sources, leading to returns on that capital flowing outside our borders.

We believe the ultimate effect of these trends will be:

- Slower economic growth
- Higher interest rates
- Persistent government budget deficits even with higher taxes
- A falling dollar versus other currencies
- Higher inflation and commodity prices

While we see the probability of these developments as more likely than not, we have very little idea of when we will see them come to pass. Unlike some, we are not predicting the Great Depression of 2010 or similar nonsense. The effects may be decades away from becoming evident. Neither do we pretend to know exactly how all these (and other) elements may synergize and produce effects that no one could possibly anticipate. We are not trained PhD's in economics (as if that would make a difference), just observers of disturbing trends. We have come to the unsettling conclusion that the current economic character, behavior, and values of the US are so different from those of preceding generations that it calls into question the use of economic and investment assumptions developed from data when this was, for better or for worse, *a different country*.

The phrase "it's different this time" has been used to justify many things, from the bubble market of the late 1990's to dire predictions of economic catastrophe. Yet, it is undeniable that many important economic trends are decidedly different in a negative way. That said, there are many that remain the same (we operate in a free market economy) and some developments with an unknown long term effect (immigration, etc.). With our heightened uncertainty, we feel it is important to seek sources of investment returns that are less dependent upon the strength of our overall equity markets.

We have written extensively about "alternative investments" in the past and will not repeat old material here. (You can read past investment memos on our web site at www.matrixwealth.com.) As time goes by, we believe a shift towards non-traditional investments will be prudent.

Is such a move urgently needed? We do not see this as being particularly time critical. The trends we believe are most likely to affect future investment performance will be years in the making. In the near term (2-5 years), there appears to be enough economic momentum to sustain reasonable growth. Given equity market valuations that are not excessive, we believe the ingredients are in place for single digit returns that are in line with historical averages. We believe we have a window of several years' duration to effect any significant portfolio changes.

To what extent should the US equities risk in a portfolio be diversified away? This is a moving target and subject to further research and analysis on our part. Our guess is that we could eventually see exposure to US equities reduced by 35% from current levels.

Where would the funds be allocated that are moved away from US equities? We foresee utilizing a number of asset classes possessing different risk and return characteristics. To the extent reliable data is available, we will analyze the correlations between various asset classes and allocate funds in such a way as to constrain overall portfolio risk. As we have explained in prior memorandums, a basic tenet of Modern Portfolio Theory is that a portfolio of “risky” assets may not be risky at all – if the assets are properly selected and allocated. While our investigative work continues, we have identified a number of asset classes that we anticipate higher allocations in future years. Some we have used already and some are still being investigated and evaluated. The list includes (but is not limited to):

- Real estate (not necessarily REIT’s)
- Commodities
- Managed futures
- Energy investments
- Private equity (companies that are not yet publicly traded)
- Timber
- Hedge funds of funds
- Non-US equities

What about bonds? We see only modest returns for bonds going forward. Bonds can continue to play a role in many portfolios due to their ability to preserve principal in all but the most adverse environments (rapidly rising interest rates and /or severe economic stresses resulting in high bond default rates). There may be opportunities to capture higher returns through astute sector rotation and duration management, but we will largely leave these decisions to our fixed income managers.

One of our concerns is that many of these investments may be unfamiliar or viewed negatively for various reasons. We understand that some clients may want or need education with unfamiliar asset classes and we are committed to doing that. You can be assured that we will not be recommending any investment alternatives until we are satisfied that we have conducted the appropriate level of research and investigation.

Another concern is that our gradual migration to alternative asset classes will be seen as a dramatic change in strategy for Matrix. The truth is that this migration is very much in line with our historical adherence to strategic asset allocation and Modern Portfolio Theory. We have always believed (and have been proven correct so far) that effective diversification is the key factor in achieving returns that will lead to the achievement of financial goals. We may or may not “beat the market” (and probably won’t in a bull market) but we will most likely avoid the permanent loss of capital that destroys dreams and endangers even a basic lifestyle. We believe the use of multiple alternative strategies will reduce the risk of an adverse economic scenario causing permanent portfolio damage.

We are also concerned that we will be seen as “betting against” the US economy and equities markets. (We dislike using wagering terminology in the context of investing, as

the two could not be more different!) Lowering our allocation to US equities over time should be seen as taking some money off the table to put into a number of other, different games. It is not an explicit bet against the US equities markets – there are vehicles for such, if one chooses to employ them, such as options strategies and short selling. (For the record, I have never been in a casino and have no desire to.)

At age 84, Uncle Hubert’s macular degeneration has made it difficult for him to read, but he keeps up with world events through CNN and the other news channels. As he sits in his recliner with his little dog Muff and watches, he tries to make sense of a world that defies explanation. It seemed so simple when he was young. Now there’s Iraq, energy prices, political gridlock, massive illegal immigration, Social Security and Medicare’s impending insolvency, exploding consumer debt, budget deficits, and the list goes on and on. Uncle Hubert’s generation rose to the greatest challenge faced by the democratic world to that time and saved the planet from fascism. Will our generation rise to the challenges created by its self-indulgences? Check back in about thirty-five years – we’ll know more then.

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| Domestic Equity Indices | |
| S&P 500 Index – Large-cap stocks (3/31/05 – 3/31/06) | 11.72% |
| S&P 400 Index – Mid-cap stocks (3/31/05 – 3/31/06) | 21.52% |
| Russell 2000 Index – Small-cap stocks (3/31/05 – 3/31/06) | 25.85% |
| Wilshire REIT Index (3/31/05 – 3/31/06) | 42.24% |
| International Equity Indices | |
| Morgan Stanley International EAFE Index (3/31/05 – 3/31/06) | 24.43% |
| Morgan Stanley Emerging Markets Index (3/31/05 – 3/31/06) | 43.45% |
| Fixed Income Indices | |
| Lehman Brothers Aggregate Bond Index (3/31/05 – 3/31/06) | 2.26% |
| Lehman Brothers Credit Bond Index (3/31/05 – 3/31/06) | 1.83% |
| Lehman Brothers Municipal Bond Index (3/31/05 – 3/31/06) | 4.75% |
| CSFB High Yield Index (3/31/05 – 3/31/06) | 6.61% |
| 90 Day T-Bill (3/31/05 – 3/31/06) | 3.83% |
| Consumer Price Index (3/31/05 – 3/31/06) | 3.11% |

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