

SECOND QUARTER 2006

Bombs exploding, missiles flying, tanks rumbling. Couple those with high crude oil prices, rising interest rates, inflation fears, and continued bad news about the trade deficit and you get a downright ugly investment climate. It should be no surprise that most asset classes have struggled lately. 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 1.4%. The small-cap Russell 2000 Index dropped 5%, while foreign stocks managed a slight gain for the quarter. Value stocks continued their dominance over growth stocks in the second quarter. Domestic investment-grade bonds were flat, but commodity futures fared better, gaining roughly 6% over the three-month period.

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, and it's very possible that commodity futures, and maybe even REIT's and small-cap stocks were a part of this strategy as well.

We can't say for certain how much of these asset classes' behavior was due to hedge funds' involvement, but we do know two things: 1) Most hedge fund managers' 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 can have an equally large presence in every other financial market). Our point here is not so much to dissect hedge funds' impact on the markets, but rather to point out 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.

There are now more hedge funds than mutual funds (8,500 vs. 8,300). Yet only 3% of Americans are eligible to purchase them.

- Chip Roame, Tiburon Strategic

For sure, there are plenty of things to worry about. There always have been and always will be. The intelligent investor has to ascertain, as best as one can, which of the worrisome things truly warrant attention, if not some sort of action. We have written at

Why Should We Worry About Inflation?

Aside from the direct damage of inflation, there is risk that the Fed will overshoot in trying to choke off inflation and that higher rates will push us into a recession. The hope among investors has been that the Fed will stop 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. (That's why news that indicates slowing growth paradoxically tends to result in good days for the stock markets.) As economic growth has continued to surprise on the upside—and the Fed has continued to raise rates—the risk of an overshoot (and the ensuing recession) has increasingly been on people's minds.

The big question we must ask ourselves is: What are the odds that continued inflation will lead the Fed to tighten to the point that the economy ultimately tips back into recession? Cutting to the chase, we believe that the longer-term inflation picture is not too troubling. Given the sizeable rate increases that have already occurred, and signs that the economy is slowing somewhat, our guess is that further rate increases will be limited and a near-term recession isn't too likely. The risk is still there, but even if it materialized, we have the benefit of going into this environment with stocks already at not unreasonable valuations, so a cyclical bear market shouldn't be too long or deep, and this would actually set stocks up for nice returns going forward.

length in the past about some things that we feel are worth worrying about: the lack of domestic consumer saving and investment, excessive consumer debt, massive unfunded entitlement liabilities (i.e., Social Security and Medicare), and huge trade imbalances. These issues seem to make the news briefly when a new statistic is released and then quickly fade into the background noise again. Not nearly as exciting as video of explosions and chaos, but these sub-surface issues are more deadly (economically speaking) than all of Kim Jong Il's and Hezbollah's missiles combined.

A while back, a client and I were speculating about the worst that could likely happen on the Korean peninsula. What if Kim's megalomania exhibits itself through a strike (even nuclear) on Japan or the South? The resulting overwhelming counterstrike (nuclear if necessary) would eradicate Kim, his government, and his military, creating a humanitarian aid need of historic proportions. The reunification of the two Koreas would make Germany's experience seem pleasant by comparison. It would take years, even decades, but a prosperous, democratic new nation on the Korean peninsula would most likely result.

On the other hand, what if our worrisome domestic economic problems continue unresolved? I will leave the speculation to the futurists and the economists as to what that future may be like. But I believe it will not be pretty and it will be long term. While

future events rarely evolve in a straight line, we ascribe a high enough probability to the “we don't manage to fix it this time” scenario to direct most of our investment research efforts into asset classes that don't require a favorable domestic equities market to produce acceptable returns. Unlike some of the financial porn that arrives in our mailbox, we don't believe in “the coming economic train wreck” or the impending “biggest financial upheaval since the Black Plague”. We do foresee these issues, if

unresolved, to affect our economy and markets similar to a termite infestation – a slow, gradual process. Therefore, we are not screaming that anything be bought or sold now, next month, or even next year. We have some time, in our opinion, to adjust portfolios incrementally to the new evolving economic reality.

Watching stocks go down isn't fun, but we must confess that as valuations have become increasingly more appealing and pessimism increasing, we're feeling a growing sense of excitement that this is another opportunity to buy when things are on sale. Long-term investors know there is always a silver lining in a down market: the potential for better-than-average returns in the future. By objectively looking at the data and considering what it implies in the real world, we can begin to differentiate between a serious long-term threat to investors and the short-term noise that causes many market participants to react based on emotion or fear. 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 do act based on irrational fear, bringing markets lower in the shorter term as they demand a greater premium for taking on risk, we will welcome the opportunities it creates for longer-term investors like us.

New tax law changes

You may have missed TIPRA (Tax Increase Prevention and Reconciliation Act), which was signed into law on May 17. Here are some highlights:

Capital gains: The 15% rate for dividends and long-term capital gains has been extended for an additional two years through 2010. For lower income taxpayers who are in the 10% and 15% regular income tax brackets, the 5% long-term capital gains rate will continue through 2007, then drop to 0% for 2008-2010.

Alternative minimum tax: A one-year band-aid has been applied by raising the exemption amount for a married couple filing jointly from \$58,000 in 2005 to \$62,550 in 2006.

Kiddie tax relief: Dependent minors with unearned income in excess of \$1,700 are taxed at their parents' marginal income tax rate. Under prior law, this rule no longer applied after the child reached age 14. The new law gives parents tax headaches even longer – now to age 18.

Roth IRA conversions: Only taxpayers with income of less than \$100,000 are currently able to convert regular IRA's to Roth IRA's. The new law removes the income limitation effective in 2010. Another benefit included in the new legislation allows taxpayers who convert an IRA to a Roth IRA in 2010 to defer the related income inclusion and recognize the income ratably over the next two years, 2011 and 2012. This will necessitate considerable number-crunching in 2010, as anyone with an IRA will need to carefully analyze the pros and cons of a conversion. Fortunately, we have a few years to think about it.

You spoke and we're listening

Matrix recently conducted a survey of clients by engaging Heathir McElroy Speet of the firm DeZinZ Creative. We worked with Heathir to design a survey that would give us the most useful feedback without being too burdensome on our clients. We achieved a very good 54% response rate, which means the results are likely applicable across the entire client population. Many of you asked that we share the results and findings.

We already knew that Matrix serves a diverse client base and the survey confirmed this. 42% of clients are age 60 or older, while only 2% are younger than 30. In terms of occupation, there was a near equality between physicians, business owners, professionals, and retirees, with executives a somewhat smaller percentage. Retirement plans, another significant client sector, were not surveyed.

Over 85% stated that they refer others to the firm. We are delighted with that statistic as we depend upon referrals as our primary source of new clients. However, it also showed that we need to somehow facilitate the referral process. If each client referred one prospective client per year, we would be having many, many more prospective client meetings than we currently do. One thought is to provide clients with "referral kits" containing essential information that could be given to a prospective client. We have also discussed various rewards and recognition for referrals.

The frequency of client contact, level of personalized service, and being valued as a client received agree or strongly agree ratings of 80%, 87%, and 82%, respectively. 75% reported being delighted or happy with the level of service received. We view those percentages as good, but far from good enough.

94% agreed or strongly agreed that the firm offers the type of services that are desired. Two-thirds feel that our fees are reasonable. 81% of financial planning clients felt the annual update process was valuable and the consensus was that the comprehensive annual update process was preferable to a series of topic oriented meetings. 85% reported being satisfied with the portfolio investment strategy being utilized.

In terms of alternative investment strategies, "neutral" was consistently the most popular response, with favorable and unfavorable opinions almost evenly divided. Real estate was the most positively viewed alternative asset class. As for "life planning", only two responses garnered over 50% support: anticipating life transitions and events, and establishing financial goals that facilitate my life goals. "None" was the preferred answer for additional services desired, although there was interest in educating children about money from 28% of respondents.

As for portfolio review meetings, 79% were satisfied with the length and detail covered, with a minority generally believing the meetings are too long and too detailed. Our

written materials (financial planning reports, investment reports, and quarterly memoranda) all received positive ratings of 82-85%.

Charitable Organizations Chosen by Clients:

Alexander Youth Network
American Cancer Society
American Heart Association
American Red Cross
Boy Scouts of America, Piedmont Council
Carolina Boxer Rescue
Children's Miracle Network
Covenant Presbyterian Church
Crossnore School, Inc.
First United Methodist Church
Foundation for the Carolinas
Habitat for Humanity International
Harris YMCA
Hospice & Palliative Care
Hospice of Lenoir
Humane Society of Charlotte
Humane Society of Concord
Jewish Family Services
Loaves and Fishes
Lois Lodge
March of Dimes
Miracle Hill Ministries-Greenville
MS Society of NC
Public Library of Charlotte
Salvation Army
Second Harvest Food Bank
Southeastern Pug Rescue
Spina Bifida Foundation of SC
St. Albans Episcopal Church
St. Michaels School Endowment Fund
United Way
Zippy's Crusade for Kids

Why do people continue to work with Matrix? Almost 9 out of 10 respondents included "I trust them" among the reasons. Other answers given by at least 50% of respondents included:

"They are good at what they do." – 70%

"Values of the company and staff." – 64%

"Personal attention I receive." – 54%

"Matrix provides comprehensive planning." – 52%

As we are contemplating relocation in 2007, it was important to gauge opinions concerning our office. A slim majority favored the present location, while 25% were neutral. We suspect that many of the neutral responses are from clients outside of Charlotte who visit our office infrequently, if at all. 20% felt our location was inconvenient. After plotting our Charlotte area clients' locations on an area map, we see that a single location that will satisfy everyone is just impossible. Our clients are not concentrated in one locale, but are spread out over most of the local area. An office in Ballantyne will likely

not please a client located in Davidson, while a University area office will not suit a client living in Waxhaw. Chances are we will remain in the same general area, as it seems accessible and centrally located for the majority of our clients.

A slim majority (53%) asked that we send a thank you contribution to a designated charity, while 47% preferred tickets to see the recent Dead Sea Scrolls exhibit. The organizations that you chose reflect the broad diversity of our clients.

One of the most surprising items to us was what other firms' clients perceive as our competition. While some responses did give firms that we feel are worthy competitors, there were a large percentage that listed brokerage firms and banks. This disturbing fact leads us to a couple of possible conclusions, either: (1) banks and brokerage firms have done a good job at disguising themselves as objective, comprehensive financial advisors, or (2) we've done a lousy job of differentiating our services and fiduciary relationship with clients from those of mere financial salespeople.

Some of the most interesting feedback came in the form of your comments, which were profuse in praise, to be honest. There were some that pointed out areas of improvement and we are equally grateful for those. There were also a few that might benefit all clients with a response.

Some clients expressed a desire to hear from us more frequently, such as monthly portfolio update emails. We must perform several balancing acts, as there are a significant number of clients that prefer less communication. I also must allocate my time to its highest and best use. While communicating with clients is clearly important, is it more important that investment research, portfolio reviews, or financial plan reviews? As you know, we recently stopped voting proxies because we determined it was a misallocation of our resources when higher priorities exist. It would be a similar misallocation to devote significant time to additional reporting that only a small minority of clients would value. That said, we have no problem with providing any sort of more frequent portfolio reporting on an individual basis, if desired.

Our quarterly newsletter is primarily written by the staff of a professional financial journalist, Andy Gluck. Andy and I have known each other for years and I highly respect his journalistic abilities. His firm produces the only client newsletter among the dozens available that I think is worthwhile for you to read. Each quarter, we select the stories we think would be the most interesting to you. We then edit the stories, if necessary, to make sure they reflect our particular outlook on the subject. So while we don't write every word in the newsletter, it is our newsletter, not some mass produced fluff. Writing this quarterly memo is where I will continue to focus my writing efforts. I only have so much inspiration to go around!

One respondent argued strenuously for Matrix to utilize performance fees, i.e. Matrix gets paid only if accounts increase or surpass a benchmark. At first glance, this may sound appealing –

The Danger of Performance Fees?

There's two weeks to go in the quarter. Fund Manager Bob is worried about performance so far – he hasn't beaten the client's benchmark. As such, there will be no paycheck if things don't change. What can Bob do? The answer is take on risk. If the portfolio still fails to beat the benchmark or even declines significantly, he's no worse off for having gambled with his client's money. On the other hand, if the bet pays off, he gets paid for the quarter. If a major portfolio objective is don't lose money, is this the position where you want to place your investment advisor?

this is how hedge fund managers get paid, right? As you read above, performance fees are believed to produce more risk taking behavior among managers. We don't feel performance fees are appropriate in situations where the goal of a portfolio is to consistently produce, over time, the required rate of return to achieve your individual financial goals and avoid serious and permanent losses of capital. While we may show you how the indexes performed for a period, our diversified portfolios are not tied to a particular index. Some positions are intended to perform quite differently from an index. While there is no perfect fee structure (believe me, we have debated them all), an assets under management fee for investment management serves to reasonably align the interests of client and advisor. Both of us want your portfolio to go up in value (and not down) for our own self-serving reasons. Performance fees belong in the hedge fund world and where portfolios have an objective of surpassing one single index.

Again, we sincerely thank each one who participated. Your feedback is truly invaluable as we seek to improve our level of service, deal creatively with your financial planning goals and dreams, and provide investment performance that will bring them to pass.

Domestic Equity Indices	
S&P 500 Index – Large-cap stocks (6/30/05 – 6/30/06)	8.63%
S&P 400 Index – Mid-cap stocks (6/30/05 – 6/30/06)	12.96%
Russell 2000 Index – Small-cap stocks (6/30/05 – 6/30/06)	14.56%
Wilshire REIT Index (6/30/05 – 6/30/06)	22.06%
International Equity Indices	
Morgan Stanley International EAFE Index (6/30/05 – 6/30/06)	26.57%
Morgan Stanley Emerging Markets Index (6/30/05 – 6/30/06)	32.15%
Fixed Income Indices	
Lehman Brothers Aggregate Bond Index (6/30/05 – 6/30/06)	-0.81%
Lehman Brothers Credit Bond Index (6/30/05 – 6/30/06)	-2.07%
Lehman Brothers Municipal Bond Index (6/30/05 – 6/30/06)	1.80%
CSFB High Yield Index (6/30/05 – 6/30/06)	5.03%
90 Day T-Bill (6/30/05 – 6/30/06)	4.32%
Consumer Price Index (6/30/05 – 6/30/06)	4.22%

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