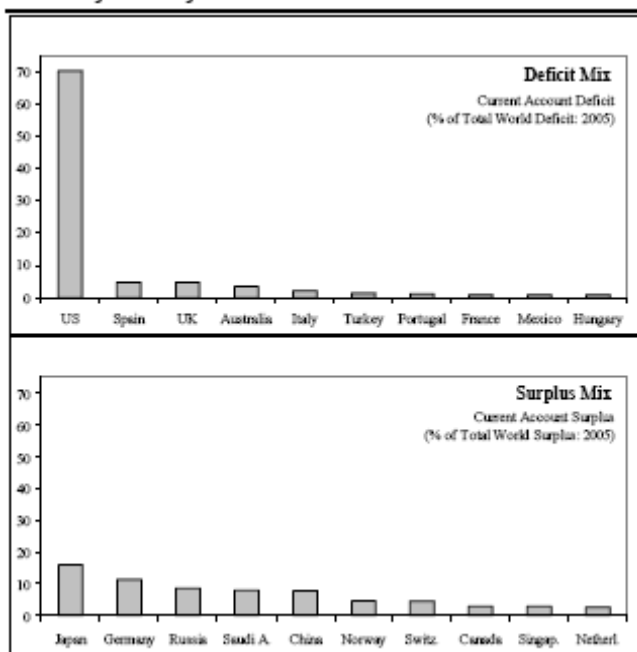


THIRD QUARTER 2005

We have all heard about the trade deficit, i.e. the difference between what we buy from other countries versus what we are able to sell in other countries. You probably know it's a big number. The last twelve months it amounted to around \$680 billion. Compared to the size of the U.S. economy (gross domestic product), that's 1.4%. As you might suspect, that percentage has been steadily growing. If a sizeable and growing trade deficit is a problem (and we believe it is for reasons we'll discuss later), then we have a problem.

When it comes to running trade deficits, no one does it better. In fact, the US constitutes 70% of the world's total trade deficits. (We only have 28% of world gross domestic product, or GDP, by comparison.) So it's safe to say that trade deficits are a US-centric problem.

The Asymmetry of Global Imbalances



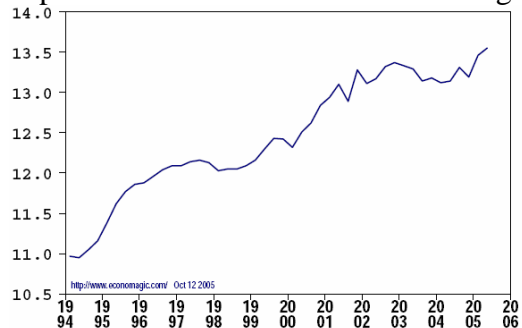
Source: IMF, Morgan Stanley Research

If you ride down I-85 into South Carolina and read the anti-NAFTA, anti-CAFTA billboards, you would believe that our deficit problem is a matter of a few other countries in the world that run huge surpluses. The truth is that trade surpluses among the countries of the world are much more evenly distributed. You have to add up the top ten surplus countries to reach the 70% mark. If our deficit was a matter of a few “bad” countries dumping their products on the rest of the world, you would expect to see a few countries dominating world trade surpluses and deficits spread out among many countries. The fact is that we see just the opposite – again, the evidence indicates a US-centric problem.

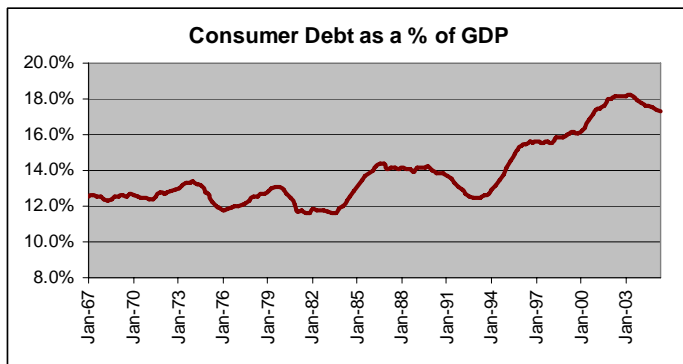
Trade deficits are often viewed as a problem in and of themselves. I have even said myself that we need to creatively increase exports or become more competitive in world markets through

better education as a means of dealing with the deficit. But the evidence suggests that any efforts to address the trade deficit in isolation will be fruitless without dealing with the true underlying problem – our **domestic lack of savings**.

The American consumer is, in totality, a negative saver. To be blunt, American consumers, as a whole, are profligate spenders addicted to a lifestyle beyond their means. Household debt service (monthly payments) as a percentage of income continues to climb, recent reaching an all-time high of almost 14%. Consumer debt (i.e., excluding debt secured by real estate) recently topped \$2.1 **trillion**. I won't trivialize the fact by calculating the height of the stack of that many dollar bills, but instead compare this to the estimated current size of the US population (297,401,625). That works out to consumer debt of **\$7,200** for every



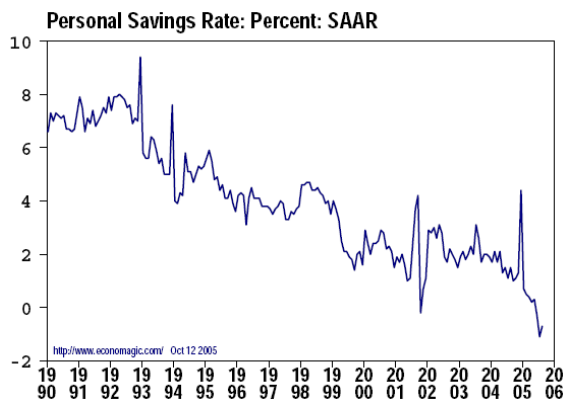
person in this country. When compared to the size of the overall economy of \$12.4 trillion as



measured by GDP, the percentage works out to 17.3%. While this is below the all time number of 18.2% reached a few years ago, it is still far above the post-war average of 12.4%. So can we take comfort in the fact that while consumer debt is at high levels, it may no longer be growing, at least by the comparison with GDP. We don't think so. It appears that consumers may have turned to sources of financing other than auto loans, credit cards, and consumer installment loans.

You have probably already guessed it – home equity. Ditech, Quicken Loans, and Lending Tree (and all the others) have done a masterful job of convincing us that it's perfectly OK to refinance or tap into the home equity line to make our ends meet.

This has been brought to the forefront recently by none other than Alan Greenspan. In a paper the outgoing Fed chairman recently co-authored, *“Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences,”* a finding is that consumers borrowed a staggering additional \$600 billion through home equity lines and refinancing in 2004. This amounted to around 7% of disposable personal income and was more than double the 2000 figure of 3%. In a recent speech, Greenspan conceded that “equity extraction” was large enough to make up for all of the decline seen in personal saving since 1995.



The decline in the personal savings rate received some media attention but has since been lost in the deluge of news. Earlier this year the personal savings rate dropped below zero for the first time in history. There are the apologists out there who make the case that the government's formula for calculating the savings rate (income minus spending equals saving) misses the point. They say the saving rate is just fine but spending is higher because older people are spending by selling appreciated assets, distorting the apparent saving rate.

We don't buy the argument. We are way too early in the baby boomers' demographic cycle to see this happening. We know from experience that most individual's saving rate should stay positive until around age 78. Given life expectancies, consuming principal prior to then creates an unacceptably high risk of outliving your assets. With the initial baby boomers just turning 59, we should not see this phenomenon occurring for another twenty years or more.

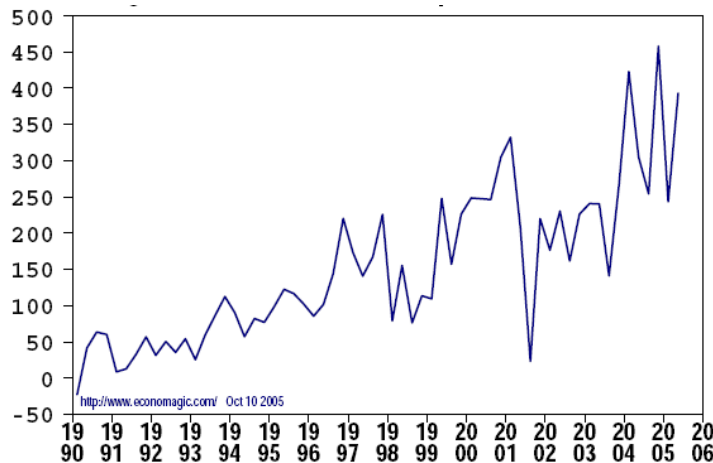
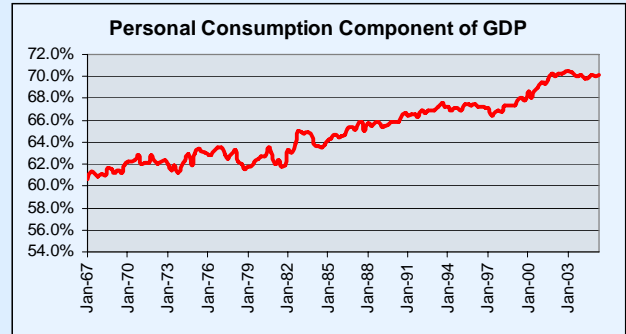
As we all know, the Federal government is also a negative saver. Deficits are expected to deepen due to the war and natural disasters, possibly approaching 4% or more of GDP in the next fiscal year.

Only the corporate sector is a net saver. But can this continue at the same pace considering higher energy, labor, pension, health care, and interest costs? Profit margins are leveling off while corporations currently need more capital that can be generated internally.

You don't have to be a math or finance major to know that the combination of growing consumer debt and negative savings by both government and consumers is going to lead to problems. An economy with consumers and its government spending more than they take in has essentially two choices: (1) curtail investment to finance the excess spending, or (2) import the capital to finance the excess spending.

A Consumption Focused Economy

Calvin Coolidge once said "The business of America is business." However, the business of America these days seems to be more about satisfying the consumer's wants and less about investing for the future. Personal consumption expenditures as a percentage of GDP has reached 71%, the highest figure on record for any developed economy.



So import we did. The next chart shows foreign capital inflows into the US (in billions) indicating that foreign investors, governments, and banks have been more than willing to buy our debt. The flow of borrowed funds back into this country from overseas, in effect, financed the trade deficit. By consuming more goods than we could afford to pay for out of current income, we had to import the goods to satisfy our demand and the capital to pay for them. It's no fluke that my current home mortgage is from HSBC (Hong Kong and Shanghai Banking Corporation).

The ongoing demand for US government securities has functioned to keep a lid on interest rates and support the value of the dollar. It has been postulated that the Chinese for their own political purposes may not be eager buyers of our debt in the future. I believe a Chinese decision to buy less US debt may be less political and more consumer driven. Collectively, Chinese consumers may, as their wealth grows, become more interested in spending rather than saving. One can imagine a thought process repeated a billion times "Hmm, get a new refrigerator or buy a US Treasury bond?" (Yes, we know individual Chinese consumers only indirectly own Treasury bonds through their banks and

monetary authorities.) Other suppliers of the capital to fund our deficits may have less capital to provide as their economies recover. Japan and Europe may use more of their own savings at home as well.

So what are the consequences to you of a free-spending, overly indebted American consumer? Let me emphasize that economic predictions rival astrology in both their accuracy and usefulness, but here are a few possible effects:

- A falling value of the dollar versus other currencies. If foreign investors reduce the level of investment into the US, the demand for dollars falls. A falling dollar raises prices on imports as the devalued dollar buys fewer foreign goods.
- Rising interest rates. While it is true that a slowdown in economic activity could keep rates not too far from where they are now, it is also possible that rates could rise as higher rates would be required to keep foreign investors interested in continuing to fund our deficits and to compensate them for the risk assumed in holding dollar denominated assets.
- The housing market slows significantly. If higher mortgage rates are the result, one would expect housing sales to slow. That could slow or halt the increases seen in home prices.
- Financial stocks, homebuilders, and materials companies experience earnings disappointments, leading to lackluster market performance overall.

Given these possible consequences, what should an investor be doing? What should it mean to you?

First, it's usually been a bad strategy to bet against the US economy. Our economy and investment markets have weathered many storms, events, imbalances, and challenges. We still believe that exposure to a well-diversified, carefully selected portfolio of domestic equities should remain the foundation for most portfolios. We don't anticipate a coming "economic earthquake" in the foreseeable future.

That said, we believe the current environment makes prudent, intelligent diversification more important than ever. We are not seeing an environment that particularly favors most directional (market based) strategies. US stocks may surprise on the upside, but it's hard to make the mathematical case for returns much higher than modest single digit returns. We know that bonds do not fare well in a rising interest rate environment. Money market instruments are offering higher yields but are essentially matching inflation. We believe most investors will benefit in the long run by diversifying beyond the familiar domestic stocks, bonds, and cash asset classes. While these are not new to many of you, here are some asset classes that we believe can play a role in a well-diversified portfolio:

- Foreign stocks. Relatively speaking, there may be more opportunities in foreign markets, where there is less analyst coverage, accounting principles vary, and markets are more inefficient. These factors, which sound negative, actually create opportunities for astute managers. Returns will probably correlate somewhat with US returns, but not completely. If the dollar does indeed fall, returns will be enhanced by holding assets denominated in euros, yen, or yuan. While we have always include a foreign stock component in any equity portfolio, we may bump the weighting more towards the upper end of the range specified in your policy statement.

- Foreign bonds. This is an asset class that we used sparingly up to this point. But with domestic bond returns anticipated to be mediocre, foreign bonds may offer return opportunities not available in the US. It should be emphasized that most foreign bonds are investment grade and of equal creditworthiness to anything in the US. The major risk is actually currency risk, which can be dealt with by hedging.
- Real estate. With all the talk about a real estate bubble, why would anyone go there? While certain property types in certain parts of the country may be unreasonably valued, that does not mean that values do not exist. Patient and careful real estate investors can still find decent deals. The real estate investment trust (REIT) market looked historically overvalued to us last year, but we may be revisiting the asset class, simply because it may be at least relatively attractive compared to stocks, bonds, and cash.
- Natural resources. We all know what energy prices have done. Sometimes it is good to be the owner of a “thing” rather than the owner of a business interest (stock) or a creditor (bond holder). While energy stocks give some play on natural resource prices, they still exhibit considerable stock market risk. “Accredited investors” have access to direct participation programs in oil and gas drilling and production programs (as some of our clients have). Anyone can buy shares in publicly traded royalty income trusts, but, as you might imagine, prices on average have been bid up beyond fair value. We remain interested in timber but postponed our research project until January given a large number of research priorities.
- Commodities. When clients request that we get them out of a specific investment due to short term performance concerns, I have such mixed feelings. I feel regret that clients are disappointed and feel we let them down in some way. On the other hand, I feel almost giddy with expectation, because it has been our experience that when people want out of an asset class, it’s usually a buying opportunity. While some have questioned our judgment here, commodities and commodities futures are asset classes that we feel offer significant diversification opportunities. Why? The sources of risk and return are largely unrelated to what happens in the equities and fixed income markets. This means that returns have a near zero correlation with equity or fixed income returns. Returns may have disappointed over a one or two year period. The S&P 500 Index shows a five year return of -1.49% as of September 30, nevertheless, stocks are still viewed as an acceptable asset class. I know that most people’s discomfort with commodities stems from a lack of understanding about this asset class. Rather than bore those who could care less with a discussion in this space, Kim Wilhelm and I are co-authoring a white paper entitled *Effective Diversification: The Case for Commodities*. It will be available to our clients for the asking.

What’s an “accredited investor”?

The Securities and Exchange Commission defines this for individuals as:

An individual whose net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000; or who had individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

“Private placement” investments are only available to accredited investors

- Hedge funds. This is an area of very cautious interest on our part. Kim Wilhelm recently attended a week long course at Wharton on this subject. If you've read much at all about hedge funds, you know there are many traps for the unwary (and even the wary). Nevertheless, we believe that there are some possible diversification opportunities using an index fund of hedge funds. We are currently evaluating this alternative.

There are other asset classes, such as venture capital, high yield bonds, distressed debt, or private equity for which we have not developed a sufficient conviction about risk-return characteristics (do potential returns justify the risk?) or found an acceptable (cost effective) way for including them in our allocations.

The decline in savings, the onset of there's-no-tomorrow spending habits, and the willingness to mortgage the future for the pleasures of today are an indicator of much deeper societal issues. One can blame the media or Corporate America for fostering this attitude, but the fact is generations have faced similar temptations throughout history. Our modern financial system has just made it far easier to fall prey to them. What is missing in our society is the values system about money of our parents' generation. We as parents (and I include myself) have failed to adequately teach our children the Biblical virtues of fiscal responsibility, thrift, delayed gratification, and the avoidance of debt. The schools make an attempt with consumer education but they cannot compete with the far more persuasive messages from the media. If these trends do not reverse, our children may face a less prosperous future than we would hope for them. We should be concerned, if not worried, about the economic future they may face.

Nevertheless, our purpose here is not so much to moralize as to state our view on the long term consequences of the irresponsible behavior we observe in the American economy. For the record, this is not the normal behavior we see among our clients, who usually make good choices with our counsel!

DISASTER 2005



If I had to reschedule all your appointments, THAT would be a disaster!

No, this is not concerning a hurricane. For some time, Matrix has been planning a disaster recovery drill in case our offices were unable to be accessed or even destroyed.

After 9-11, the Securities and Exchange Commission required all registered investment advisory firms to create plans for a disaster recovery situation.

All Matrix employees have laptop computers which are taken home each evening. We have configured a back up network server that is kept offsite. And, of course, we practice good data back up protocols. To test the



NetIntegrity IT professionals and Cindy simulate a disaster recovery situation.

effectiveness of our back up plan, we celebrated our firm's fifteenth anniversary simulating a disaster at a remote location somewhere in Union County, NC.

So long as phone service or Time Warner Roadrunner is available in an emergency, we should be able to carry on essential business. Matrix owns a 5,000 watt generator to overcome a loss of power (assuming gas would be available to run it). We did find some issues in our plan that will be addressed:

- The back up server had trouble booting up, requiring some internal hardware replacements.
- One software package version on the back up server was older than the version on the office server, requiring us to implement procedures to update the back up server anytime new software is installed on the office server.

We consider the disaster recovery drill a success, not because everything worked perfectly, but because we found out what needed to be changed to be prepared if a real emergency ever arises.

Our disaster drill experience and the recent Gulf Coast hurricanes do bring up some important reminders. If you had to leave your home in one hour due to an emergency, are your necessary documents in an accessible place? What if you had to leave in five minutes? Or five seconds? Do you have copies of important documents in a safe place away from your home? These might include your attorney's vault, your safe deposit box, or a relative's home. However, these locations might not be quickly accessible in an emergency. One idea is to copy your documents (password protected, of course) to a CD that could then be kept in an accessible place such as your office or trunk of your car. It's also a good idea to keep a copy in your travel bag in case a document (such as a health care power of attorney) would be needed while away from home. If you would like any help in creating such a CD, please let us know.



Jonie, Kim, and Brett simulate their reaction to a disaster.

As mentioned above, Matrix has passed the fifteen year milestone. It has been a most remarkable journey and it is not over yet! Our progress would never have been possible without the loyalty of clients like you, the hard work and diligence of faithful employees, the patience and understanding of family members, and the strength and wisdom that God has provided through it all. We will continue to strive to be the very best advisors that we can be and never, ever settling for anything less.

Domestic Equity Indices	
S&P 500 Index – Large-cap stocks (9/30/04 – 9/30/05)	12.26%
S&P 400 Index – Mid-cap stocks (9/30/04 – 9/30/05)	22.10%
Russell 2000 Index – Small-cap stocks (9/30/04 – 9/30/05)	17.96%
Wilshire REIT Index (9/30/04 – 9/30/05)	29.77%
International Equity Indices	
Morgan Stanley International EAFE Index (9/30/04 – 9/30/05)	25.82%
Morgan Stanley Emerging Markets Index (9/30/04 – 9/30/05)	42.51%
Fixed Income Indices	
Lehman Brothers Aggregate Bond Index (9/30/04 – 9/30/05)	2.80%
Lehman Brothers Credit Bond Index (9/30/04 – 9/30/05)	2.74%
Lehman Brothers Municipal Bond Index (9/30/04 – 9/30/05)	5.00%
CSFB High Yield Index (9/30/04 – 9/30/05)	6.31%
90 Day T-Bill (9/30/04 – 9/30/05)	2.84%
Consumer Price Index (9/30/04 – 9/30/05)	3.86%

Your Matrix Team:

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Brett A. Coffman, CFP, MBA, EA
Chenetta Williams

President
Portfolio Administrator
Investment Analyst
Financial Planning Manager
Financial Planning Manager
Administrative Assistant

Please let us know if you have any questions. As always, we appreciate your trust and confidence in us.