

THIRD QUARTER 2006

The Value of Patience

Too much information can be as dangerous as too little. We have learned this sometimes the hard way. In years past, we provided relative performance statistics in our client portfolio presentations. In the spirit of full disclosure, we would detail the performance of every manager in the portfolio, giving the peer group percentile ranking from *Morningstar*. Most of the meeting, it seemed, would be devoted to a discussion of why Manager X had underperformed his or her peer group over the past quarter, year, or (gasp) even three years. We got pretty good with the standard list of reasons:

“The manager’s style is distinctive and is currently out of sync with market trends.”

“This has been a period when low quality stocks have performed well, which the manager doesn’t want to own.”

“Sector A has been the top performer lately. Manager X doesn’t like Sector A because of _____.”

“*Morningstar*’s peer group isn’t a good comparison for this manager’s style.”

And if nothing else seemed to explain the underperformance, we could always resort to: “The manager has admitted making some mistakes lately. He just seems to be in a slump. You need to keep the long term in mind.”

Some clients and 401(k) plan participants could be unforgiving, wanting any underperforming manager – for any period of time - removed. Instinctively, we knew knee-jerk reactions to fire managers were usually mistakes. We knew all professionals – athletes, attorneys, or investment managers – are not always 100% at the top of their game. If we still believed in a manager’s style, process, philosophy, and character, we tended to stick with them through a mediocre period.

Finally, there is a landmark study published that validates the premise that even the great managers will go through periods of underperformance. Released in September by the highly regarded investment firm of Litman/Gregory, the study has deservedly made it into the business and financial press. Their findings are worthy of examination.

The study first identified through a screening process mutual funds that achieved clearly superior performance (1% higher annual returns than a benchmark index) over a significant time period – ten years, in this case. Funds were broken down into commonly used style and market capitalization categories. The study then examined the frequency where a period of underperformance occurred and the severity of the underperformance.

“The lesson is that it is normal and to be expected that a superior manager will underperform at some point.”

So you have invested in what appears to be a good fund. Some time later, you look at the recent performance of the fund and are dismayed to see that the fund has trailed its benchmark by 2% annualized over the past three year period.

Should you be alarmed? Is it time to sell? Hardly. The study found that anywhere between 88% - 100% (depending upon the category) of the funds that produced the long

term superior performance experienced such a performance drought. The lesson is that it is normal and to be expected that a superior manager will underperform at some point.

Manager Tenure - Does It Matter?

The answer is a definite "it depends"! If a transition is from one excellent manager to another, it may not be a concern. The study found immaterial differences between the performance of the superior funds which experienced a manager change during the ten year study period and those that did not. Our take is that funds that plan for and successfully execute a manager transition can go on to perform well. (Those that brought in an inferior manager and subsequently bombed never made the study's performance cut in the first place.) Some examples of well executed transitions that come to mind are the Jean-Marie Eveillard to Charles de Vault change at First Eagle Overseas in 2004, where de Vault had worked alongside Eveillard for many years. Another is the 1994 family transition from Shelby M. C. Davis to Chris Davis and Kenneth Feinberg at Davis Selected Advisors.

What if a fund trails its benchmark by a whopping **5%** annualized for a three year period? Surely then it's time to cash in and move on, right? Not really. The study showed that between 50% and 72% of the superior funds suffered through such a period and went on to beat their benchmarks over a ten year period. On the path to superior performance, the odds are that there will be substantial underperformance along the way and it will last for years. Long, patience-trying years!

Does this mean that one blindly ignores periods of underperformance? Of course not. A meaningful period (don't even talk to me about a quarter, six months, or even a year) of substantial underperformance should prompt questions about why the fund is underperforming. One thing we try to understand is what drives a

manager's performance – both when the results are superior and inferior. What has historically been the manager's edge when outperforming? Likewise, what are the market environments that seem to be the manager's anathema? Like the factors at the beginning of the memo, we try to ascertain the manager's performance in the context of the market environment. A manager with a fundamental, intrinsic value style (in the vein of a Warren Buffet) found it tough sledding in the late 90's when sustainable business models and cash flow became passé. By sticking to his discipline and buying companies that actually produced profits, a manager sealed his doom in terms of keeping up with the popular indices. More recently, managers who have always avoided energy stocks for historically defensible reasons (due to their cyclical nature, commodity driven companies, capital intensive businesses, etc.) found themselves staring at sub-par numbers in the last few quarters.

On the other hand, there are signs that concern us about a manager – whether performance has been good or bad. One is style inconsistency, where a manager strays from his discipline and begins buying stocks that are far afield from his historical areas of expertise. That said, some stocks can migrate from high flying growth stocks to bargain basement specials, where they appear on radar screens where they have never been before. We have lately seen some die-hard value managers snapping up Microsoft and Dell, which are now almost cheap by valuation standards.

Another warning sign for us is major personnel turnover. Investment management, like any other business, will normally have people moving on to better opportunities, such as an analyst moving to an assistant portfolio manager position at a different shop. However, when the turnover is massive, ongoing, or both, one has to wonder about the quality of the work that is being done by a constant stream of new hires. We like to see tenured folks in key support positions behind the portfolio manager.

Another item that causes us concern is too much of a good thing – asset inflows to a fund. This can overwhelm a manager’s ability to stay true to an investment discipline, leading to either over-concentrations in some positions, a migration to larger, more liquid companies, or the forced addition of so many issues to spread the money around that focusing on the best investment ideas is watered down by having to include more and more merely good ideas. Different fund companies (and investment styles) have varying capabilities to manage large asset bases. For some, adding an additional manager or analyst staff may work. For others, closing the fund to new investors (“soft close”) or all investor inflows (“hard close”) is the only good solution.

Third Quarter Recap

Returns were generally good in the third quarter for most asset classes. Some stock indexes are finally reaching record levels first touched over six years ago (though the NASDAQ remains far below its peak). The larger-cap S&P 500 index ended up 5.6% for the quarter. Small caps were nearly flat, gaining 0.4%. Value outpaced growth across all market caps. Other asset classes were also positive for the quarter: domestic investment-grade bonds and international stocks were each up about 4%. Commodity futures had the worst quarter by far, as measured by the Dow Jones AIG Commodity Index, losing 6.5% and down 6.1% over the past twelve months.

Which is most important - the manager, the fund, or the fund company? The answer is - yes, they are all important. According to research conducted by Emory University Assistant Finance Professor Klaas Baks, only a minority of the differences in performances between funds could be statistically attributed to the fund manager.

For his doctoral dissertation at Wharton, Baks constructed a database of fund managers who, at some point in their careers, switched funds. He found that, in most cases, a manager would do much better at the helm of one fund than another.

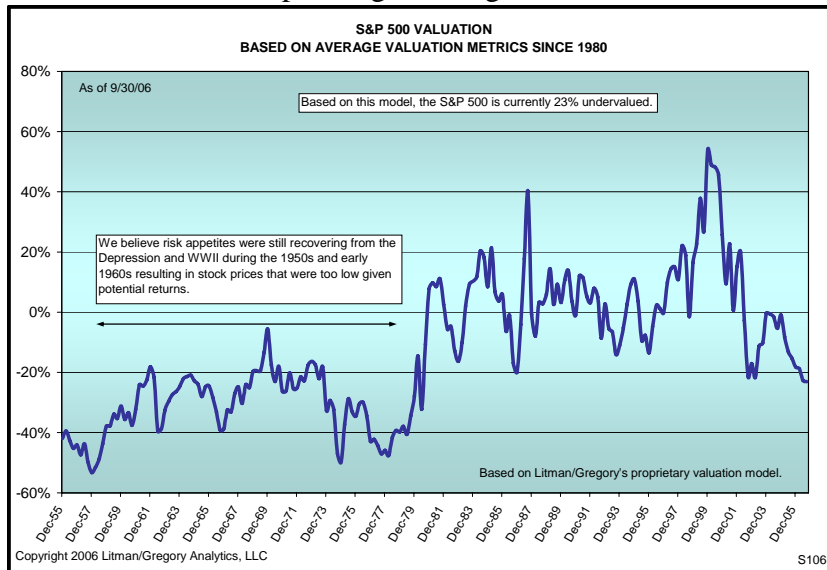
He also found that the funds of certain fund families tended to perform better or worse than others, regardless of who managed them.

These results together suggested to Baks that the fund organization - its analysts, its research methodology, its trading desk, etc. - can be more important than the manager. Testing this hunch with a complex statistical model, he found that about 70% of the differences between the performances of funds can be attributed to the fund companies, with just an average of 30% accounted for by the managers themselves (the range was from 10% to 50%).

The moral of the story is that managers still matter, but so does the organization behind them. Don't expect a "star" manager to continue a great track record if he joins a second rate organization. Truly great performance is more likely, in our opinion, when you have both: an excellent manager working in a superior organization. That's why a considerable amount of our research effort goes into understanding the support structure of the firm behind the manager.

- Source: Dow Jones Newswires

With oil prices dropping and the Fed finally pausing after a lengthy string of rate hikes, the markets have had a nice run in the past few months. From its most recent bottom in mid-July, the S&P 500 is up almost 9%. Normally a rising stock market makes stocks more expensive, but earnings (helped by a reduction in the supply of stock due to company buy-backs and takeovers) have also been positive over this stretch. Investors who buy a share of stock are really buying a share of a company's future earnings, and rising earnings have kept the valuation picture from changing as much as one might think. One valuation model (Litman/Gregory) estimates that the S&P 500 is a little more than 20% below fair value. The Fed's often-cited model—which compares the consensus 12-month forward operating earnings estimate for the S&P to the current 10-year



Treasury yield— suggests undervaluation of more than 30%. Several other analyst models tell a similar story; the degree of undervaluation varies quite a bit from one method to another, but even the more conservative of these valuation methods suggest the market is at worst in a fair-value range. This is not to

say that all experts believe the market is undervalued—some who use different valuation methods do not.

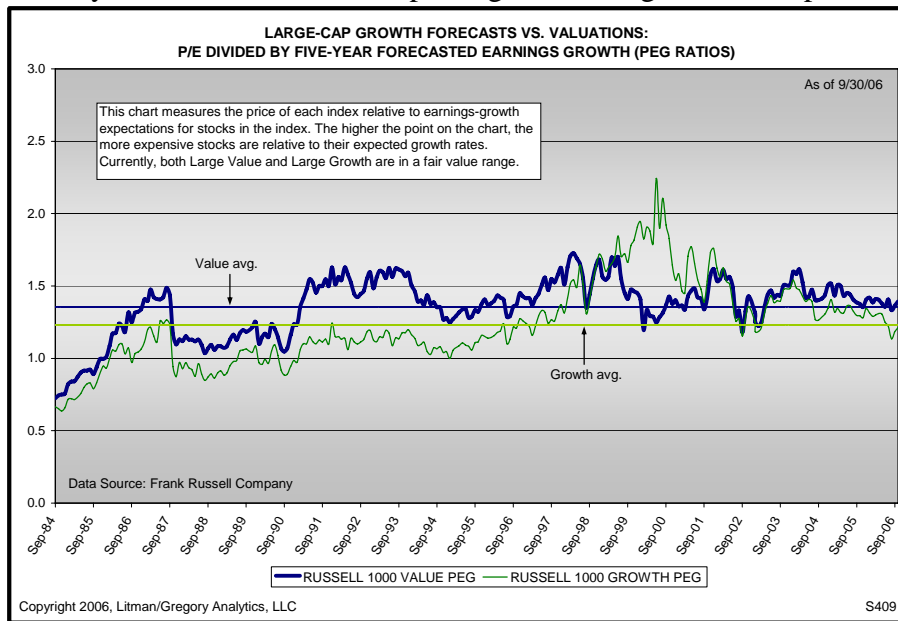
Why do stocks measure as being cheap right now? The stock market (or more accurately, the collective opinion it represents) seems to believe that a significant economic downturn is likely enough that it is pricing stocks based on a potentially big decline in earnings. How big? When we walk through the math, it shows that earnings would have to decline by a historically large amount in order to validate current stock prices. As an example, normalized earnings would need to drop by almost 25% for the Litman/Gregory model to show stocks as being fairly valued; since 1950, there have only been one or two instances where earnings moved that much from peak to trough. Over rolling five-year periods, it has also been very unusual for nominal earnings to show average declines of more than a couple percent per year annualized. There are many factors that could contribute to declining earnings going forward—a housing-induced recession, underfunded employee liabilities such as pensions and health insurance, and even a simple reversion to normal profit margins—but it's really only a perfect storm that would cause earnings to drop so much and/or over so prolonged a period that it would justify current valuations.

The stock market is not always right (we are reminded of the quip about the market having predicted nine of the last five recessions) and if it is wrong then stocks really are undervalued. But broad risk levels seem to be higher than average right now, and we are no different from the rest of the market in that these risks impact our enthusiasm for stocks. In addition to the above-mentioned factors, there remain problems associated with

our current account and federal budget deficits, the looming threats of Social Security and Medicare liabilities, lack of personal savings and investment, high levels of consumer debt, the growing—and potentially large—amount of unregulated private lending and derivative use that has evolved along with the growth of hedge funds and other similar entities, and the continuing risk of an economically damaging terrorist attack. These bigger-picture risks are on top of normal cyclical risk; with the economy slowing and the housing market deteriorating rapidly, recession risk has risen. These risks are material enough to make us more cautious than we otherwise would be.

On the positive side, it is entirely possible that the U.S. economy will have a soft landing and continue to expand for several years, and we are always pleased when stocks are priced with a big valuation cushion, since this reduces downside risk (most bear markets, for example, start from a point of high optimism or excessive valuation). As long as stock prices are factoring in a higher risk premium, stocks will continue to look undervalued relative to valuation comparisons over the past 25 years. However, if investors' risk perceptions improve, the resulting higher valuations would drive a return spike (all other things being equal).

Among other equity asset classes, foreign stock valuations are in line with their historical average relative to the U.S. Should we be investing in China? India? How about Norway? As usual, we are expecting the managers in our portfolios to decide at the

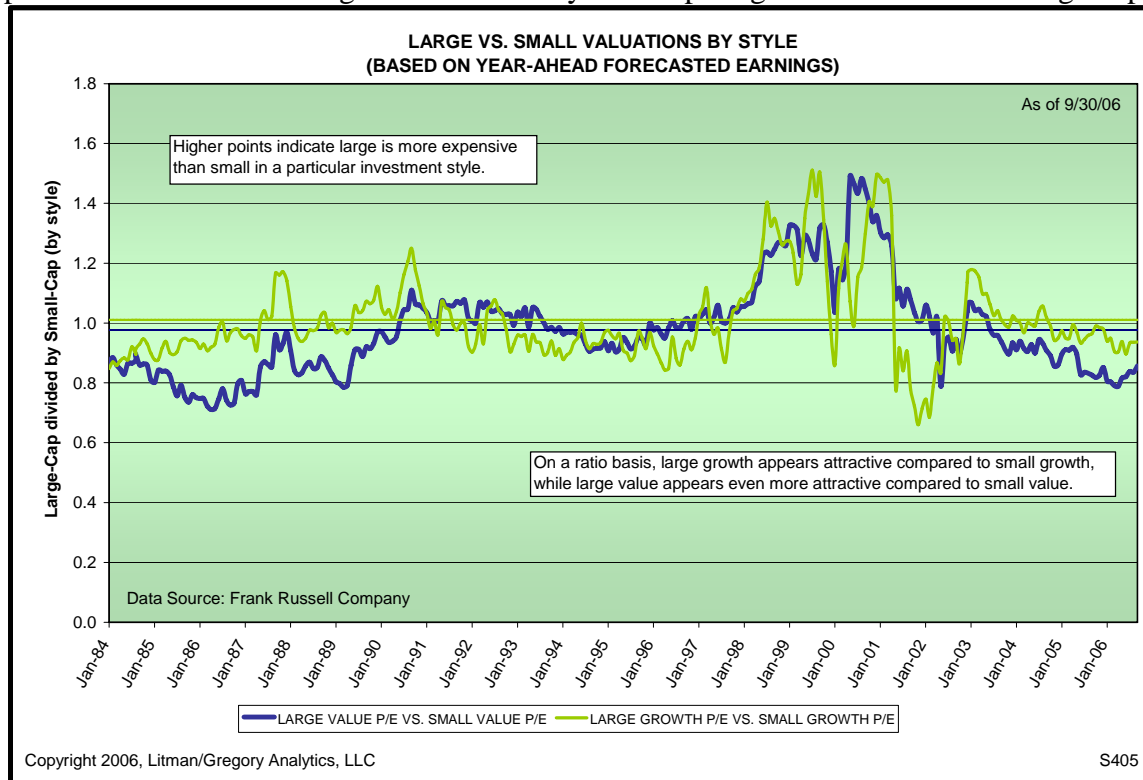


individual stock level where the best places are to invest.

Among domestic equities, growth stocks look slightly cheap relative to value stocks on a statistical basis, an opinion which has also been voiced by many of the

managers we respect. This is somewhat comforting to us, as most of our portfolios have evolved into a slight to moderate growth bias over the last few years. This growth bias has definitely held back the performance of portfolios, as growth has lagged value of late. This was not a conscious move to growth on our part, but rather the collective decisions of several managers represented in our portfolios. While the underperformance has not made us very ecstatic, we are comfortable letting managers like Bill Miller, Chris Davis/Ken Feinberg, and others make the decision as to which specific stocks represent the best investment opportunities. That said, we are experimenting with building some additional constraints to more closely monitor, and perhaps control, the allocations our managers make to growth versus core versus value stocks.

One equity area of interest to us is the valuation relationship between larger-caps and smaller-caps. We are seeing some metrics that show 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, and a lower P/E ratio means you are paying a lower price. This chart is nothing more than a way of comparing the "costliness" of large-caps



and small-caps relative to one another based on their P/Es. 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 other data sources as well.

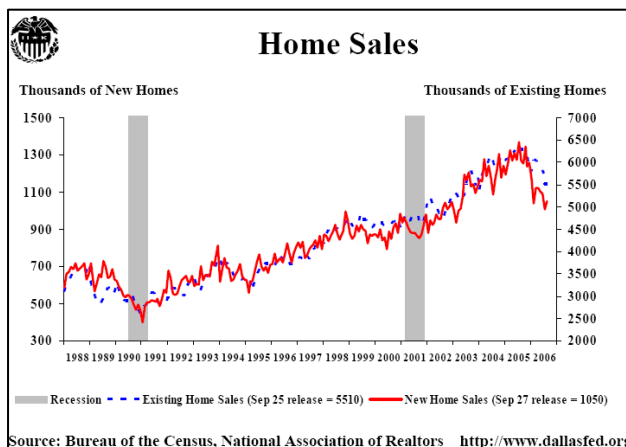
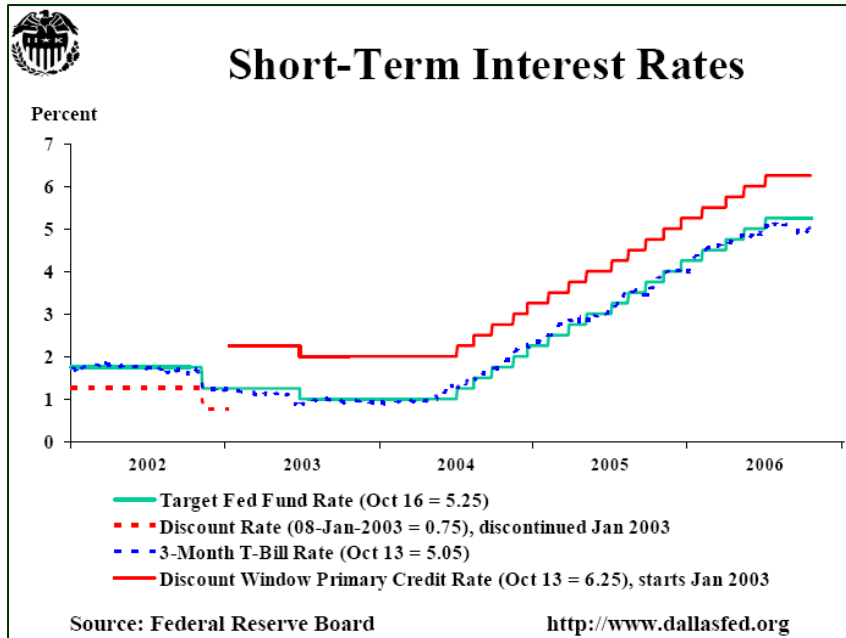
One can also argue that cyclical considerations show small-caps may face a head wind. We're well into the economic cycle, and small-caps' best periods of relative performance typically come early in the cycle. Another cyclical argument comes from the Leuthold Group, which states that since 1950, periods of small-cap outperformance have lasted an average of 70 months. The current cycle has been going for 87 months (as of June 2006), so we're well beyond the average, although still well short of the run that small-caps had in the 1970s and early 80s, which lasted roughly 120 months (10 years). Neither of these observations alone would cause us to make a move, but when combined with the valuation backdrop, the odds seem very good that large-caps will beat small-caps on average over the next five years. This could play out in several different ways. For example, we could have a short bear market, where larger-caps go down, but smaller-caps go down a lot more. Or we could have an extended period of mediocre or weak earnings growth, where larger-caps generate average gains in the mid to upper single digits, while smaller-caps return close to zero. It's entirely possible that on average over the next several years, assuming no recession, larger-caps could generate decent returns—perhaps even in the low teens—which implies that smaller-caps would probably

still put up positive numbers. Maybe larger-caps are not currently a compelling absolute return opportunity on their own, but smaller-caps are clearly less attractive versus larger-caps. This means we expect to, over time, shift our asset allocation towards the low end of the range specified for your portfolio.

Humility requires a reminder that neither we nor anyone else can say with great confidence how larger- and smaller-caps are likely to perform relative to one another in the near term. 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. Remember large cap growth stocks in the mid to late 1990's? While we can use history as a guide in forming our expectations, there is no way to know for sure how long it will take for this situation to play out. Smaller-caps could already be on their way down, or they could continue to outperform larger-caps for a few more years (if the current economic expansion continues for several more years, which is a real possibility).

The Economy and Bonds

The Federal Reserve has finally put on hold the string of interest rate hikes that began more than two years ago. Over this time period, the Federal Funds rate climbed from 1% to 5.25%, making it one of the sharpest tightening cycles on record. Decelerating earnings growth, a slowdown in the housing market, and a drop in oil prices, among many other factors, all undoubtedly contributed to the Fed's decision to hold off on further hikes. Among the sources we look at, there is a growing consensus that the economy is slowing down, but there remains a wide range of opinions as to what happens next.



Some bears argue that the decline in housing prices will have a material effect on the economy: a negative wealth effect will cause consumers to cut back on spending, and the construction and financial industries that experienced job growth during the housing boom will turn the other way as that boom reverses. Combined, they argue, these factors will result in a meaningful recession.

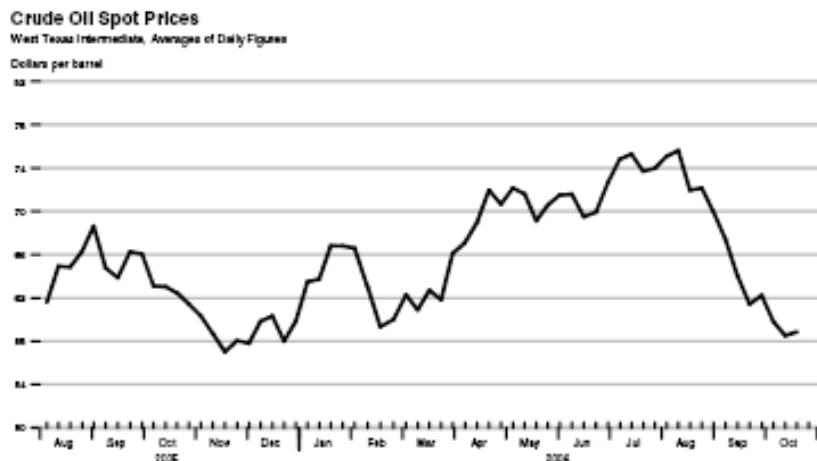
The bulls, meanwhile, argue that corporate America is in great shape, and that even if housing takes a nosedive, the data does not support a meaningful contagion effect throughout the broad economy. The fact that there is disagreement even within particular firms—including PIMCO and FPA’s fixed-income team—reinforces our belief that economic forecasting is a notoriously tricky process.

Where does that leave us? In short, the risk of recession is greater today than in recent years. This view is bolstered by the fact that the current economic expansion has lasted 60 months, compared to a post-war average of 55 months. Of course, this is just an average, and there have been expansions—such as the one throughout most of the 1990s—that lasted roughly nine years. We believe it’s largely impossible to predict with consistent accuracy when a recession will occur, but the longer we go without one, the closer we are to the next one. For us, that means we need to manage our portfolios with an eye towards this risk, as well as others. Balancing the potential downside of negative scenarios with the potential upside of positive scenarios, then wrapping it all in the context of the client’s goals and risk tolerance, has always been the key to how we make portfolio decisions. High-quality bonds are generally the best-performing asset class during recessions, and as such we believe bonds still have an important role to play in balanced portfolios (bonds help mute the volatility of equities in other scenarios as well). The bottom line is that you don’t need to be able to forecast the economy with precision in order to make sound portfolio decisions.

Commodity Futures

The last several months have been a reminder that commodity futures are a volatile asset

class. Given that spot oil prices have declined from a peak of almost \$80 per barrel earlier this year to just under \$60 as of this writing, and that natural-gas prices have plummeted approximately 70% in 2006, it’s not at all surprising that commodity futures have declined recently as well. While the short-term has been unpleasant, we continue to believe that this asset class



has significantly positive characteristics that make it worth owning, including: (1) the “risk premium” earned for absorbing shorter-term price volatility, (2) in some cases, the added return over time from periodically rebalancing the components of the commodity-futures index, (3) the return on the collateral backing the futures investment, and (4) its diversification benefits when mixed with stocks and bonds. Presently, we have utilized three different commodities strategies in some client portfolios, with varying results among the three:

	<u>One year return 9-30-06</u>
PIMCO Commodities Real Return Institutional	-9.24%
Aspen Diversified Fund	6.69%
MLM Index Fund Leveraged Series B	-11.24%

The second and third alternatives above are “private placements” not available to all clients, which is why we may not have discussed them with you. The first and third funds are indexing strategies, while the Aspen fund is run by human beings. Maybe skill, judgment, and talent still have a place in the investment world?

The MLM Index Fund’s performance has caused more heartburn for affected clients than any investment in recent memory. We know that patience is a virtue if you’ve done your homework. We also are humble enough to realize that not every recommendation will turn out as expected. Inevitably, there will be some investments that had all the right attributes and seemed to be good ideas at the outset, but turn out to be disappointments. The reasons for the losses are beyond the scope of this memo. However, our Investment Committee is devoting special attention to this investment and will be preparing a special analysis for applicable clients in the next few weeks.

Conclusion

Our slight overweighting of growth equities has proved to be a damper on returns during this value-led year. The fact that several of our managers have trailed their benchmarks at the same time hasn’t helped. The shorter-term underperformance of our managers does not impact our confidence in their ability to beat their benchmarks over the long term. As discussed at the beginning, over the years we have often observed and commented that even top managers occasionally have lengthy and sometimes significant stretches of underperformance. The managers we use are chosen based on extensive due diligence, and we follow up with them frequently. As long as our original thesis remains intact, and there are no material issues that impact our confidence in their investment edge, we know that underperformance is not by itself a reason to make a change. Even the greatest managers will at times test their investors’ patience, but as in all investing, patience and discipline are essential.

Domestic Equity Indices	
S&P 500 Index – Large-cap stocks (9/30/05 – 9/30/06)	10.79%
S&P 400 Index – Mid-cap stocks (9/30/05 – 9/30/06)	6.55%
Russell 2000 Index – Small-cap stocks (9/30/05 – 9/30/06)	9.91%
Wilshire REIT Index (9/30/05 – 9/30/06)	28.05%
International Equity Indices	
Morgan Stanley International EAFE Index (9/30/05 – 9/30/06)	19.18%
Morgan Stanley Emerging Markets Index (9/30/05 – 9/30/06)	17.56%
Fixed Income Indices	
Lehman Brothers Aggregate Bond Index (9/30/05 – 9/30/06)	3.67%
Lehman Brothers Credit Bond Index (9/30/05 – 9/30/06)	3.38%
Lehman Brothers Municipal Bond Index (9/30/05 – 9/30/06)	4.45%
CSFB High Yield Index (9/30/05 – 9/30/06)	7.77%
90 Day T-Bill (9/30/05 – 9/30/06)	4.76%
Consumer Price Index (9/30/05 – 9/30/06)	2.67%

Please let us know if you have any questions. As always, we appreciate your trust and confidence in us. Please note that we now have individual personal fax numbers that come directly to our computers. They are listed on the chart below. The general Matrix fax number of 704-358-3522 is also available for your use.

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