



M W I N V E S T M E N T
S T R A T E G Y G R O U P

JULY 2006

Global market volatility increased substantially during the second quarter. US stocks declined although most major market averages recorded only minor losses. The S&P 500 index fell 1.5%; foreign stocks were flat and bonds were off a fraction. Riskier asset classes such as small cap and emerging market stocks were broadly lower.

Model Portfolio Performance

Our four portfolio models declined by between 0.6% and 2.0% for the quarter. For the year to date, our portfolios have increased in value from 1.0 to 3.0%. Returns for the trailing twelve months range from 5.5 to 12.0%. This wider range between the returns of our most and our least aggressive portfolios is due to our early 2005 decision to be more cautious with our Conservative portfolio model.

Most of our US equity mutual funds lost ground during the three-month period. Growth stock funds, both large and small cap, suffered the worst during the May-June sell-off. TCW Select Equity, Harbor Capital Appreciation, and Masters Select Smaller Cap each declined by between 5-7%. On a positive note, Selected American managed a small gain in this otherwise down quarter. The performance by Selected American, our largest single equity fund holding, and whose allocation is more than twice that of any other we hold, provided a significant buffer to the declines elsewhere in our portfolios.

MUTUAL FUND MODEL PORTFOLIOS CURRENT PERFORMANCEⁱ				
MODEL	NEUTRAL ALLOCATION	2ND QTR	TRAILING 12 MONTHS	CUMULATIVE SINCE JAN 99
All Equity	80% US Stocks/20% International	-2.0%	12.0%	83.3%
Growth	65% US Stocks/15% International/20% Fixed Income	-1.3%	9.9%	72.4%
Balanced	53% US Stocks/12% International/35% Fixed Income	-0.9%	8.6%	73.0%
Conservative	35% US Stocks/5% International/60% Fixed Income	-0.6%	5.5%	61.1%
S&P 500		-1.5%	8.5%	15.7%

Returns for our bond and foreign stock funds were mixed, with changes of 1% or less for the majority. Our best performing fund was PIMCO Commodity Real Return, which gained 5% during the quarter.

Investors Reawaken to Risk

Market sell-offs that last more than a few days are unpleasant experiences. May and June were no exception. One client commented "I just don't understand why this decline is happening." The US economy was still strong and the worries – oil prices, higher interest rates, our global trade and budget deficits – had all been there for more than a year. "Something must have changed, but what?"

From our perspective, the underlying fundamentals remain unaltered. What clearly has changed is institutional and individual investor sentiment. Clouds have formed on their horizons, and risk is once again a part of the normal investment decision-making process. This reawakening to the realities of investment risk has been a major factor in the current sell-off. Frankly, we find this to be a good thing, as a healthy respect for investment risk keeps markets honest and helps prevent the sort of reckless abandon last seen in the late 1990s.

A point we keep returning to in these pages (some might say obsessively) is that the markets are still working through the aftermath of the 1990s dot-com bubble. Some of us may wistfully recall the double-digit returns generated by investors in those years. Many of us would likely want to forget the subsequent losses. But remembered or forgotten, the market consequences of the excesses of that era remain with us today.

In early 2000, the S&P 500's Price/Earnings ratio peaked at an unprecedented 50 times earnings¹, a reflection of the remarkable enthusiasm (some might prefer "delusion") of the era. It has been only recently that this standard valuation measure has finally returned to its historical norm of around 17. This adjustment has been massive, but generally quiet, accomplished with far less drama and pain than might have been expected. A single nasty bear market and two years or so of backing and filling is a relatively small price to pay when compared to the far bloodier aftermaths of prior asset price bubbles. Credit this performance to the remarkable growth of US corporate profits, with an assist by the astute management of the Federal Reserve.

The role of the Federal Reserve has been critical. Its job after all is to try to keep the economy on an even keel - not a straightforward task given asset price bubbles, global financial crises, terrorist attacks, etc. The Fed's primary tool in trying to manage the growth of the economy is its control over short-term interest rates. Imagine adjusting the water temperature in a shower with a very, very long time lag and you get a sense of the challenge. In the Fed's case, the lag between the time it changes the controls/interest rates and the time the temperature/growth rate changes is usually six months to a year. To get things just right under these conditions requires more than a little skill, considerable experience with the system, and some luck. So far, the Fed has had all three.

Still, getting the shower temperature just right is a hit-or-miss operation. It is easy to under- and over-adjust, occasionally with painful consequence. And so it is with the Fed. If the Fed under-shoots on rates, they are concerned that inflation will take root in the economy. Once established, inflation is enormously difficult and painful to eliminate. On the other hand, if they over-shoot and tighten too far, the Fed runs the risk of leading the country into recession (prior worries of deflation seem a distant concern today). Given that recessions are far easier to correct than inflation, the Fed's natural bias is risking recession, rather than risking inflation.

And so that is where investors find themselves today – with the growing perception that the Fed may overshoot (or has done so already), not just slowing economic growth but dragging the US, and possibly the rest of the world, into recession. This is a market risk, albeit a small one, that we cannot ignore. To quantify this risk, we look to a model² created by the New York Federal Reserve. The NY Fed's model forecasts the odds of recession from the relationship (spread) between US interest rates. As of June, the odds of recession were forecast at between 20-25% six to twelve months hence. For the odds of recession to increase, longer-term US interest rates would need to fall by three-quarters of a percent or more below short-term rates, an unlikely occurrence in the present environment.

¹ S&P 500 P/E calculated on normalized NIPA earnings by NDR Research.

² The NY Federal Reserve Bank's 1996 study demonstrated the recession- predicting power of the spread between the interest rates on the 3-month Treasury bill and 10-year Treasury note.

Investing in Uncertain Times

“If we accept that investing through uncertain times is the rule and not the exception, then the question to ask is not whether to invest or when, but rather how to invest.”

Shelby Davis, Founder, Selected American fund

We cannot be at all certain what direction the economy or the markets will take in the months ahead. We never can. But we do not find market risk to be greater, or lesser, today than it was last month or last year. Longer-term investment risk is ever-present and relatively constant, whether in rising or falling economic conditions, in optimistic or in fearful markets. Faced with a slowing economy and a risk of recession, our core approach to diversified asset allocation remains unchanged. In the longer run, investors are best served by resisting the temptations to overreact to the normal cyclical behavior of the markets and the economy.

However, higher market volatility does increase short-term risk for some, and it creates longer-term opportunity for others. Short-term risk is increased for those who have a current need for invested cash (notably those in retirement), as this latter may only be available at a lower value when needed. Longer-term opportunity is created for those with no current need for cash and with a long investment horizon (those saving for retirement and other goals), as they are able to take advantage should prices become depressed in the short-term.

Our approach is two-fold under these circumstances. For those clients in retirement phase, we are creating ladders of short-term government securities, matched to each client's expected outflows for the next 1-2 years. The recent upswing in rates creates an opportunity to lock in a guaranteed 5.00% or higher annual rate of return on short-term funds. This secures a source of ready cash for projected needs at a relatively low opportunity cost during what might be a more turbulent period for the markets.

For those clients without a current need for cash from their portfolios, we would view any further market sell-off as an opportunity to shift some funds out of fixed income and commodities and into an over-weight allocation to large cap US stocks.

Martin Weil President

We are pleased to report that the July issue of Financial Advisor, a trade magazine, lists MW Investment Strategy Group as one of the 100 fastest growing advisors in the US during 2005 in the under-\$100M in assets category. We like to think this means we are doing a superior job for our current clients who have so enthusiastically recommended us to others.

Model Portfolio Performance Disclosures:

- a) Performance data is for model portfolios and is not a composite of actual client accounts.
- b) All MWI managed client accounts are based on one of four diversified mutual fund model portfolios. These four models are geared to different investor levels of risk tolerance, generally expressed as a one-year maximum loss threshold. New accounts are invested following one of these models, typically using dollar-cost averaging over a period of months, not to exceed one year. Once an account is fully invested, it is expected to track the performance of its underlying model. Exceptions to this include accounts with restrictions such as: the client-directed retention of legacy holdings and/or excess cash, substantial withdrawals or additions. Accounts smaller than \$100,000 are restricted by purchase minimums at certain mutual funds and the performance of these accounts may differ somewhat from the models. Taxable accounts employing municipal bond funds in place of the taxable bond funds used in the models will slightly underperform on a pre-tax basis.
- c) Benchmarks are custom created following the neutral asset allocation shown for each portfolio. Components of the benchmark allocations are Vanguard's S&P 500 index fund, iShares Russell 2000 index, Vanguard Total International and Total Bond index funds. The S&P 500 index performance is calculated with dividends included.
- d) Net of fees: The performance for MWI model portfolios is calculated net of our maximum annual management fee. The returns of the portfolio benchmarks and market indices do not include these management charges. All returns assume dividends and income are reinvested.
- e) Rebalancing: Model portfolios are routinely rebalanced every six to twelve months on the last day of a quarter. Actual client accounts may be rebalanced at other times. With tax-efficiency a part of our decision criteria, taxable accounts may be rebalanced less often and/or less completely than retirement and other accounts not subject to current taxation. This may result in performance discrepancies between taxable and non-taxable accounts managed following the same portfolio model.
- f) Model allocation changes: Changes to model allocations are infrequent but can and do occur at any time. When a model is changed, allocations to client accounts are changed as soon as is practical. However, changes to the model portfolios are only recorded, for performance purposes, on the last day of any quarter.
- g) Closed funds: From time to time, mutual funds that form part of MWI model portfolios close to new investors. Clients already owning closed funds in their accounts will generally continue to hold and/or add to their positions. New client accounts will be invested in alternate funds. At year-end, MWI will substitute in its models for any funds that have closed during the year with alternate funds available at that time to new clients. As a result, performance disparities may develop between older and newer client accounts, and between older client accounts and current model performance.
- h) Historical performance is not a guarantee of future results. While the performance period since January 1999 includes both rising and falling stock markets, there can be no assurance that the portfolios will perform as well under future market conditions. In particular, the performance of our Conservative and Balanced models relative to the S&P benefited from the severe bear market in US stocks during 2000-2002. In a rising equity market, the Balanced and Conservative models would be expected to underperform a similar investment in the S&P 500.