MW INVESTMENT STRATEGY GROUP

**JANUARY 2006**

The S&P 500 index of US stocks rose during the fourth quarter, ending a lackluster twelve months with a 4.9% gain. Foreign stocks outperformed the US market with the EAFE index returning 13.5% for the year. The Lehman Brothers broad bond market index rose 2.4% in 2005.

## Model Portfolio Performance

Our four model portfolios, on which our client accounts are based, gained between 3.7% and 9.1% for the year. Three of the four exceeded the return of the S&P 500 in 2005, generally doing so with less risk of loss. Since inception in 1999, each of our diversified portfolios has decisively outperformed the broad US stock averages.

**MUTUAL FUND MODEL PORTFOLIOS CURRENT PERFORMANCE[i]**

| MODEL | NEUTRAL ALLOCATION | 4TH QTR | 2005 | CUMULATIVE SINCE JAN 99 |
|---|---|---|---|---|
| **All Equity** | **80% US Stocks/20% International** | **3.6%** | **9.1%** | **78.5%** |
| **Growth** | **65% US Stocks/15% International/20% Fixed Income** | **2.5%** | **7.5%** | **68.7%** |
| **Balanced** | **53% US Stocks/12% International/35% Fixed Income** | **2.1%** | **5.9%** | **69.3%** |
| **Conservative** | **35% US Stocks/5% International/60% Fixed Income** | **1.5%** | **3.7%** | **59.1%** |
| S&P 500 | | 2.1% | 4.9% | 12.7% |

We were rewarded by the exceptional performance, once again, of Selected American Shares. The fund rose 10.2% in 2005, besting the S&P for a sixth consecutive year. Selected American is our largest equity holding, comprising about 15% of our total client assets. Over the last decade, the fund has returned on average nearly 13% per year, a cumulative 36% more than the S&P. Selected American received Morningstar's 2005 US Equity Manager of the Year honors.

Disappointingly, Oakmark Select, another of our core equity funds, returned a sub-par 5%, following a sensational five-year run of outperformance. Bill Nygren of Oakmark remains one of the most astute and skilled stock-pickers we know. Occasional years such as these, from even the greatest managers, are to be expected so this one-year performance is of no great concern.

In 2005, we enjoyed excellent returns from all our foreign stock funds with Thornburg International Value gaining 18%, Artisan International Small Cap 25%, Matthews Asian Growth and Income 16% and Oakmark Global (a Foreign and US equity blend) 13%. PIMCO Commodity Real Return rose 20% during the year.

A major disappointment in 2005, however, was PIMCO Global Bond, a position we initiated due to our expectations for a continued decline in the dollar. However, the dollar's slide reversed during the year and we sold this fund for a small loss in the fourth quarter. We continue to believe that the dollar will again come under renewed pressure, and we replaced the position in our models with what we anticipate is the more promising PIMCO Developing Local Markets fund.

## Looking Back

In general, 2005 was a frustrating year for equity investors. Residential real estate was a different story and homeowners typically saw substantial increases in their net wealth. But for equity investors, it was a bit like watching paint dry. As we have written many times before, stock valuations suggest that annual returns for US stocks in this post dot-com era will average in the single digits. These returns may come in bursts (as with the S&P's 28% gain in 2003) or in dribs and drabs, as in 2005. However, before impatience drives us to rush into high-flying asset classes like gold, or yet more real estate, it is worth noting that five years of 8% annual growth compounds to a 47% cumulative return. Even an extremely modest 5% return compounded over five years adds up to nearly 30%.

We began 2005 with 3-5% cash positions in all accounts, with an overweighting to non-US assets, a small exposure to commodities, and an extremely cautious stance in our US bond allocations. This overall positioning reflected our views that both bonds and the dollar were vulnerable, and that inflation posed a greater threat to investors than recession. Events unfolded differently than expected. And while we did not reap the benefits we had hoped for from our foreign bond positions, our selection of mutual fund managers and our allocation to foreign equity funds more than made up in outperformance for the slight underperformance in the fixed income holdings in our portfolios.

With its larger exposure to fixed income, our Conservative portfolio ended the year 0.1% behind its benchmark. This is only the second time in six years that one of our models has failed to outperform its portfolio benchmark. During 2005, our caution in our fixed income allocations cost our clients a few tenths of a percent of return and this added caution meant the difference between the Conservative portfolio beating and lagging its benchmark for the year.

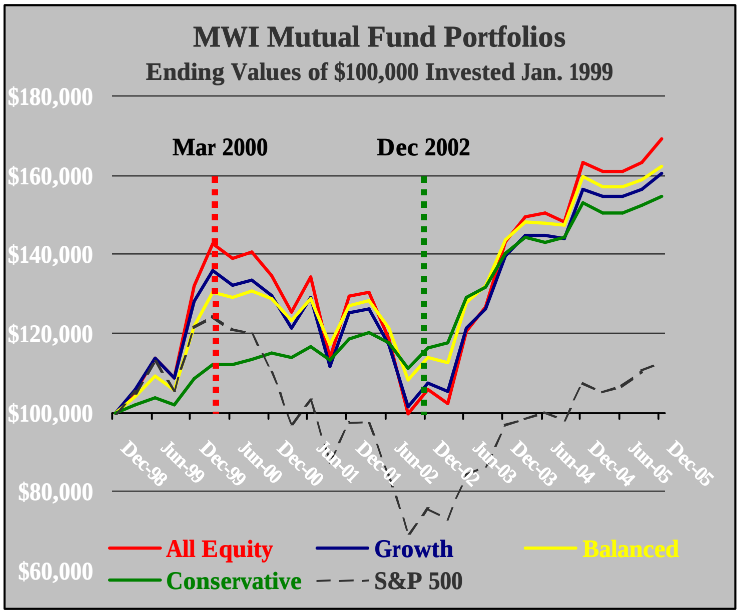
By December, we had reallocated our remaining cash to our core positions. Given Litman Gregory's analysis that the market was slightly under-valued at year-end, we increased our allocations to US stocks from underweight to neutral. This is not exactly a whole-hearted endorsement, but an improvement in our outlook from one year ago. At this late stage in the economic cycle, we find it prudent to be underweight small cap stocks versus large cap, a reversal of our positioning of the last three years.

Finally, a word about oil and other natural resources stocks: Investors who were significantly overweight in these sectors last year outperformed the market by a wide margin. In spite of the fact that we made a conscious decision not to overweight energy on our own and to leave that decision to our underlying fund managers, our portfolios generally managed to outperform the market by a comfortable amount.

## Longer Term Performance

It was in January 1999 that we began managing client accounts following asset allocation and mutual fund research provided by Litman Gregory. Since that time, our four model portfolios, and the client accounts based on them, have exhibited exceptional performance. Their cumulative returns have far exceeded US stock market averages. As shown in the graph that follows, $100,000 invested in one of our four models would, as of 12/31//05, be worth between $155,000 and $169,000 net of fees. A similar investment in the S&P 500 would be worth just $113,000, dividends included.

And while this performance is certainly welcome, we want to briefly discuss what is commonly called "performance chasing." This is best described as decision-making by investors based on the most recent short-term (one or two year) returns for an investment sector or style.




Let's imagine for a moment that it is Spring 2000 and our performance graph ends just where you see the vertical dotted red line. At that point, a $100,000 initial investment in our All Equity portfolio would have been worth more than $140,000. The same investment in our Conservative portfolio was worth but $117,000 and the other portfolios ranged between.

Seeing this substantial divergence, investors in 1999 and 2000 would have been (and in fact were) clamoring to move up the scale, from Balanced to Growth or from Growth to All-Equity, to capture this "better" performance.

Now let's move forward to the dotted green line, just two and a half years later in December 2002. And let's assume that a theoretical investor had invested at the market peak in 2000, back around the vertical red line. An investor in our All Equity portfolio would have seen his value decline by nearly 40% in the two-plus years that followed (the S&P performed even more poorly), while an investor in our Conservative portfolio in March 2000 would, by the end of 2002, have earned a modest gain. Seeing this new performance divergence, investors might have been tempted yet again to switch. But this time they would be switching out of the equity-based models and into the better-performing fixed-income based portfolios. Such performance chasing in either case would have been the worst possible decision.

A principal objective of our focus on selecting an appropriate risk model - and then sticking with it through thick and thin - is precisely avoiding this temptation to succumb to a "rear-view mirror driving" investment approach. Emotions are often not our best guide to good investment decisions. In our practice, it is the individual investor's specific goals, not short-term returns, that must be the driver of our investment decisions. If we seem to be overly repetitious about risk models and asset allocations, it is because it is this discipline that keeps us from making emotion-driven choices that might substantially impair our clients' chances of reaching their goals.

## Company Developments

MW Investment Strategy Group continued to add both clients and assets during 2005. At year-end, we counted more than $20M of client assets under management versus $14.5M on December 31, 2004. The results of our client survey this past summer revealed a very high satisfaction rate amongst our clients (overall satisfaction scored an average 4.7 out of a possible 5.0) and an extremely high willingness to refer our services to friends and colleagues (2.9 out of a possible 3.0). We are grateful to everyone who took the time to respond to the questionnaire.

We are also extremely grateful to those of you who referred new client relationships to us in the past year. All our new business comes to us by way of client referrals. Over the next 2-3 years, we are looking to add 4-5 new clients per year before placing restrictions on our growth. If you know of someone who might benefit from our approach to rational, diversified investment management, please feel free to give our contact information.

A major project in 2005 was the total re-design of our company website. This new site has useful information for current clients (e.g. click on "Client Resources" for a link to the web page of each of the mutual funds in our portfolios), as well as for potential clients and it features a blog commentary on financial matters by Yours Truly. If you have not yet visited our new site, take a moment to do so at www.mwinvest.com. We would be very interested in hearing your feedback.

**Looking Ahead**

The big news the past two years has been the rapid appreciation in home prices, particularly on the coasts. Most forecasters agree that this price spiral cannot continue and expect home prices to flatten in 2006 and beyond. Prices for many commodities – notably for oil and gold, but also for more mundane items such as copper and cement – were driven higher by surging global demand and speculation. There is no consensus on the direction for commodity prices in 2006.

Our current outlook tends to the macro perspective of Bill Gross, lead manager at PIMCO, who sees an end to the Fed tightening cycle early in 2006 and an economic slowdown further down the road. The major risk to this outlook is the risk of recession. Recession is by no means a given. But it is a significant enough risk that we are beginning to incorporate it into our scenarios. While the lower interest rates that would accompany an economic slowdown are generally good for stocks – thus the market gains in the first days of 2006 - recession is not, at least not the run-up to recession. Nor would a recession be bullish for commodities. It would however be bullish for bonds.

A final thought: With these quarterly letters, we attempt to provide our clients with some insight into our perspectives on global economics. In doing so, we are in no way delving into the forecasting or prognostication business. We simply hope to help clients understand which of the many possible investment risks we are currently concerned with and how we are, or are not, positioning their accounts as a consequence. Our perspectives on the economic cycle inform our tactical decisions around what remains a fundamentally solid, and largely unchanging, core of all-weather, broadly diversified investment portfolios.

The downside of this moderate approach to investing is that when we are right, our clients will not make a killing. The upside is that when we are wrong, they will not lose their shirts. As substantial losses of capital are the greatest threat to reaching one's longer-term goals, we are very happy making this trade-off.

As always, if you have any questions about your portfolios or the content of this newsletter, please do not hesitate to contact me.

With our very best wishes for 2006,

**Martin Weil**
**President**

**Note:** As we have done for the past four years, MW Investment Strategy Group is pleased to have made charitable contributions in the names of our clients. Given the unique challenges faced by the Gulf Coast in the aftermath of Hurricanes Katrina and Rita, we have contributed the remainder of our 2005 giving budget to Habitat for Humanity's rebuilding efforts in that region, having made an earlier donation to the Red Cross' emergency relief efforts in the Fall.

**Model Portfolio Performance Disclosures:**

a) 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 tolerances, 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 individual restrictions such as: the retention of legacy holdings, substantial withdrawals or additions, and client-directed retention of cash, as well as accounts smaller than $100,000. 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.

b) The results represent the theoretical pre-tax performance of MWI model portfolios and the S&P 500 index. They do not reflect that of an actual client account or accounts.

c) <u>Net of fees:</u> 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.

d) <u>Rebalancing</u>: 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.

e) <u>Model allocation changes</u>: 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.

f) <u>Closed funds</u>: 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 for any closed funds in its models with the alternate funds available then 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.

g) 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 between 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.