



MW INVESTMENT  
STRATEGY GROUP

**JANUARY 2007**

The US stock market finished 2006 on an upbeat note as the S&P 500 index gained nearly 7% for the quarter and 15.7% for the year. Foreign stocks had another good year with the EAFE index rising 26.6% in 2006. Real estate funds continued to soar, gaining 35.1%. Bonds registered modest gains for the year with a total return of 4.3% for the Lehman broad bond market index.

**Model Portfolio Performance**

Our four portfolio models moved sharply higher during the fourth quarter, earning between 4.0 and 7.6%. Total returns for the year ranged from 8.0-12.7%. These results are rewarding, but are lagging relative to the risk benchmarks we have established for each portfolio. We discuss our relative performance in 2006 further on in this letter.

Each of the equity funds we own participated in the fourth quarter rally. For the year, Longleaf Partners was far and away the standout of our domestic stock fund holdings. A 21.6% return puts Longleaf’s performance in the top 2% of all domestic large cap equity funds for the year, and the top 3% for the trailing five and ten year periods. Mason Hawkins, Longleaf’s manager, earned Morningstar’s Domestic Equity Fund Manager of the Year Award. Among our bond funds, standouts in 2006 were Loomis Sayles Bond, ahead 11.2% for the year, and our new addition, Pimco’s Local Developing Markets, returning a similar amount. Foreign stock funds were a major plus for our portfolios again in 2006, with Artisan International Small Cap continuing as our best performer with a 33.2% gain for the year. Our reduced position in Pimco Commodity Real Return was the single negative fund performance in 2006, down 3.5%.

| MUTUAL FUND MODEL PORTFOLIOS<br>CURRENT PERFORMANCE <sup>1</sup> |                                |                        |       |                               |
|--|--------------------------------|------------------------|-------|-------------------------------|
| MODEL  | RISK<br>BENCHMARK              | 4 <sup>TH</sup><br>QTR | 2006  | CUMULATIVE<br>SINCE<br>JAN 99 |
| All Equity   | 100% Stocks                    | 7.6%                   | 12.7% | 100.9%                        |
| Growth   | 80% Stocks<br>20% Fixed Income | 6.1%                   | 11.1% | 87.3%                         |
| Balanced   | 65% Stocks<br>35% Fixed Income | 5.3%                   | 10.4% | 86.8%                         |
| Conservative   | 40% Stocks<br>60% Fixed Income | 4.0%                   | 8.0%  | 71.8%                         |
| S&P 500  |                                | 6.7%                   | 15.7% | 30.0%                         |

**2006 & 2007**

It was an eventful year for the US economy with a major election, a housing slowdown, volatile energy prices and shifting Federal Reserve policy all affecting the markets. After a lackluster first six months, US stocks put on a display of strength during the year’s second half. The S&P earned 13% of its total 15% gain for the year between late July and year-end. By mid-summer, it seemed that all the bad news – trade & budget deficits, stalemate in Iraq & failing confidence in Washington, higher energy costs, weak dollar, vulnerable housing prices and a slowing economy – had been fully priced into the market. When no further bad news emerged and the worst case scenarios failed to materialize, investors must have heard an “all clear” signal and started buying.

Looking ahead to 2007, the market's strength seems to forecast another "soft landing" for the US economy, i.e., a slowdown but no recession, and the next move by the Fed to lower short-term interest rates. While we are increasingly optimistic about the markets over the next three years, we cannot ignore the very real short-term risks to equity and bond prices. Unexpected bad news – whether US economic conditions turning less favorable than generally anticipated, or an external event, such as terrorism - could have a significant impact on stock prices. We would view any downturn, however, as short-term and even consider using such an event to further increase equity exposure in our portfolios.

At year end, US equity valuations remained in the fair to slightly undervalued range according to numerous measures employed by our research team at Litman Gregory. These valuations are comfortable enough to warrant being fully weighted, but not sufficiently undervalued by our standards to be substantially over-weighted US stocks. That said, there are opportunities within our US equity allocation. A long period of small-cap stock outperformance (in which we more than fully participated these past five years) has created a valuation disparity relative to large-caps. As a result, all our portfolios are now underweight small cap stocks and overweight large caps. We continue to believe the dollar is vulnerable, and although the timing of any possible decline is wholly unpredictable, we remain overweight both stock and bond funds that do not hedge their foreign currency exposure.

Changes to our portfolios in early 2007 will be minor: we plan to shift assets from Selected American to Clipper (the latter is a more concentrated version of the former and run by the same management) in accounts where this will not cause recognition of a capital gain. Additionally, we are reviewing whether we will add real estate funds (REITs) as a permanent, as opposed to opportunistic, asset class in our models. With domestic REITs near extreme over-valuation levels, this is not a propitious time to begin assuming new positions. However, we do see opportunities within overseas REITs and may begin to add positions in early 2007.

## **2006 performance discussion**

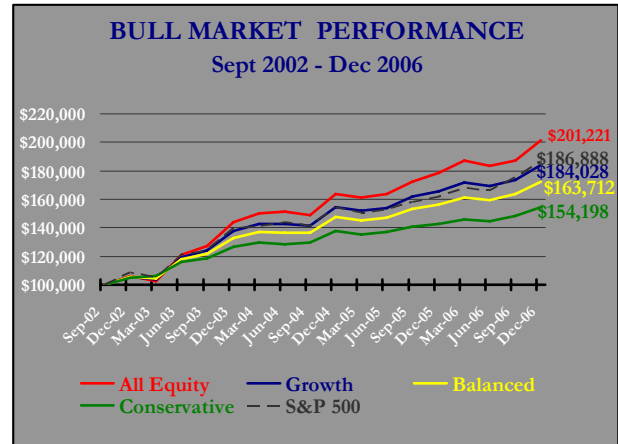
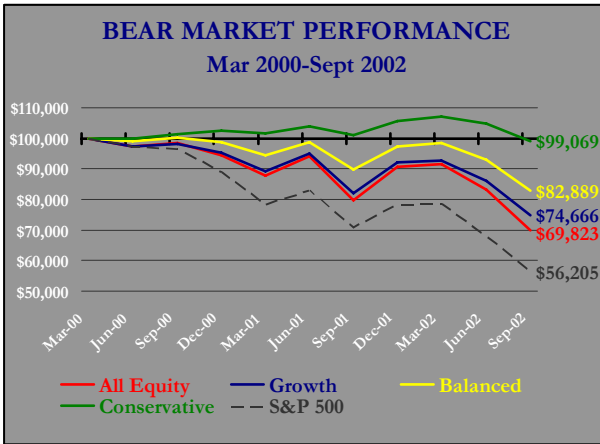
Compared to 2005, 2006 was a very good year for our clients on an *absolute* basis. Returns ranging from 8% for our Conservative accounts to 12-plus% for All-Equity were considerably higher than 2005 results, and in line with long-term average expectations for these portfolios. That said, we could have done better. Whereas clients are typically happiest when they have high *absolute* returns, we measure our value to our clients by our *relative* performance. This latter is measured against a custom risk benchmark for each portfolio and tells us the value of our manager selection and asset class decisions. In 2006, we did not add value in either of these areas, as each of our model portfolios materially underperformed their specific benchmark for the first time in eight years. This result is disappointing. It would be natural to ask if we have been doing something differently or are making any changes as a result of the underperformance. The answer to both is no.

The primary negative contributor to our 2006 relative performance was the synchronized and substantial underperformance by several of our equity managers during the first nine months of the year. Underperformance by any of our managers over a period of a year or more is not unusual. What was so out of the ordinary was the concurrence of at least six of our managers, employing different investment styles, underperforming during the same time frame.

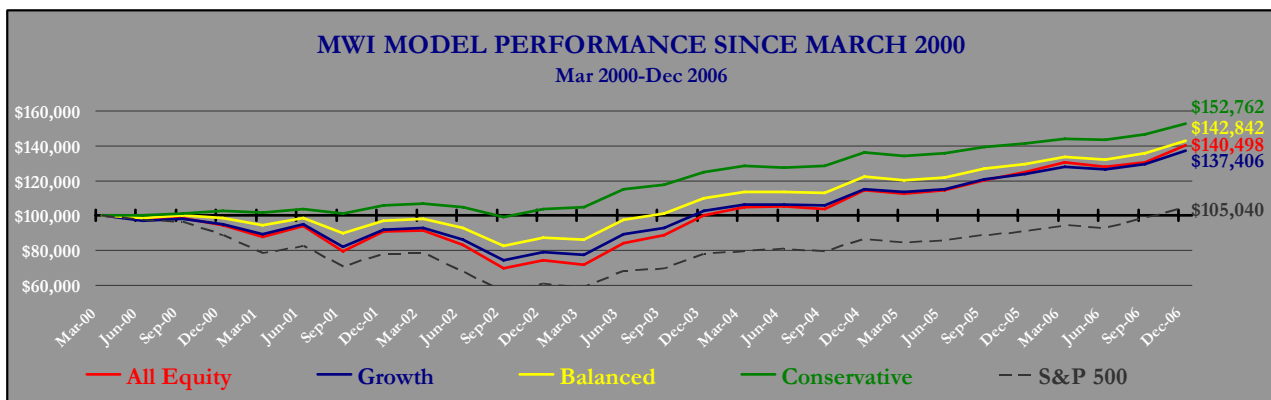
Studies have shown that even the best managers underperform, occasionally for extended periods. And we have been through this with managers before – Mason Hawkins at Longleaf, commended above, is a maverick investor, notorious for long periods of underperformance. The research clearly shows that a bad period by a superior investor is often followed by an extended period of superior

returns. Thus selling good managers after slumps solely on the basis of performance is likely to result in poor long-term returns. Our principal discipline remains diversification among managers who have demonstrated superior long-term results, a high conviction and clear investment discipline, as well as an expense ratio in the lowest quartile of comparable funds.

We are buy-and-hold investors and our objective is to perform in line with the market on the upside and to outperform on the downside. While this approach may be frustrating during market rallies for those with shorter time horizons, the three graphs below clearly illustrate the long-term benefits of this approach. The first two graphs pair the performance of our portfolios during the 2000-2002 bear market compared with their performance during the subsequent bull market, 2002-present.



During the two-year market sell-off that saw a decline of nearly 45% in the S&P, our four diversified portfolios, even our most aggressive, preserved investor capital to a far greater extent than did the market as a whole. Avoiding large losses is a fundamental part of our investment philosophy for a simple reason: large losses of capital are the single most damaging contributor to wealth enhancement. The price we pay to avoid such losses is more moderate gains when the market is surging ahead. The second graph above demonstrates how our portfolios perform in-line with, but not ahead of, the market during bull markets



When we combine the two market periods, bear and bull, 2000-2006, the results shown in the final graph above are clear. This is our continuing goal – long-term outperformance over a full market cycle.

## **Company highlights**

The responses by clients to our 2005 survey were very informative. Satisfaction was high for our investment management and services overall. However, one area in which clients expressed a desire for more help was retirement planning. In response, we made two changes during 2006 to enhance our retirement planning services. We upgraded to a significantly more sophisticated retirement forecasting software in-house and developed an alliance with a senior financial planner, Patricia Jennerjohn, CFP® (Certified Financial Planner™) practitioner. Throughout 2007, we will be reviewing and more fully developing each client's retirement projections as necessary and reporting back during our normal review cycle.

With a continued focus on upgrading our financial planning resources, I personally completed two years of coursework in 2006 to earn a Certificate of Personal Financial Planning from UCLA. This certification will allow me to sit for the CFP exam in 2007. On a related note, my article on college savings 529 plans was published during 2006 on seven web sites including the major reference site, About.com.

In 2006, MW Investment Strategy Group participated in a Charles Schwab study of more than 1,000 independent investment advisers. We are happy to report that we ranked in the top quartile for client growth over the three years ended December 2005 for our peer group (under \$100M in assets), and in the lowest quartile for management fees charged to clients.

In closing, we are grateful to each of our clients for the trust you have confided in us.

With my very best wishes for a prosperous 2007,

### **Martin Weil President**

Based on feedback from clients, we have made changes to the format of our standard portfolio account holdings statement. Clients will find a page describing these changes in the account statements section of their packets.

As we have done for each of the past four years, MW Investment Strategy Group has made contributions to several charities at year end. Our contribution list for 2006 includes America's Second Harvest, Doctors Without Borders and Habitat for Humanity.

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## 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, and cash. The S&P 500 index data is based on the performance of the Vanguard S&P 500 fund and includes dividends.
- 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.