

HAMMOND ASSOCIATES

INSTITUTIONAL FUND CONSULTANTS, INC.

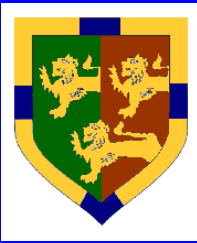
RESEARCH REPORT

Fourth Quarter 2005

In this report . . .

- ✓ Hints of a Slowdown in the Housing Market
- ✓ Does an Inverted Yield Curve Signal a Recession?
- ✓ US Dollar: A Cyclical Spike Within a Secular Decline
- ✓ Will International Equities Continue to Outperform?





Hammond Associates

Market Commentary

January 2006

The global economy grew briskly in 2005. Despite sharply higher energy prices, global economic growth was almost 4.2% for the year. Most economists expect a similar growth rate in 2006. Strong economic growth in 2005 and abundant liquidity contributed to outsized investment returns in many markets, but not in the US. Unfortunately, domestic equity indexes generally provided modest returns. The S&P 500 earned 4.9%, and the broader Wilshire 5000 index earned 6.4%. These returns paled in comparison to returns available in many other markets. The MSCI EAFE index of international developed market stocks returned 29.0% in local currencies and 13.5% in dollars. Emerging market equities continued to benefit from positive economic fundamentals and massive inflows of money, appreciating 34.0% during the year in dollars.

Valuation convergence persisted in 2005. The relative mispricings and bargains created by the inflation of the tech bubble in the late 1990s and the subsequent global bear market continued to correct, and in some cases, overcorrect. This has definitely benefited investors who were willing to diversify away from the S&P 500. A sample 75% diversified equity indices / 25% diversified bond indices portfolio (with tilts in favor of international, small-cap, and value stocks) has earned 7.5% annualized since the beginning of 2000 and 18.7% during the recovery over the past three years.¹ In contrast, a relatively undiversified 75% S&P 500 / 25% Lehman Aggregate Bond portfolio was up only 1.1% and 11.7% for those two time periods, respectively. **The bad news is that it's becoming increasingly difficult to find assets that offer attractive risk-adjusted returns in this low-return world.**

US Stock Market Still Expensive

Looking forward, we remain concerned about equity valuations domestically. The S&P 500 is priced to provide a long-term real return of only 4.2% (6.7% nominal) assuming current valuations hold. This represents only a 2.2 percentage point risk

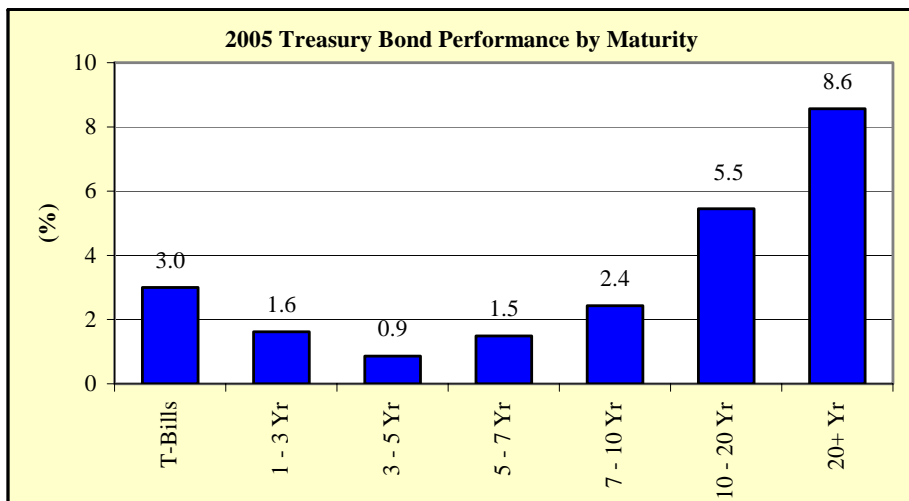
¹ The results of the diversified and non-diversified portfolios are shown for informational purposes only. They do not represent advice given to Hammond Associates' clients. The non-diversified portfolio is comprised of 75% S&P 500 and 25% Lehman Aggregate Bond. The diversified portfolio is comprised of 16% S&P 500, 8% Russell 1000 Value, 7% Russell Mid-Cap, 11% Russell 2000, 5% Russell 2000 Value, 7% Wilshire REIT, 7% MSCI EAFE, 7% S&P/Citigroup EMI EPAC, 7% MSCI EMF, 13% Lehman Aggregate Bond, and 12% Lehman TIPS.

premium to long-term inflation-protected bonds. If investors aren't satisfied with that risk premium (half of long-term norms) or if long-term real interest rates rise, valuations are likely to decline. Our best guess is that the S&P 500 will earn only a 2.5% real return (5% nominal) over the next decade as valuations return to more reasonable levels.

Within the domestic equity market, the picture doesn't improve much. In 2005, small-cap stocks, as measured by the Russell 2000, earned only 4.6%, underperforming the S&P 500 for the first time since 1998. Surprisingly, mid-cap stocks earned 12.6% in 2005. Value stocks modestly outperformed growth in large/mid (1.8%) and small (0.6%). The outperformance was driven by energy, utilities, and REITS. As we suggested in our Third Quarter Research Report (see "Domestic Equity Strategy: Have We Reached an Inflection Point?"), investors who tilted their portfolios to small-cap and value stocks should consider reducing or eliminating those bets. Both segments appear expensive relative to the broad market. A relatively attractive segment of the market is high quality large-cap growth stocks. These stocks are typically large (often multinational) companies with stable and growing earnings, high profit margins, strong balance sheets, and low debt. They have underperformed the market during the rebound of the last three years and, as a result, are priced more reasonably than the broad market.

The yield curve finished 2005 nearly flat. The Federal Reserve raised the overnight interest rate from 2.25% to 4.25% during the year, but longer-term rates barely budged. The yield on the 10-year Treasury bond increased from 4.22% to only 4.39%. The yield on the long bond actually declined from 4.83% to 4.54%. Fed Funds futures predict a quarter-point increase in the overnight lending rate at the Federal Reserve meeting on January 31 (Alan Greenspan's last meeting) is a near certainty. Futures further suggest that the Fed Funds rate will top out at 4.75% in 2006, with a 50% chance of that occurring at the March 28 meeting (Ben Bernanke's first meeting). Unless the 10-year yield spikes, it seems likely the yield curve will invert between 10-year and cash rates in 2006. Historically, this has been a predictor of recessions.

The Lehman Aggregate Bond index earned 2.4% in 2005. The flattening yield curve produced interesting returns across maturities, as shown in the chart below. Three-month T-Bills earned 3.0%. Treasury bonds with maturities between one and ten years underperformed T-Bills. However, bonds with maturities greater than ten years outperformed T-Bills. Investment managers who favored a "barbell" approach to duration management (combining very short- and very long-term bonds to target duration) had an advantage over those using "bullet" (holding bonds at the target duration) or "laddered" approaches (holding bonds across the maturity spectrum).



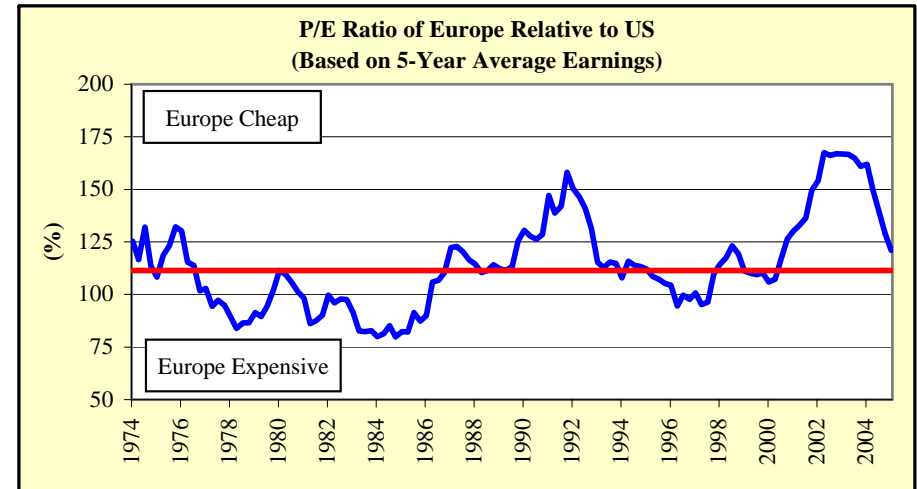
Credit spreads widened moderately in 2005. The option-adjusted spread on high yield bonds increased from 2.9% to 3.6%, leading to a disappointing return of 2.1% for the year. High yield bond spreads remain well below their long-term averages. We expect spreads to continue to increase, particularly if the US economy shows any signs of weakness. While domestic credit spreads widened, spreads on dollar-denominated emerging market debt contracted to record lows. Emerging market bonds now offer just a 1.9% premium to Treasuries, down from 3.1% at the beginning of the year. Historically, this spread has averaged 5.8%. The strength of emerging market economies justifies below-average spreads on their debt, but a premium of less than 2% is too low for our comfort.

In spite of a couple of high profile frauds and the shockwaves triggered by the GM/Ford downgrades, hedge funds had a good year. The HFR Fund of Hedge Funds index generated a return of 7.5%, bettering both domestic stocks and bonds. Hedge funds are attracting significant new assets, but we believe a prudently constructed hedge fund program will add value to an institutional portfolio.

International Equities Save the Day

While domestic equities generally delivered disappointing returns, international stocks performed extraordinarily well again in 2005. The MSCI EAFE index gained 13.5% during the year, the fourth consecutive year it outperformed the S&P 500. Most surprising was the ability of international developed markets to overcome the strengthening dollar. The dollar appreciated by 14% based on EAFE currency weightings. In local currencies, EAFE gained 29.0%. Japan was one of the top performing markets, earning 25.5% in dollars and 44.6% in yen, as further signs emerged that the country may be coming out of its long slump.

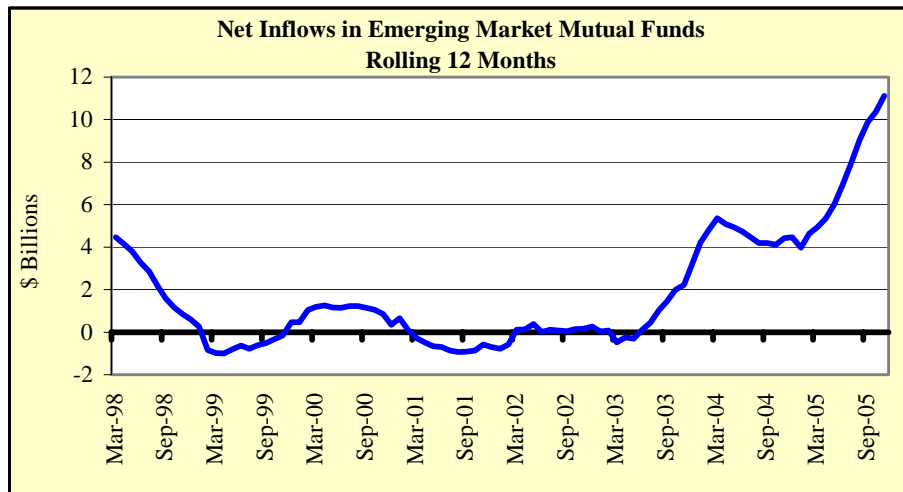
Emerging market equities also continued to rack up impressive gains, and the currencies of these countries mostly held their own against the dollar. The MSCI Emerging Markets index surged 34.0% in dollars (35.3% in local currencies). Over the last three years, international developed markets and emerging markets have earned 23.7% and 37.9%, respectively, versus a 14.4% return for the S&P 500. Despite the outperformance of the past few years, we still believe international markets offer better value than the US market, though the margin is not as pronounced as before.



Investors should be particularly cautious about emerging market equities. While we think it may be the best performing equity asset class over the next decade, price appreciation has increased downside risk. At the end of 2002 these markets were true bargains, trading at low P/Es on cyclically depressed earnings. As a result of the 162% cumulative gain over the past three years, they are now trading at mid-teen P/Es on cyclically high earnings and appear overvalued (albeit no more overvalued than many other asset classes). The most significant short-term concern we have is their ultimate reliance on US consumers for economic growth. China's export-led economy is heavily dependent on US demand, and other emerging market countries in Asia and Latin America are exporting raw materials and other supplies to China. A slowdown in US consumption as a result of weakness in the housing market or other factors would almost certainly spill over into emerging markets. In this event, we'd expect emerging market equities to fall harder than domestic equities.

Compounding these concerns is the apparent rise of hot money flows in recent years. Emerging market mutual funds have received \$11 billion in net inflows over the last year. Furthermore, we frequently hear of large public pension plans and

other institutions adding new emerging market allocations. As a result, many of the best-performing emerging market managers are no longer accepting new money. Four of the six emerging market equity managers we have recommended to clients over the past five years have closed, and the remaining two are likely to close in 2006. **We would not be surprised to see another strong year for emerging markets in 2006, but investors should be mindful of the risks and take advantage of recent gains to rebalance.**



Real Asset Investments Continued to Surge

Real asset investments were lucrative in 2005. High energy prices lifted natural resource investments, and the ongoing search for yield pushed commercial real estate prices higher. The DJ-AIG Commodity index climbed 21.4%. Energy was the primary driver, but industrial and precious metals were also strong contributors. Natural resource stocks, as measured by the energy-dominated Goldman Sachs Natural Resources index, surged 36.5%. Real estate investment trusts (REITS) posted a return of 13.8% in 2005, pushing their dividend yield down to 4.6%. Over the last ten years, REITS have earned 15.4%, annualized.

Gold attracted attention when it topped \$500 per ounce for the first time since 1981. For the year, gold climbed 25%, and it has more than doubled since 2001. Clients frequently ask us our opinion of gold as an investment. With our view that inflation remains a long-term risk and the dollar is likely to decline, gold has some allure. Still, we are unconvinced about the desirability of strategic gold allocations in institutional portfolios. The long-term expected return is too uncertain. Gold produces no income. Storage costs and insurance result in negative cash flow. So, the metal starts in the hole every year versus all income-producing assets. The

future return of gold is based solely on what others are willing to pay for it, and it is impossible to forecast with any confidence what that will be. The primary demand is for jewelry and as an alternative to paper money. It has few industrial uses. We believe there are better ways to hedge against inflation and a weaker dollar. Diversified commodity baskets, such as the previously mentioned DJ-AIG Commodity index (which has a 6% allocation to gold) and energy-related investments seem like better bets. They usually perform very well in inflationary environments, and they should provide competitive returns even if inflation remains benign.



Conclusion

2005 once again demonstrated the value of diversification. While domestic equities and bonds struggled, international equities and real asset-related investments posted strong returns. However, it's becoming more and more difficult to find attractive opportunities. Generating a 5% real return will be no simple task over the next decade. In this low return world, it is particularly important to diversify broadly and keep a sharp eye out for new opportunities.

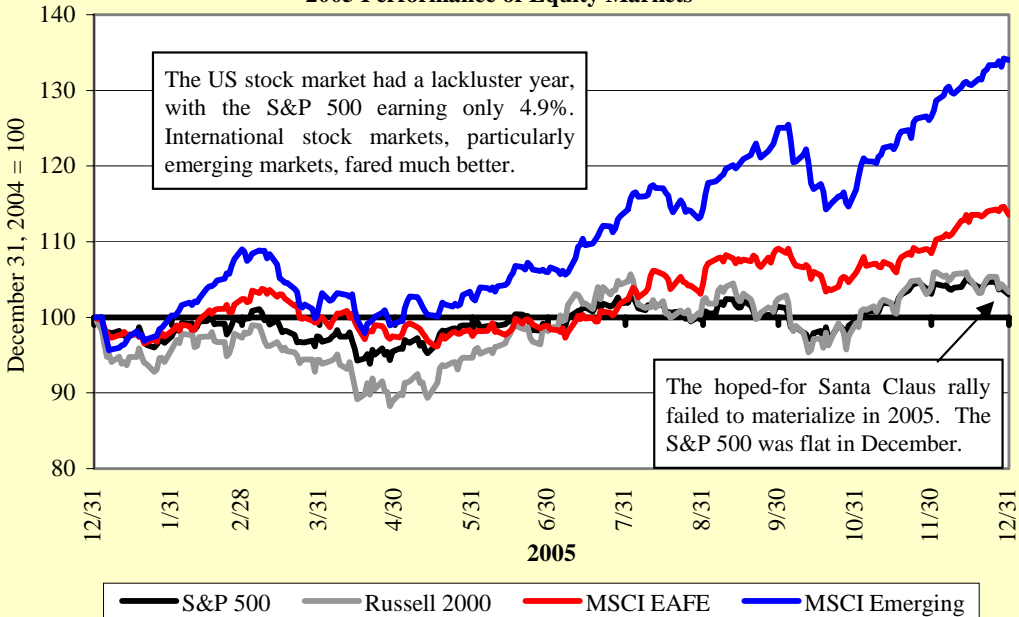
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Fourth Quarter Executive Summary

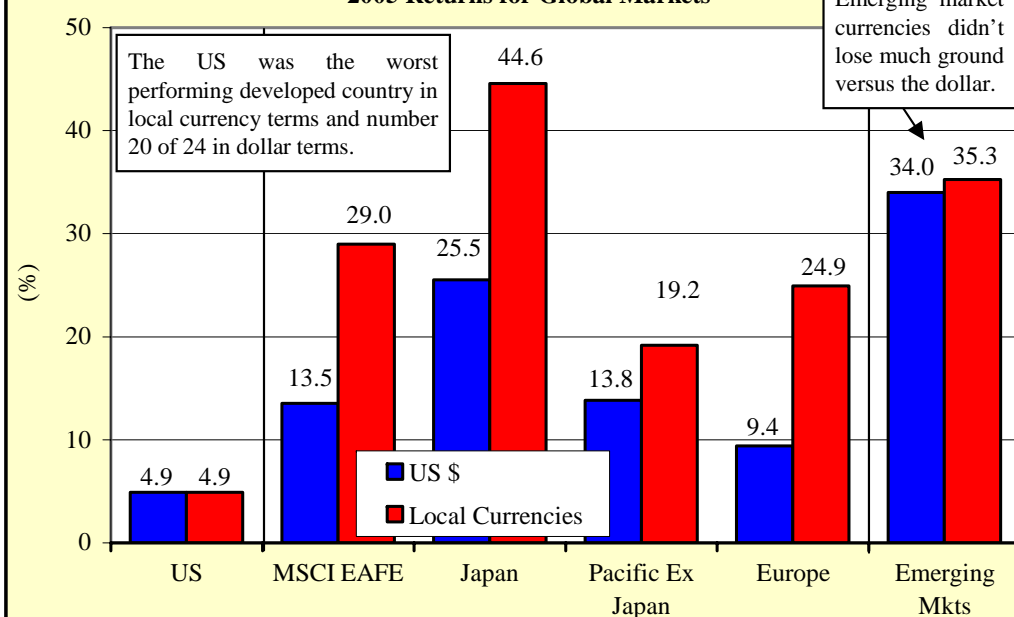
- The US stock market had a lackluster year, as the S&P 500 earned only 4.9%. This paled in comparison to returns available from international stock markets. The MSCI EAFE index of developed market stocks climbed 13.5% in spite of a strong rebound in the dollar. Emerging market stocks surged 34%. Real asset-oriented investments, including REITS, commodities, and natural resource stocks also performed very well.
- Economic growth for the year was about 3.6%, which was in line with expectations. Economists expect growth of 3.5% in 2006. We would not be surprised to see growth meet this rate in 2006. However, the risks appear weighted to the downside. They include rising energy prices, a slowdown in the housing market, and a hard landing for the dollar.
- The Fed raised the Fed Funds rate from 2.25% to 4.25% in 2005, but the yield on the 10-year bond increased only 17 bps to 4.39%. Fed Funds futures suggest that the overnight rate will top out at 4.75% in 2006. This could result in an inverted yield curve, which has been a fairly accurate predictor of recessions. This time might be different because foreign bond purchases could be distorting the yield curve.
- The dollar performed surprisingly well during 2005. It gained 14% versus the euro and 15% against the yen. However, the current account deficit worsened in 2005 as domestic savings rates continued to decline. A significant decline in the dollar still seems necessary to reduce the deficit. We expect the dollar to resume its descent in 2006. **We continue to recommend substantial exposure to foreign currencies and other assets, such as natural resources, that will benefit from a secular depreciation of the dollar.**
- Profits continued to grow for the S&P 500 in 2005. As a result, the trailing reported P/E ratio declined from 21 to 18. Our concern is this P/E ratio is based on record profit margins. Historically, profit margins have been highly cyclical and mean reverting. Based on our normalized earnings measure, the P/E ratio of the index is 24. **We predict the S&P 500's real return to be in the low single digits over the next decade as profit margins fall. As for 2006, we expect it will be another disappointing year for the market. Within the US equity allocation, we recommend reducing or eliminating tilts toward small-cap and value stocks, and overweighting high quality growth stocks.**
- **We expect the MSCI EAFE index to outperform the S&P 500 again in 2006 due to relatively attractive valuations, but we have less conviction in this call than in previous years because the valuation gap has contracted. Emerging market stocks are likely to perform well again in 2006, but they are particularly vulnerable to a slowdown in the global economy.**
- **The high returns experienced by real asset investments over the past few years are cause for caution, but we still consider them an important part of a well-diversified portfolio.**
- Hedge funds performed well in 2005. The HFR Fund of Hedge Funds index earned 7.5%, outperforming domestic stocks and bonds. **In a world of low returns for traditional asset classes, superior hedge fund managers have as much place in institutional portfolios as ever.**

US Stock Market Sputtered in 2005

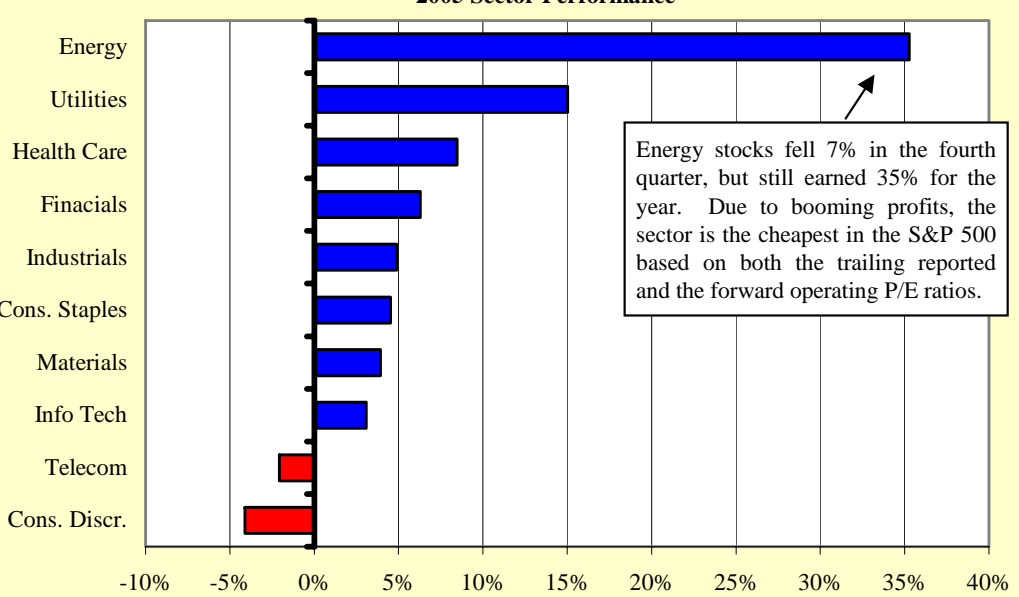
2005 Performance of Equity Markets



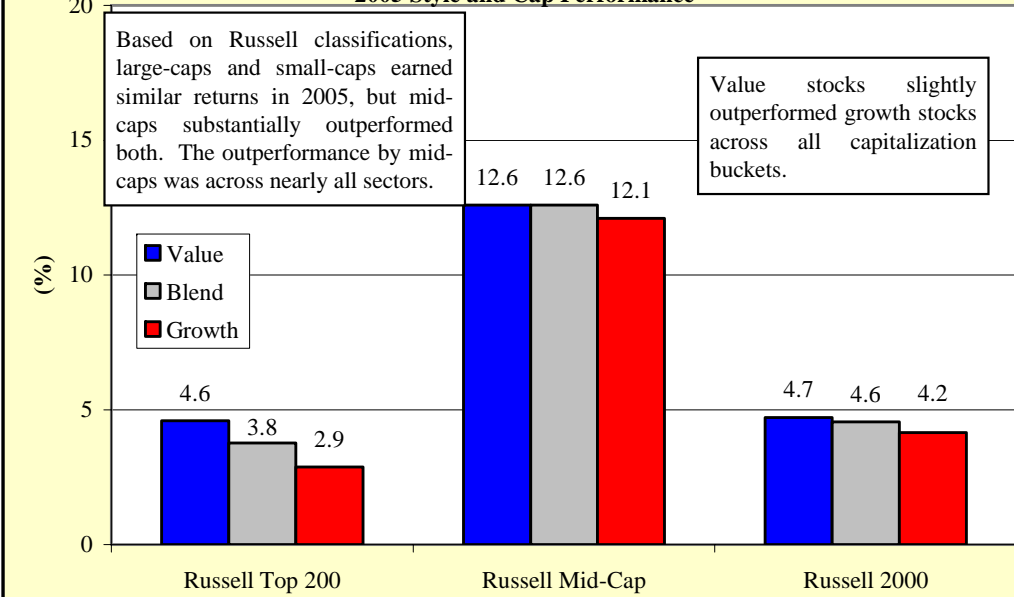
2005 Returns for Global Markets



2005 Sector Performance

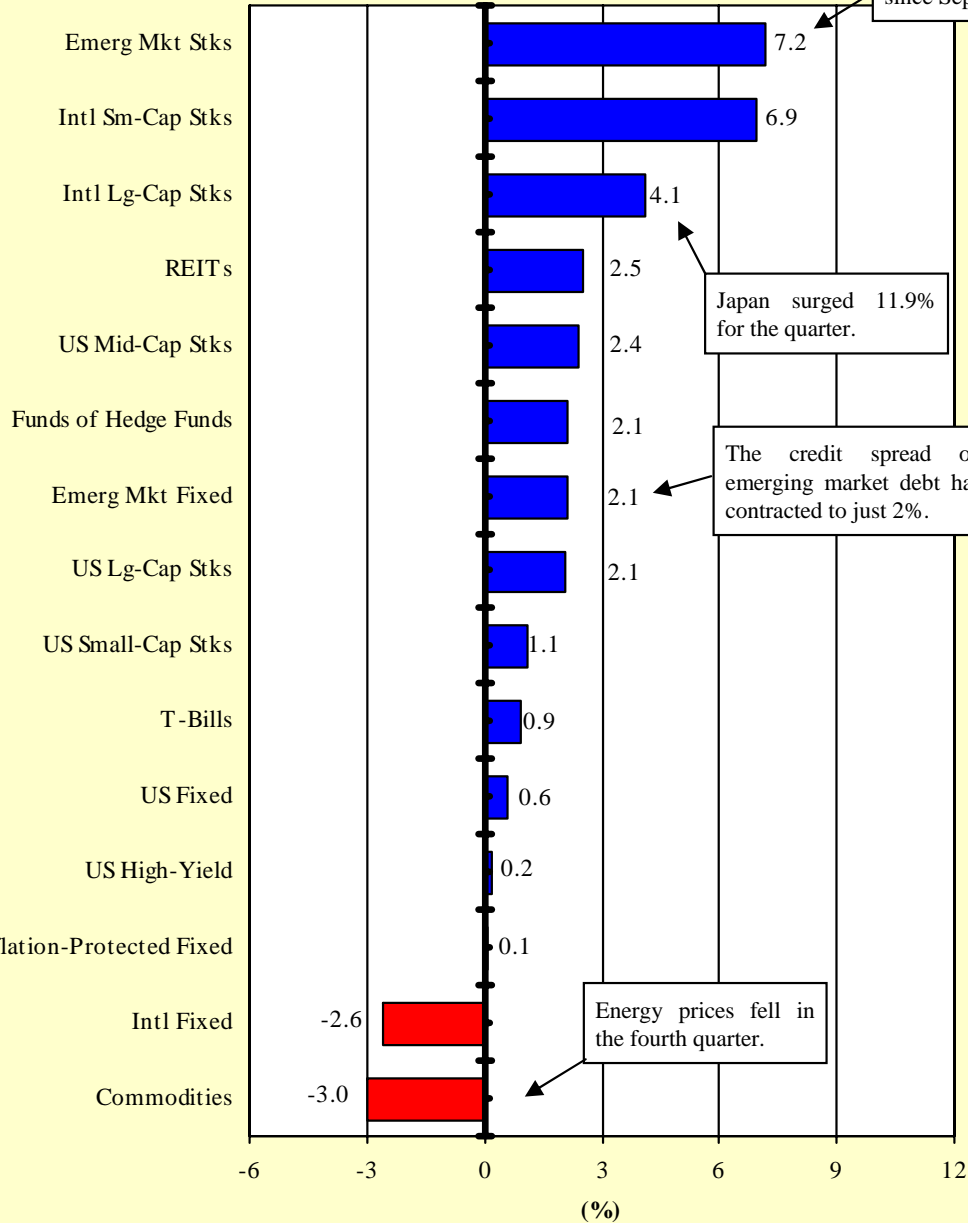


2005 Style and Cap Performance

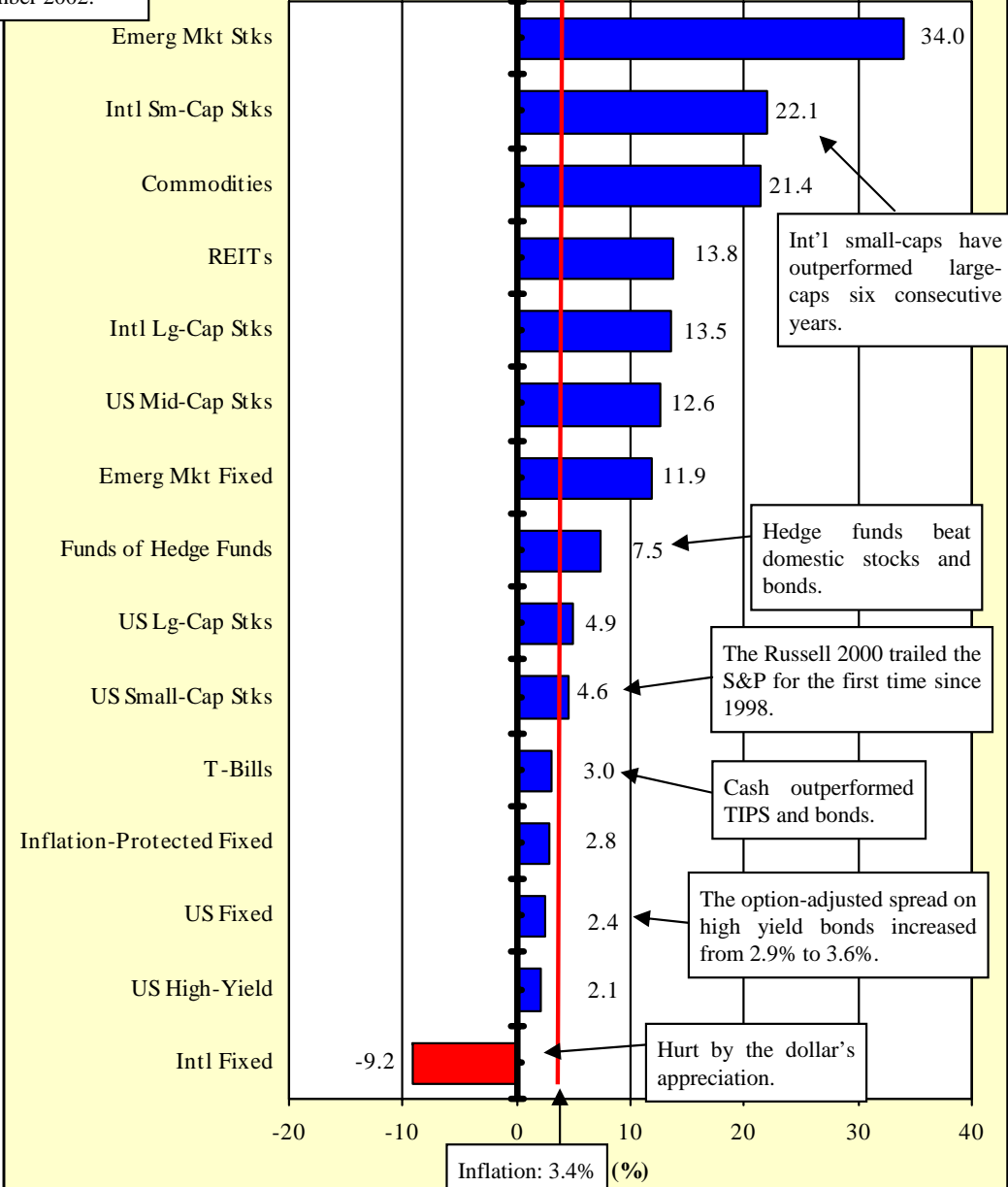


US Stock Market Sputtered in 2005 (cont.)

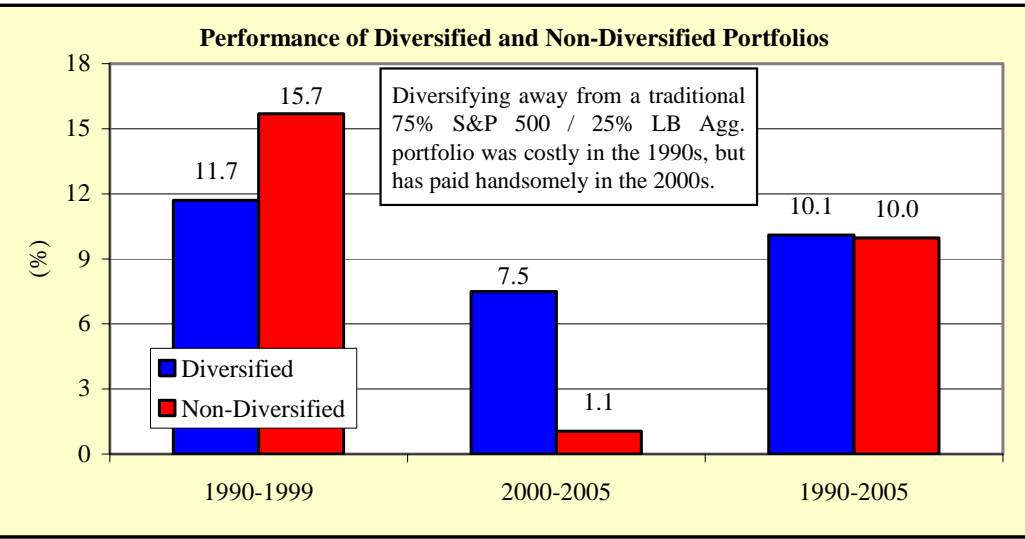
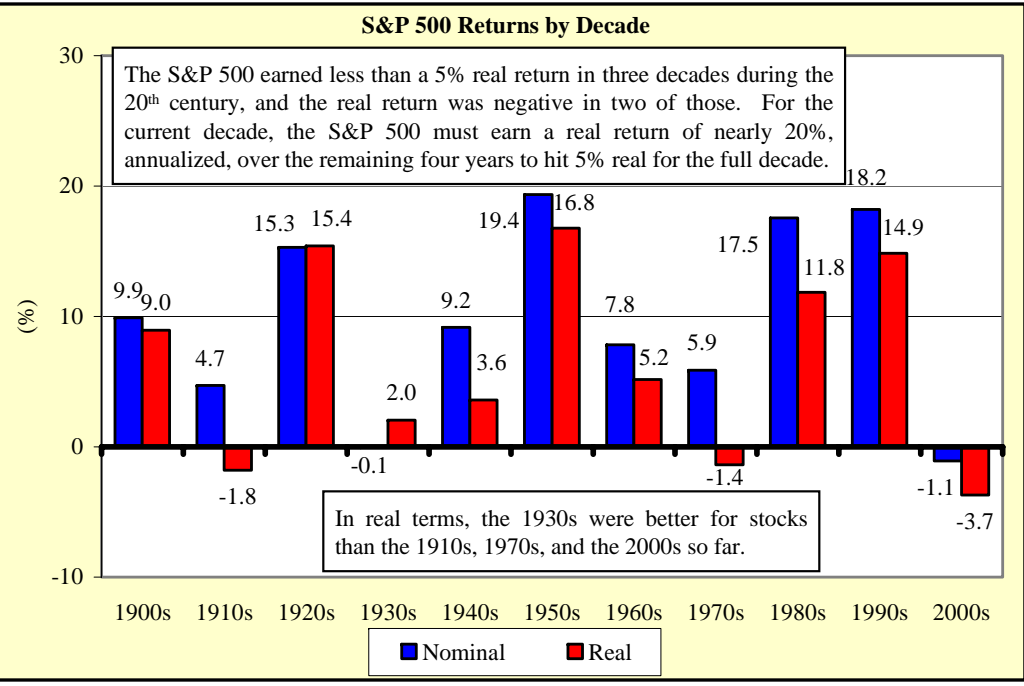
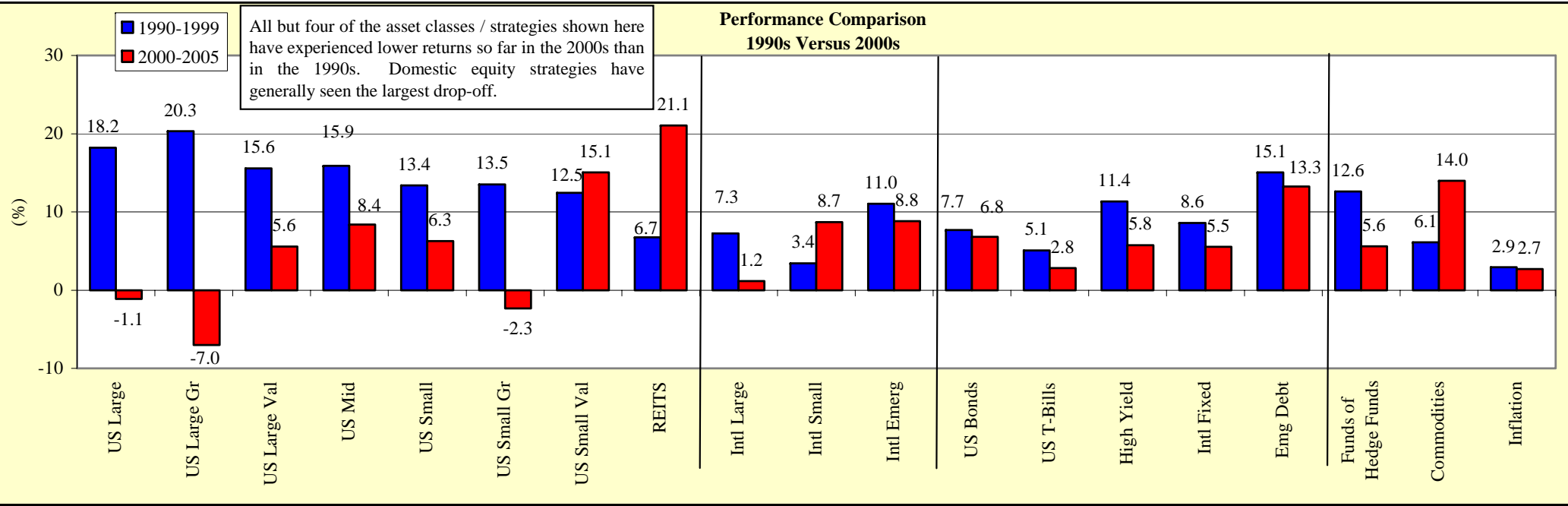
Fourth Quarter 2005 Performance



2005



A Comparison of the 1990s and 2000s

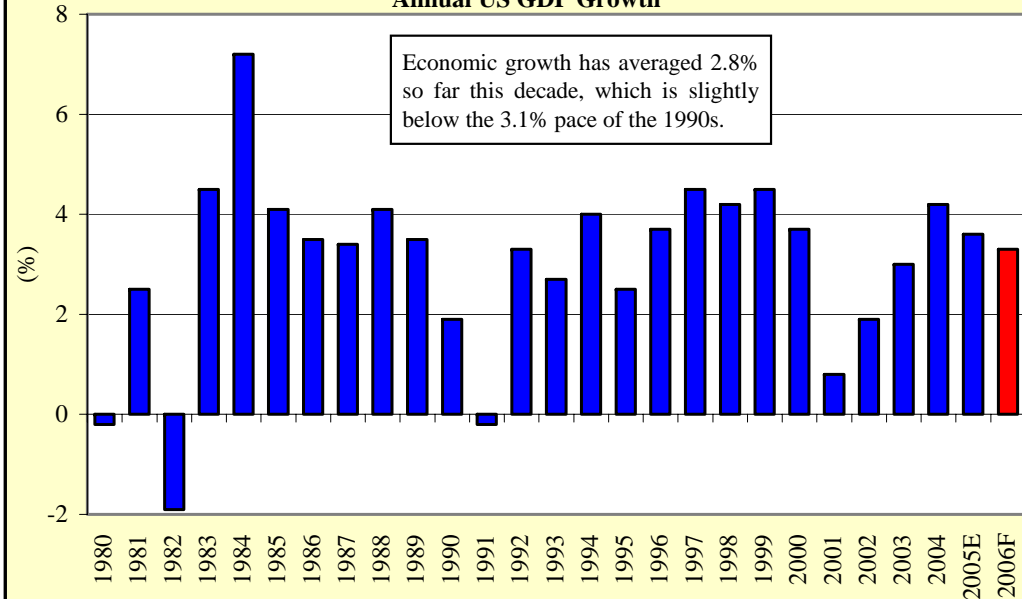


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What Will 2006 Bring for the Economy?

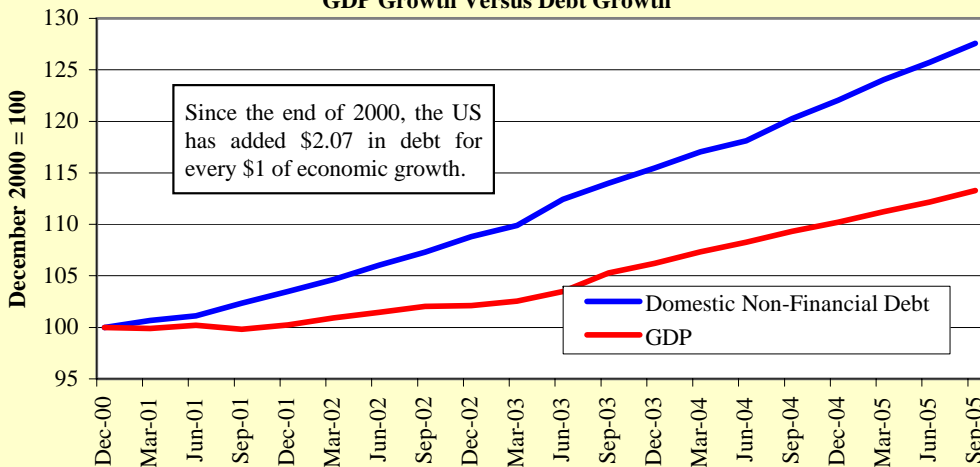
- The US economy was resilient in 2005 in the face of the hurricanes, rising interest rates, higher energy prices, and debt-laden households. Growth for the year was about 3.6%, which was in line with expectations from the beginning of the year. Economists polled by *The Economist* expect growth of 3.5% in 2006.
- The performance of the US economy over the last three years has been impressive given the challenges it has faced. We would not be surprised to see growth meet expectations again in 2006. However, the risks appear weighted to the downside.
 - ✓ **Energy prices** – The US and global economy has handled higher energy prices in stride, but the ability of the economy to bear higher energy costs is not unlimited. Perhaps the largest concern is a major supply shock, such as political upheaval in the Middle East or more natural disasters.
 - ✓ **Housing market** – Households are still cashing out home equity to support spending, but there are signs that the housing market is beginning to slow. Consumer spending represents almost 70% of the economy.
 - ✓ **Hard landing for the dollar** – If foreign central banks sharply reduce purchases of our bonds and private investors lose confidence in the dollar, interest rates may spike putting strains on the housing market.

Annual US GDP Growth



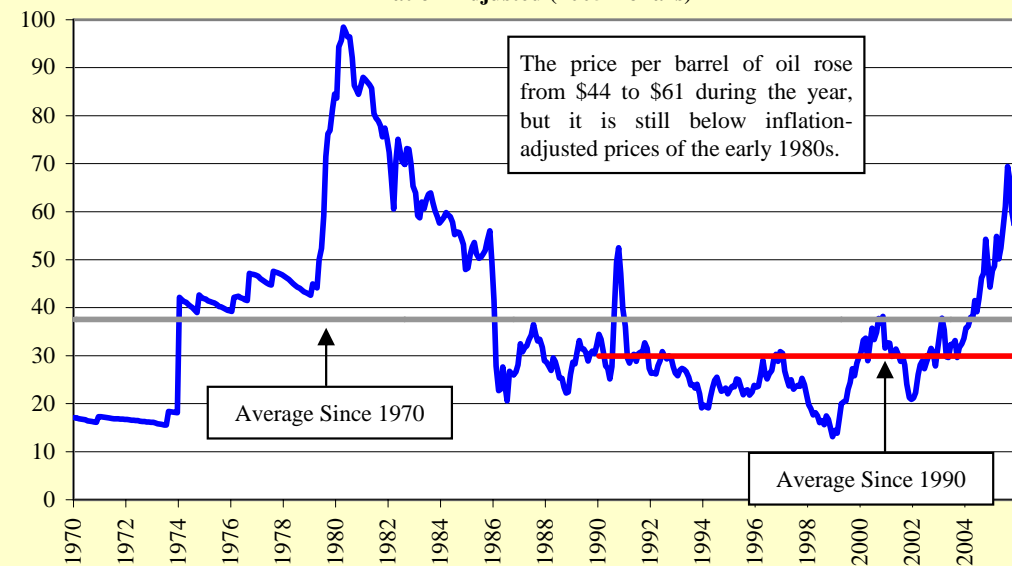
Source: Bureau of Economic Analysis

GDP Growth Versus Debt Growth



Source: Federal Reserve

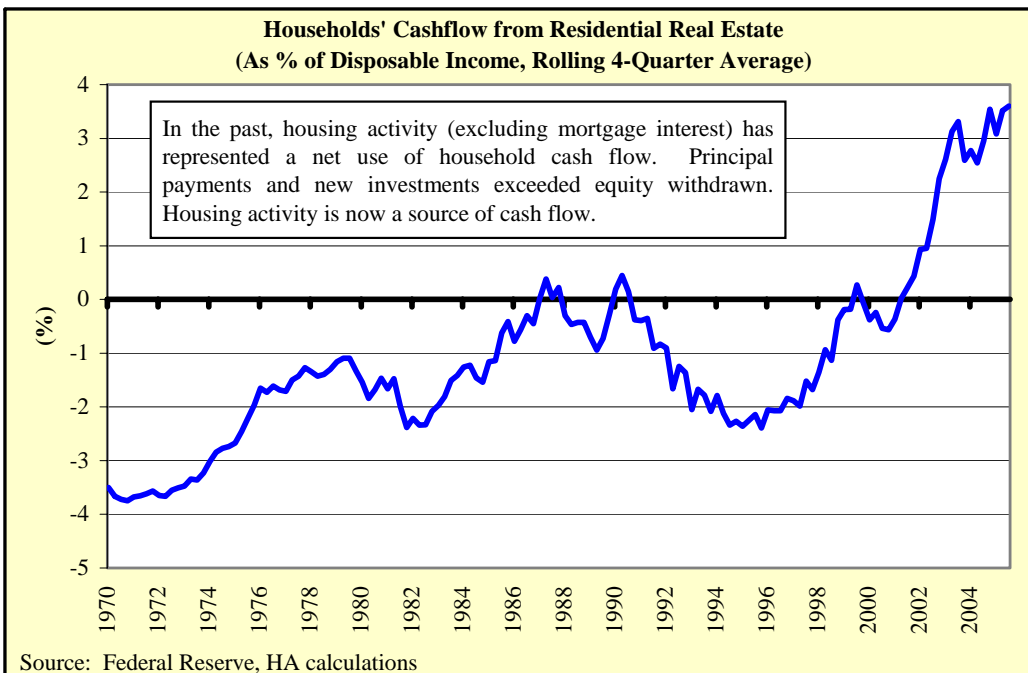
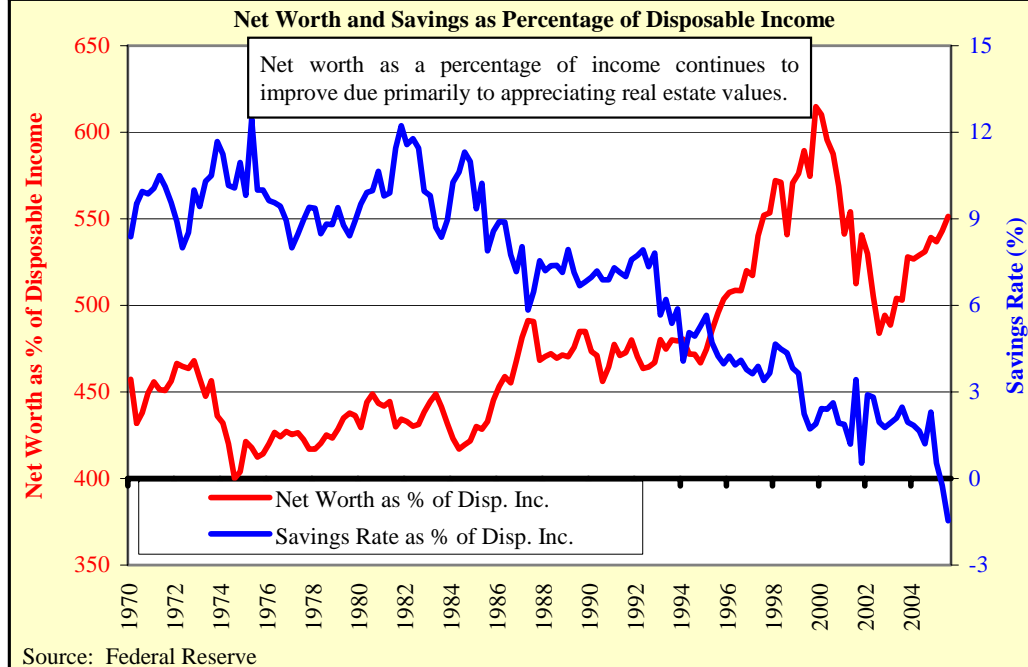
Price per Barrel of West Texas Intermediate Crude
Inflation-Adjusted (2005 Dollars)



Source: Federal Reserve, Bureau of Labor Statistics

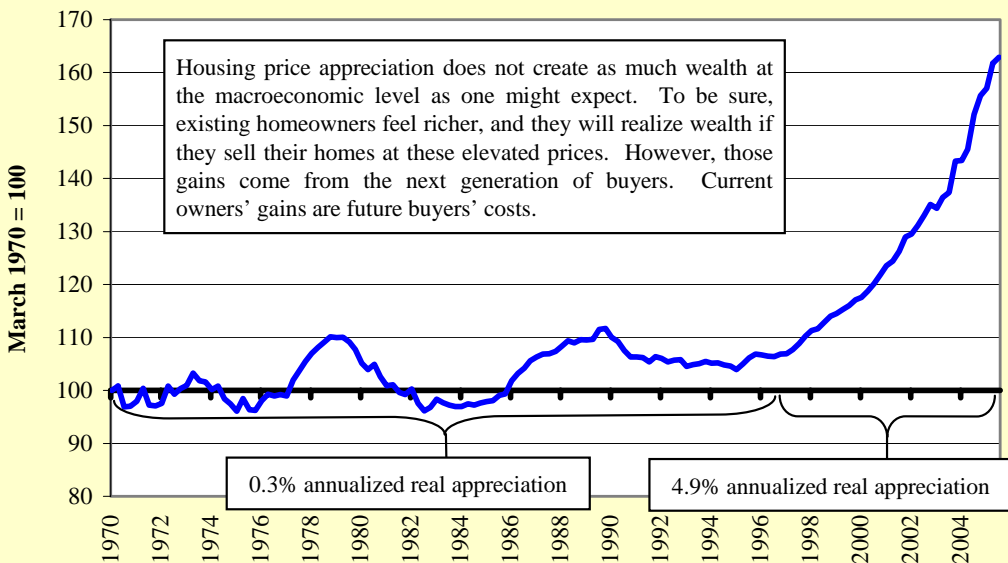
Hints of a Slowdown in the Housing Market

- Booming residential real estate prices have helped support consumer spending over the past few years in the face of sluggish wage and salary growth.
- Real estate was the source of roughly \$300 billion of cash flow for households over the last 12 months, or about 3.5% of disposable income. As a result of this excess spending, the personal savings rate was negative in 2005 for the first time since 1933.
- The latest data suggests that the end of the housing boom may be near:
 - ✓ Home affordability is at a 14-year low despite mortgage rates remaining fairly low.
 - ✓ The home ownership rate has fallen from its highs. This suggests first time buyers are being priced out of the market.
 - ✓ The number of months supply of existing homes on the market has reached a two-year high in November and the months supply of new homes reached a nine-year high.
- Housing activity appears to have finally peaked. However, absent a sharp increase in mortgage interest rates, significant price declines are not likely at the national level. What seems more likely is that we have a decade or so of stagnating prices, which will allow rents and income to catch up.
- This, of course, will present challenges to US households who have grown accustomed to cashing out appreciation to support spending. The savings rate is likely to drift higher over the next several years, which will dampen spending growth. Since personal consumption plus residential fixed investment represents nearly three-quarters of the economy, this will be a serious headwind to economic growth in the coming years.



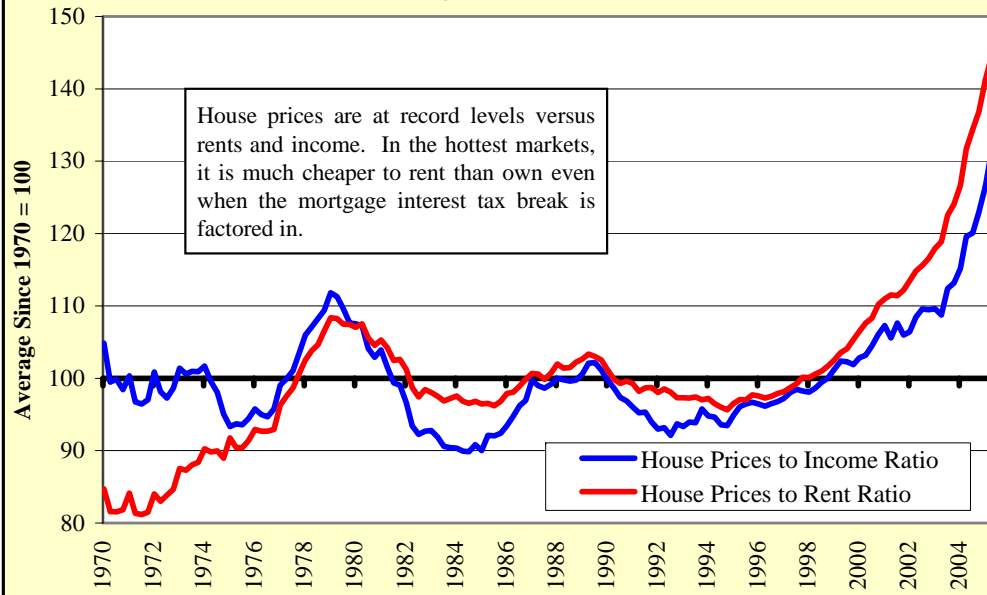
Hints of a Slowdown in the Housing Market (cont.)

Growth of Inflation-Adjusted Residential Real Estate Prices (Through September 2005)



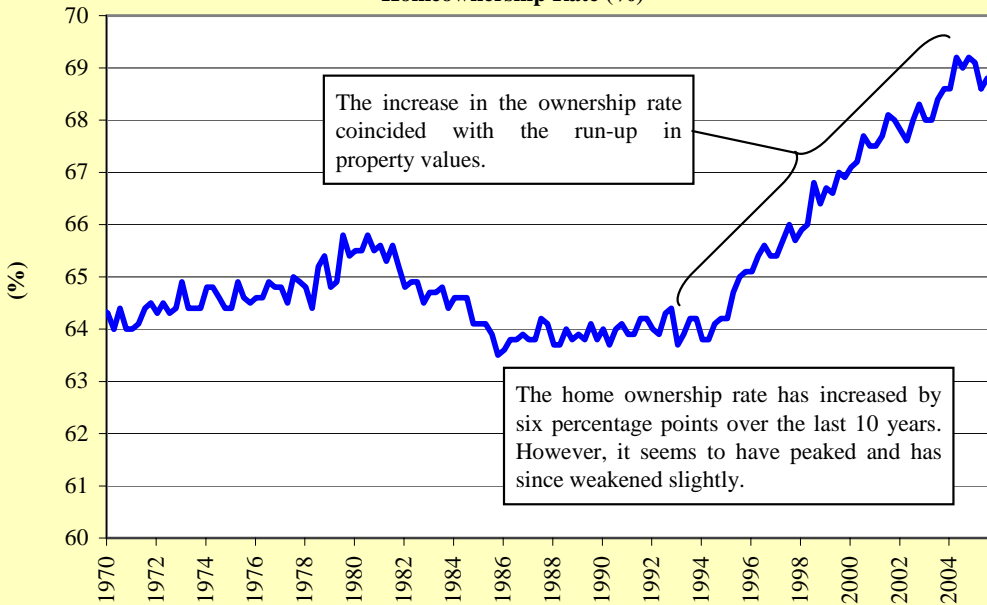
Source: Freddie Mac

Growth of Housing Prices Versus Rent and Income



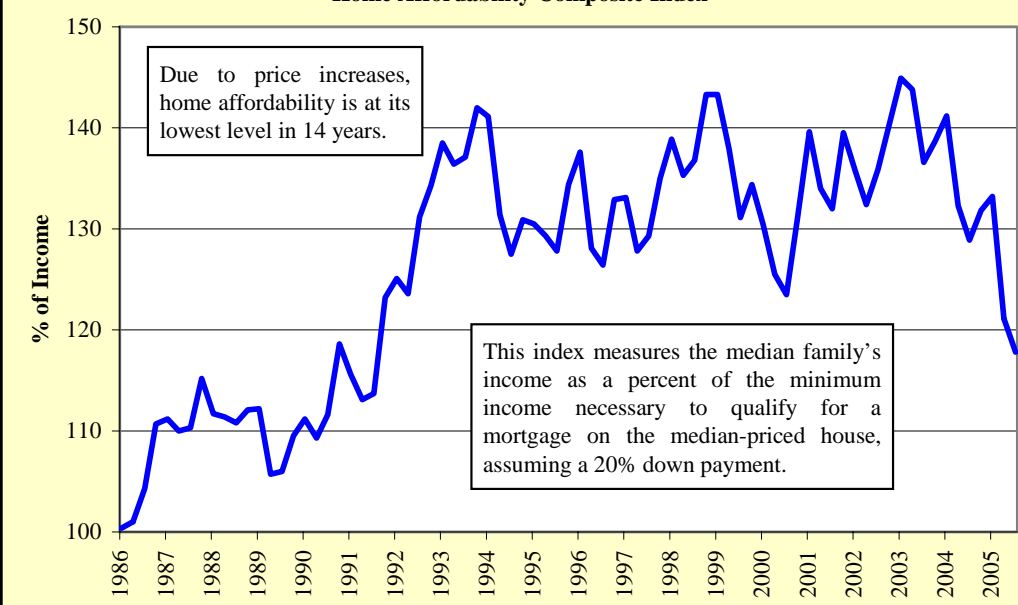
Source: Freddie Mac, Bureau of Labor Statistics, Federal Reserve, HA calculations

Homeownership Rate (%)



Source: Bloomberg

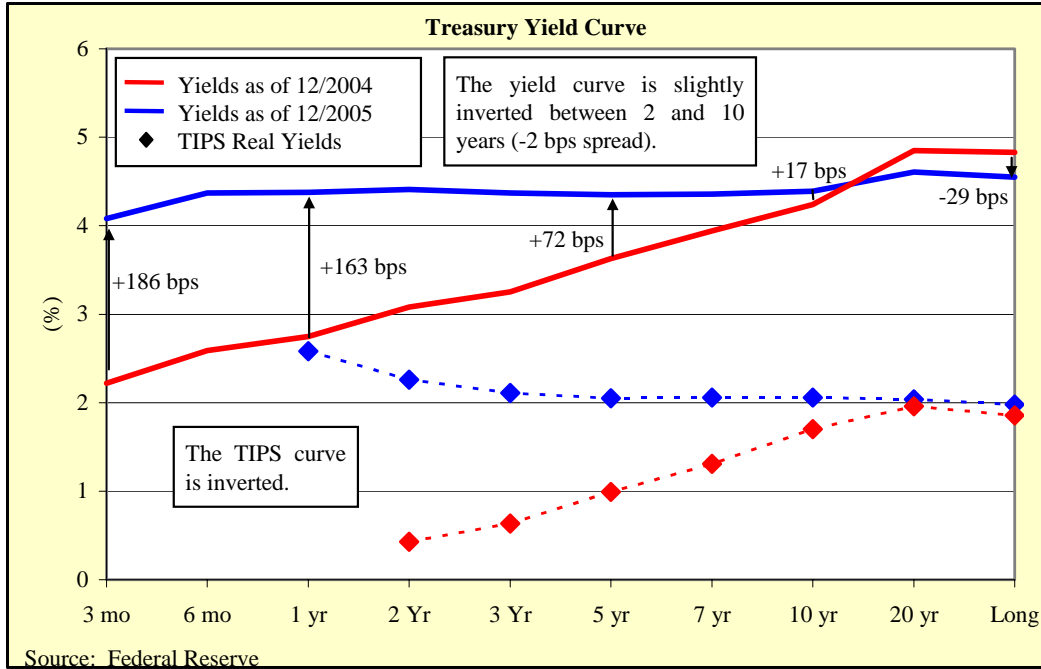
Home Affordability Composite Index



Source: National Association of Realtors

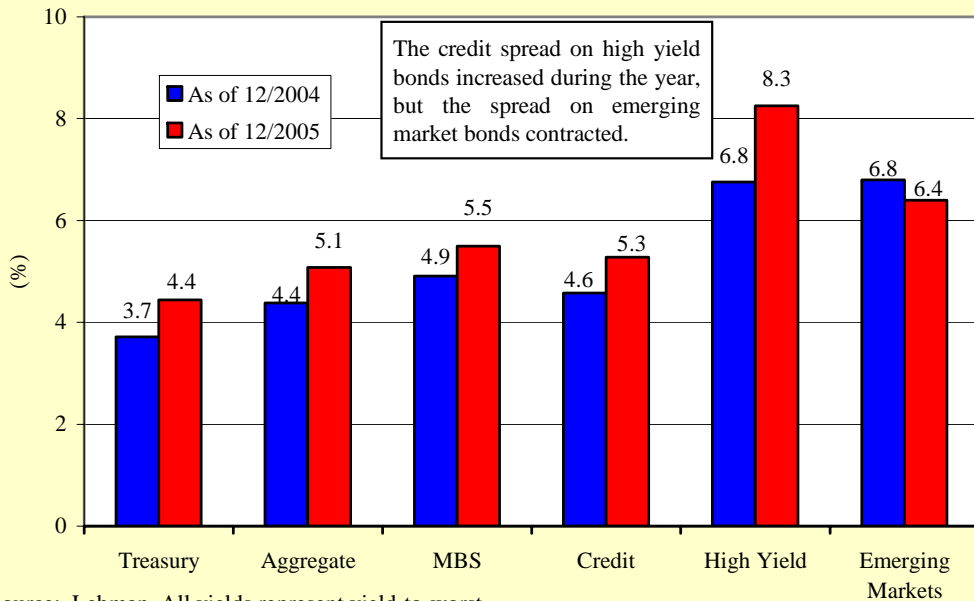
The Yield Curve Flattened in 2005

- The Fed raised the Fed Funds rate from 2.25% to 4.25% in 2005. As a result, short- and intermediate-term rates jumped during the year. However, the yield on the 10-year bond increased only 17 bps to 4.39%. The yield on the long bond *declined* by 29 bps to 4.54%. The yield curve is virtually flat between 1 and 10 years.
- Fed Funds futures suggest the end of this tightening cycle is near. A quarter-point increase appears to be a near certainty at Alan Greenspan's last meeting on January 31. There is roughly a 50% chance that a second quarter-point increase to 4.75% will occur at Ben Bernanke's first meeting on March 28.
- Futures suggest that the Fed Funds rate will top out at 4.75% in 2006. This would be the lowest Fed Funds rate at the end of a major tightening cycle since 1959. Unless the current 10-year Treasury yield rises, it will result in an inverted yield curve.



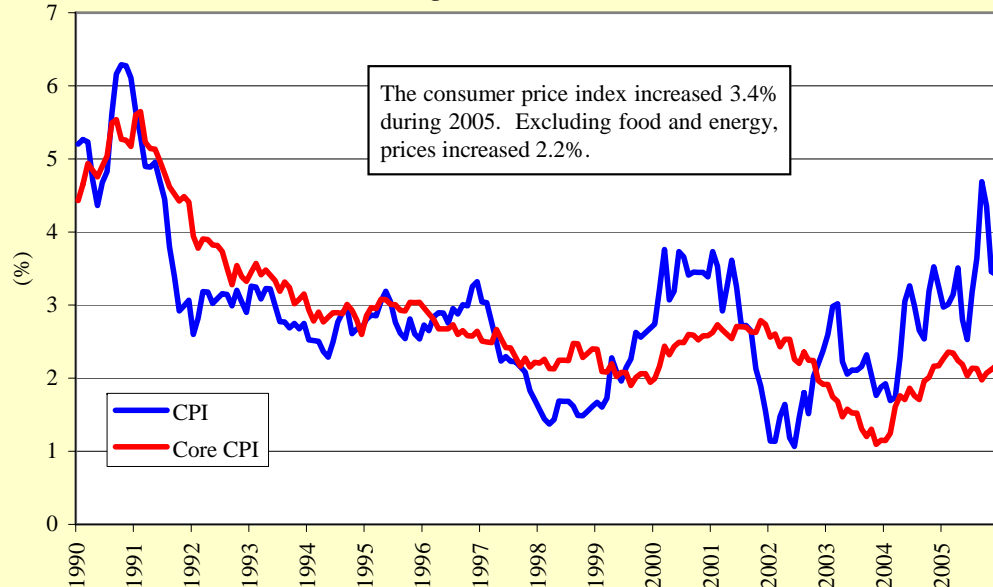
Source: Federal Reserve

Yields on Lehman Bond Indices



Source: Lehman. All yields represent yield-to-worst.

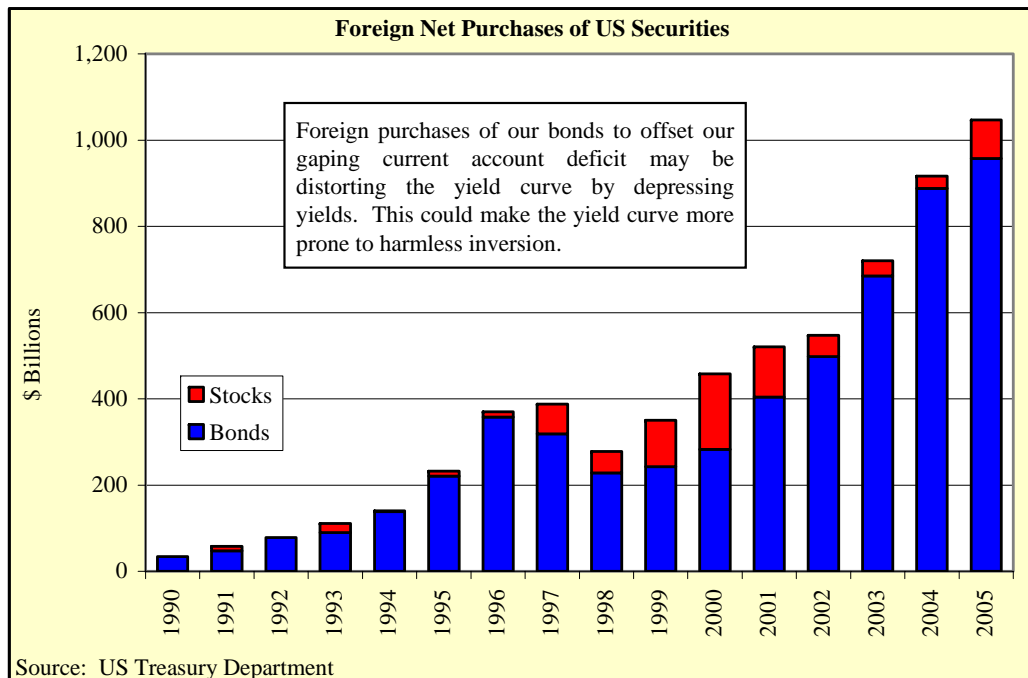
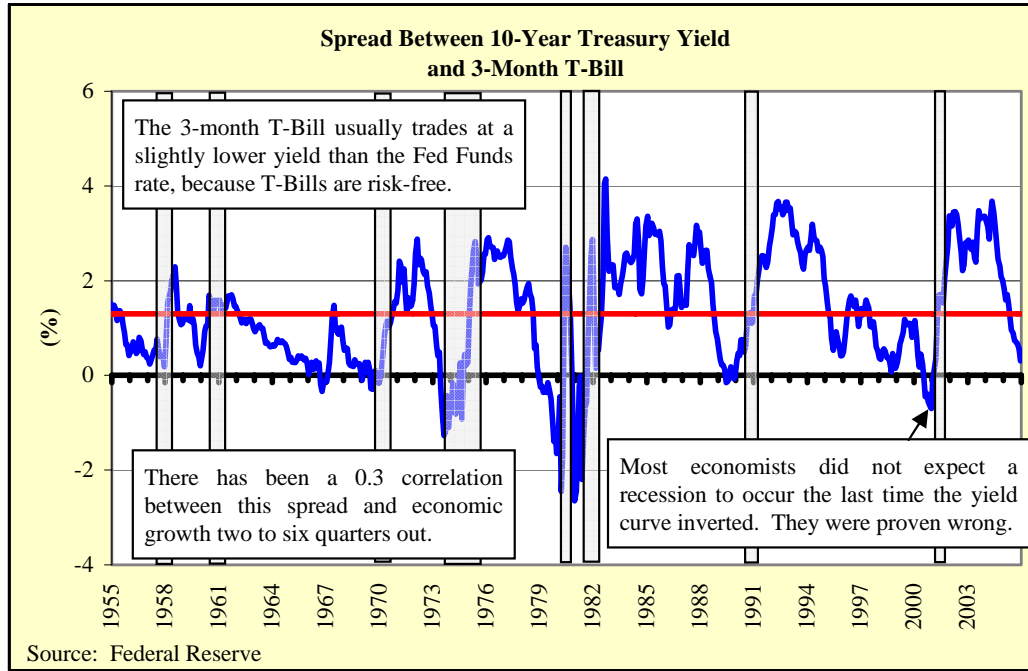
Rolling 12-Month Inflation



Source: Federal Reserve

Does an Inverted Yield Curve Signal a Recession?

- Historically, the yield curve has been a fairly accurate predictor of recessions. An inverted yield curve suggests that short-term rates will be cut significantly. When short-term rates are cut to this magnitude, it is usually in response to a weak economy, as in 2001.
- The determination of whether the yield curve is inverted depends upon maturity pairs used. The yield curve is currently slightly inverted between 2 and 10 years (negative 2 bp spread), but it remains upwardly sloping between 3 months and 10-years at a 31 bp spread. Academic research has suggested that the 10-year / 3-month spread is the most reliable indicator. Since 1970, all six instances when the spread between these maturities turned negative, a recession followed shortly thereafter. (There was a false positive in 1967.)
- The Fed is expected to lift overnight lending rates by another 50 bps in 2006. If this happens and 10-year yields stay about the same, the 10-year / 3-month spread will turn negative. Does this suggest a recession is impending?
 - ✓ One reason why it could be different this time is that maturity premiums might be structurally lower. The “normal” maturity premium could have been pushed down because of lower perceived inflation risk and foreign central bank buying. (See our Second Quarter Research Report.) This is indicated by the low level of interest rates on 10-year Treasuries.
 - ✓ If the normal maturity premium is high, an inverted yield curve means the Fed is expected to cut rates significantly, which is an indicator of a very weak economy. If the normal maturity premium is low, expectations for Fed easing do not have to be as high to cause inversion. The market may simply be forecasting a typical easing cycle.
 - ✓ If Treasury bond investors expect a recession, high-yield bond investors aren't listening. While credit spreads on high yield bonds increased in 2005, they remain low by historical standards.
- The yield curve suggests that the Fed will begin a new easing cycle in late 2006 or 2007. While this does not necessarily mean a recession is coming, it does hint that the economy will begin to slow in 2006.



US Dollar: A Cyclical Spike Within a Secular Decline

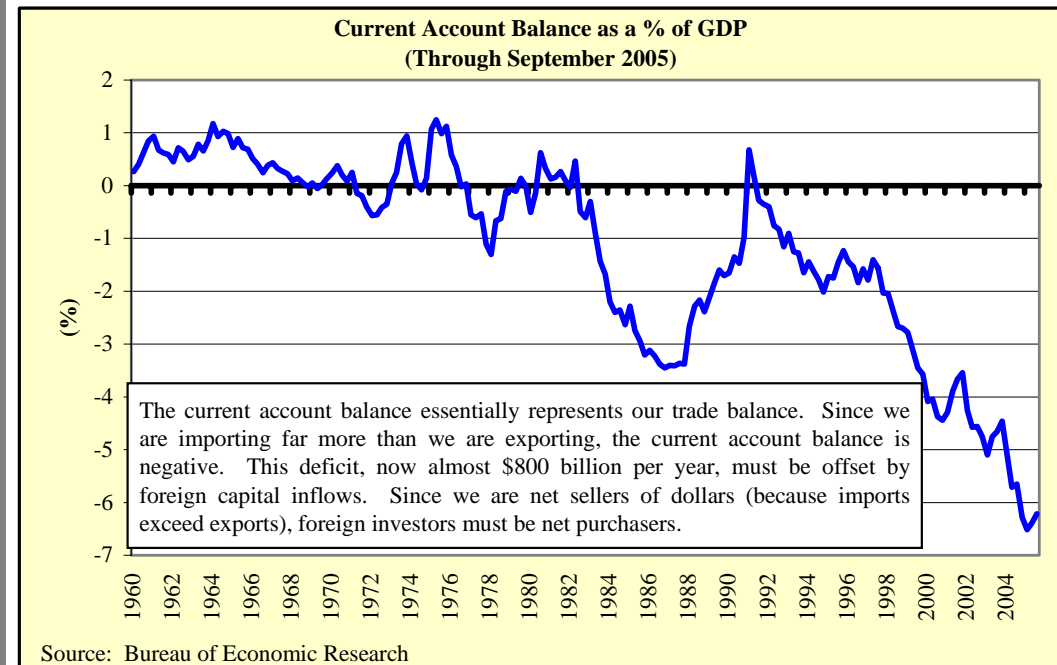
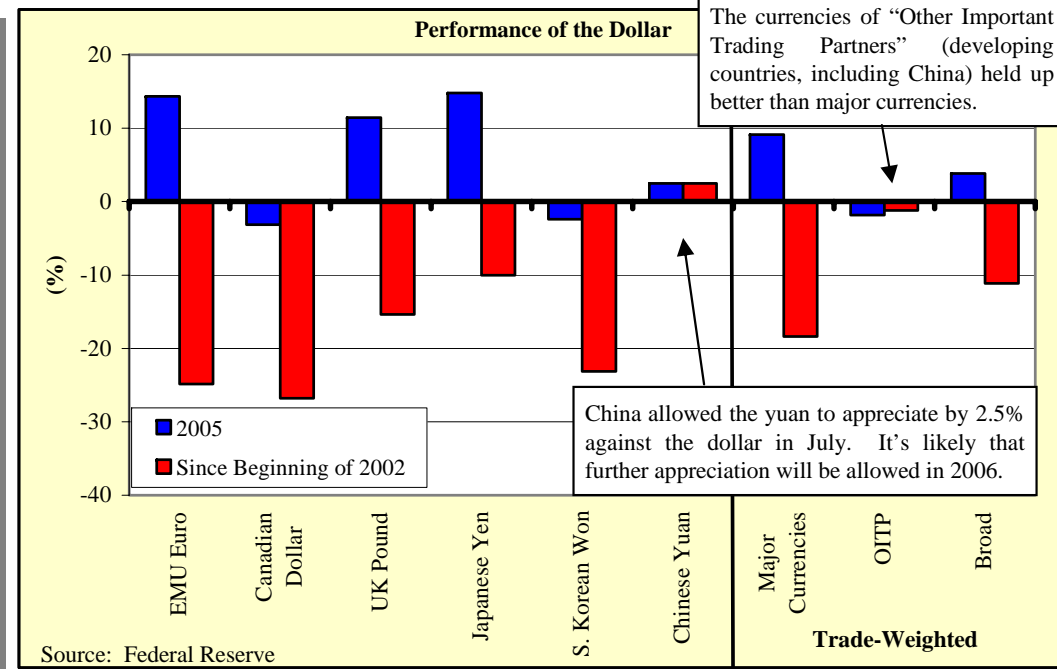
➤ The dollar performed surprisingly well during 2005. It gained 14% versus the euro and 15% against the yen. The broad trade-weighted dollar increased 3.8%. Some of the possible explanations for the dollar's performance include the following:

- ✓ **Interest rates** – The Fed lifted short-term interest rates more than expected. At the beginning of the year, markets anticipated a 3.5% year-end Fed Funds rate versus the 4.25% actual. The Fed seems close to the end of this tightening phase, while the European Central Bank has just started to raise interest rates. Japan may even end its zero interest rate policy soon. Dollar support from interest rates will recede in 2006.
- ✓ **Petrodollars** – Higher energy prices have resulted in booming trade surpluses for oil exporting countries. Part of these surpluses have been recycled back into dollars. With energy prices still high, this may continue to be a source of inflows in 2006.
- ✓ **Repatriation of foreign profits** – Congress passed a law allowing companies to repatriate profits from foreign subsidiaries at a temporarily lower tax rate. Much of these foreign profits were already being held as or hedged against dollars. Still, it may have produced over \$100 billion of dollar inflows. This tax holiday has now expired.

➤ The current account deficit worsened in 2005 as domestic savings rates continued to decline. For 2005, the deficit exceeded 6%, which was a new record. It is likely to approach 7% in 2006. At a 7% deficit, we must borrow more than \$880 billion in net foreign capital every year. Eventually it has to decline to more sustainable levels, or the debt service burden will be too much for the economy to bear.

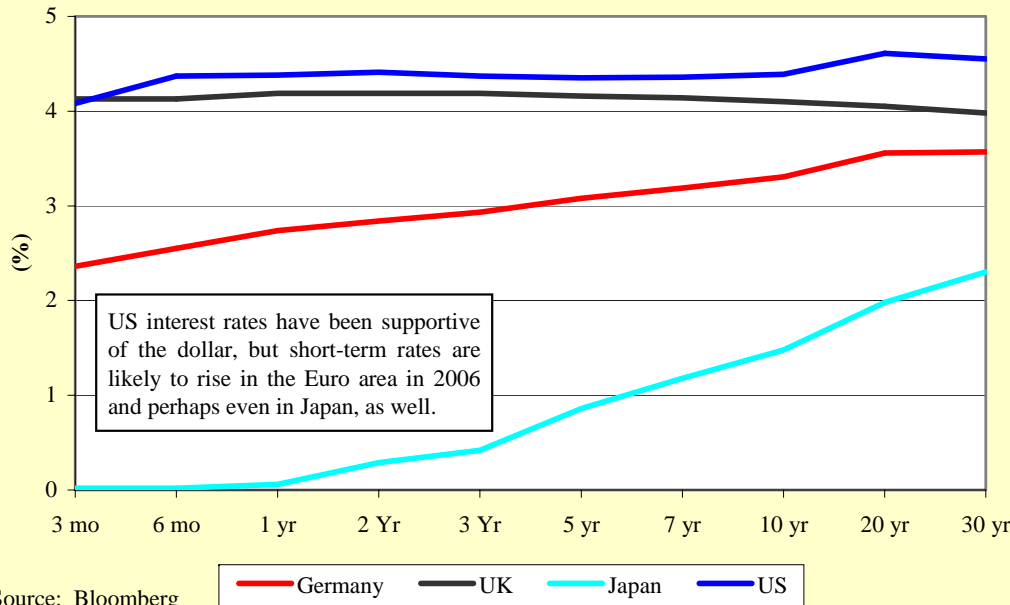
➤ A significant decline in the dollar still seems necessary to reduce the deficit. We expect the dollar to resume its descent in 2006. The dollar needs to depreciate most against Asian currencies, particularly the Chinese yuan. However, with Asian central banks continuing to limit their currencies' appreciation against the dollar, we expect the dollar to also rise against freely-floating European currencies.

➤ **We continue to recommend substantial exposure to foreign currencies and other assets, such as natural resources, that will benefit from a secular depreciation of the dollar.**

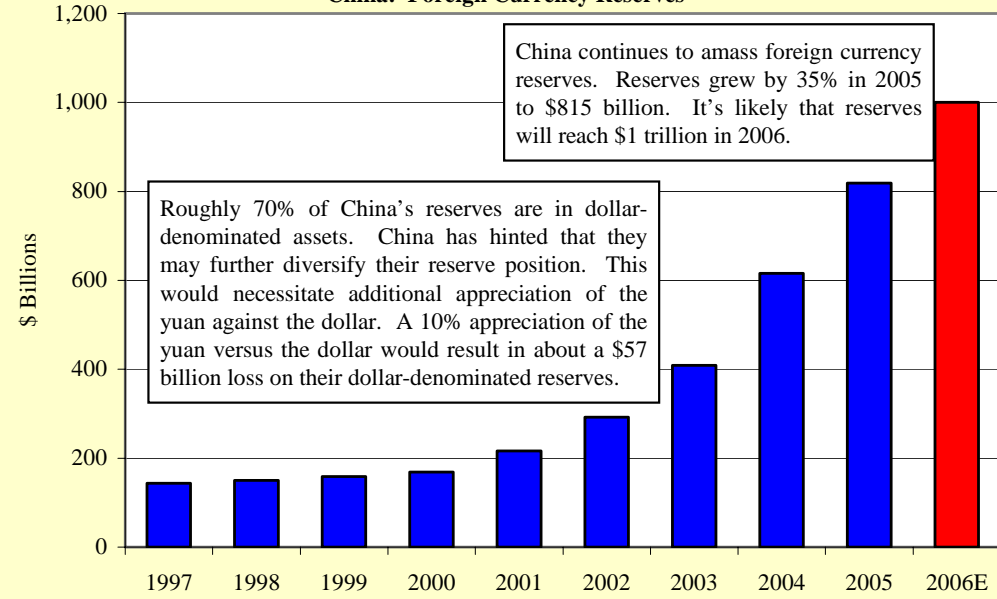


US Dollar: A Cyclical Spike within a Secular Decline (cont.)

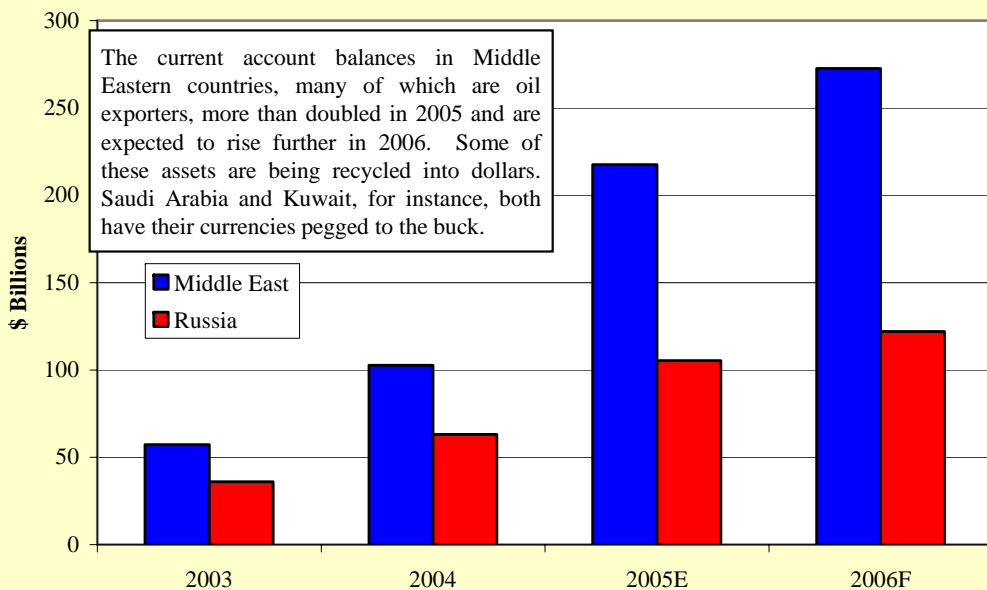
Global Interest Rates



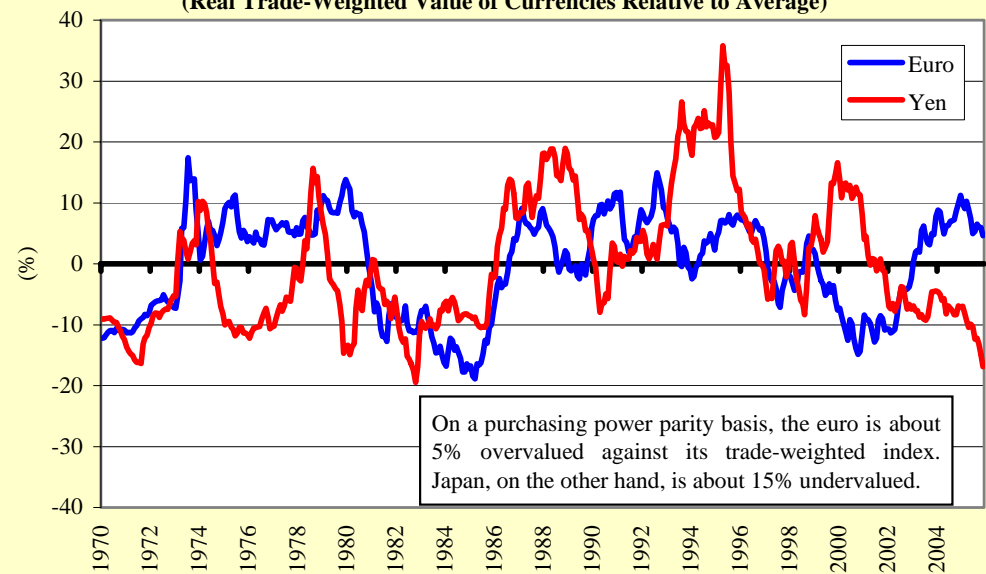
China: Foreign Currency Reserves



Current Account Balances of Oil Exporters



Relative Purchasing Power Parity (Real Trade-Weighted Value of Currencies Relative to Average)



Source: Bloomberg

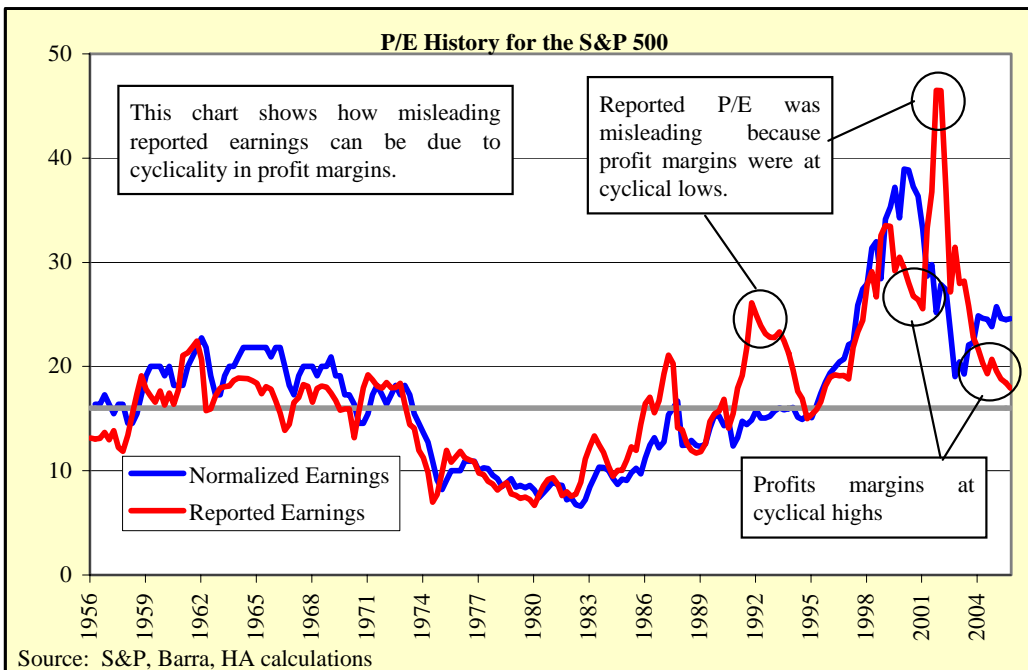
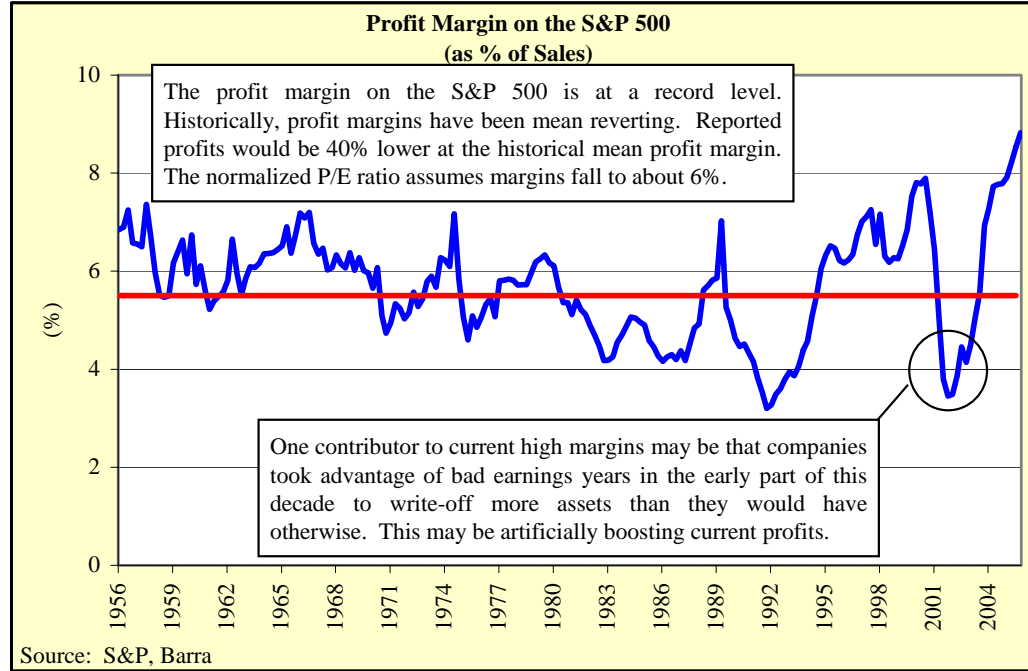
Source: IMF

Source: IMF

Source: JP Morgan, HA calculations

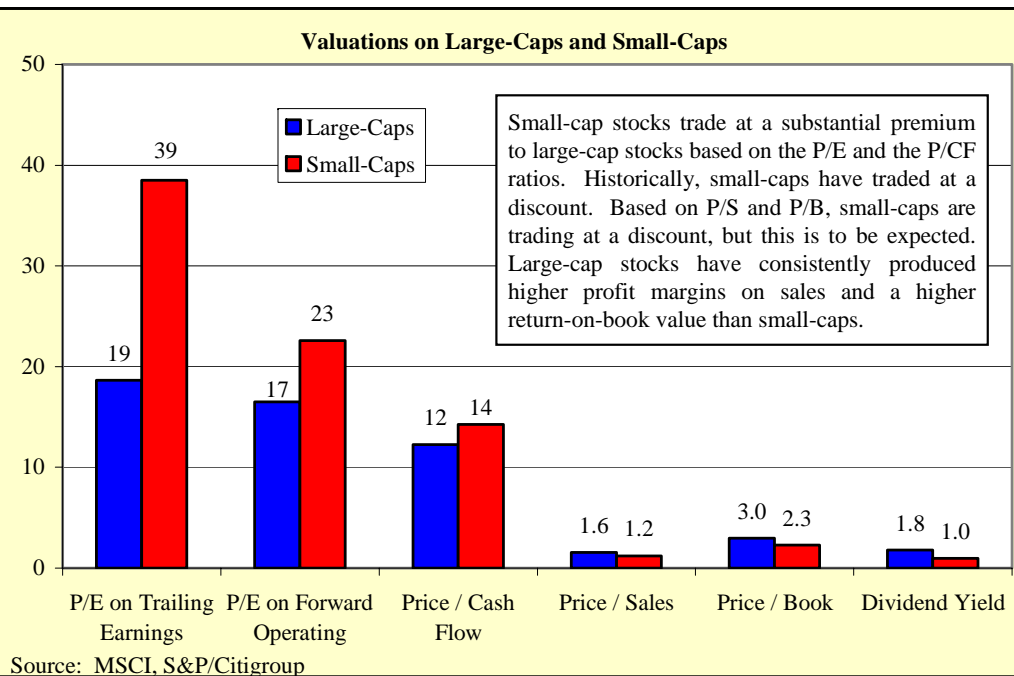
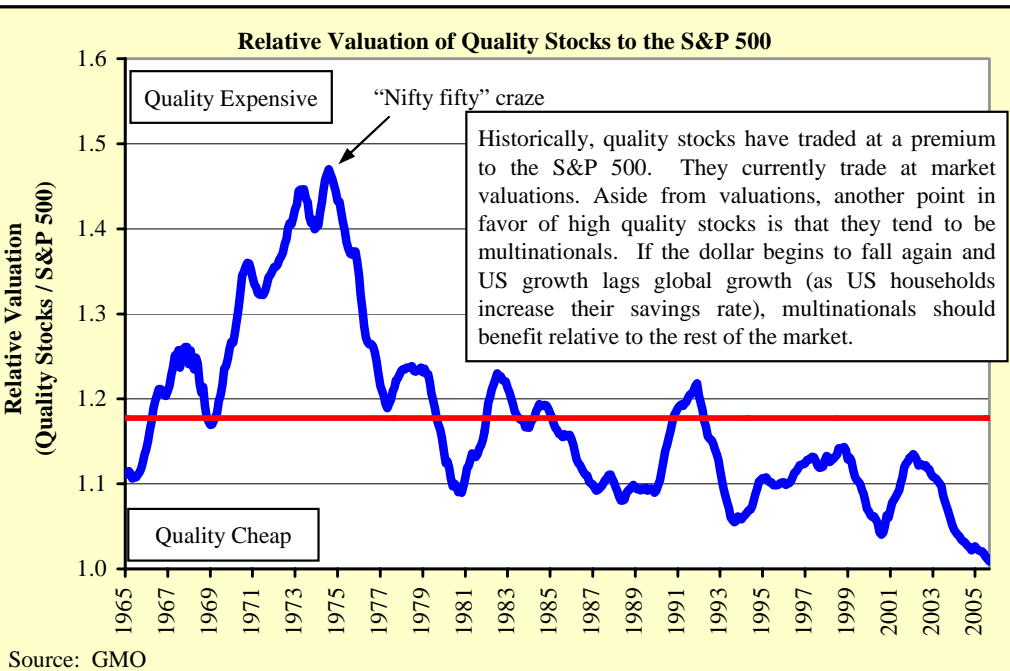
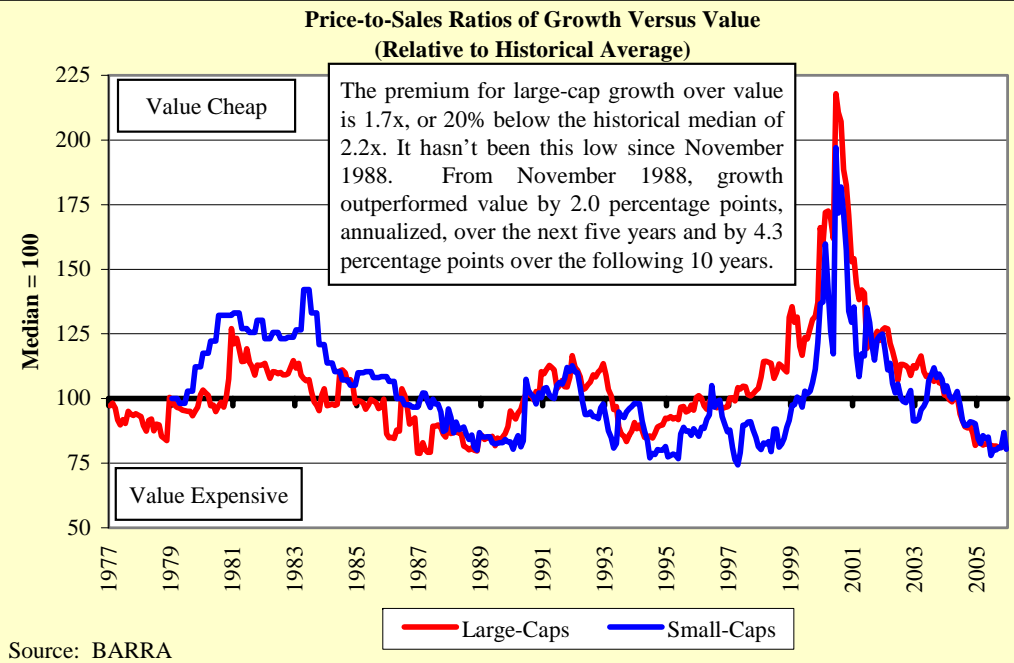
US Equities: Can Companies Maintain High Margins?

- Profits continued to grow for the S&P 500 in 2005. Reported earnings for the index increased about 20%, compared to the index's total return of 4.9%. As a result, the P/E ratio on trailing reported profits declined from 21 to 18. A P/E ratio of 18, while above the historical average of 16, is reasonable. It suggests a long-term real return of about 5.5%, which is a 3.5 percentage point premium to long-term TIPS.
- Our concern is that the reported P/E ratio of 18 is based on record profit margins. The profit margin on the S&P 500 is 8.8% of sales, which is 60% above average. Historically, profit margins have been highly cyclical and mean reverting. Based on our normalized earnings measure, which assumes profit margins decline (although not all the way back to the historical average), the P/E ratio on the index is 24. A P/E ratio of 24 suggests a long-term real return of only 4.2% (assuming valuations hold).
- Could we have reached a permanently higher plateau for profit margins?
 - ✓ One argument for this is that the cheap source of labor in China and other emerging markets, coupled with information technology, will keep a lid on wages in the US, allowing a greater share of productivity gains to go to shareholders rather than workers. Economic data shows that wage growth has, in fact, been depressed in recent years.
 - ✓ Nevertheless, we live in a capitalistic society. Fat profit margins attract competition. Eventually productivity gains tend to get passed along to consumers through lower prices because of competition. The profit margin for the S&P 500 is likely to fall over the coming years, which will lead to stagnating or even falling profits.
- We predict the S&P 500's real return to be in the low single digits over the next decade as profit margins fall. **As for 2006, we expect it will be another disappointing year for the market.** The pace of earnings growth seems likely to decline, and the second year of Presidential terms has historically been relatively poor for the market.



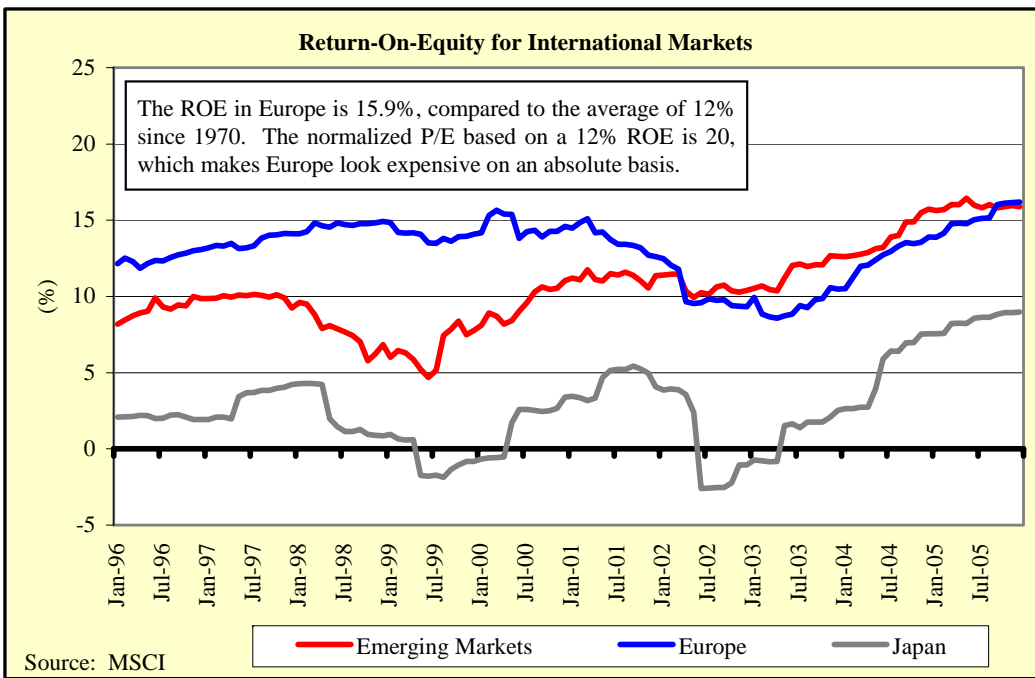
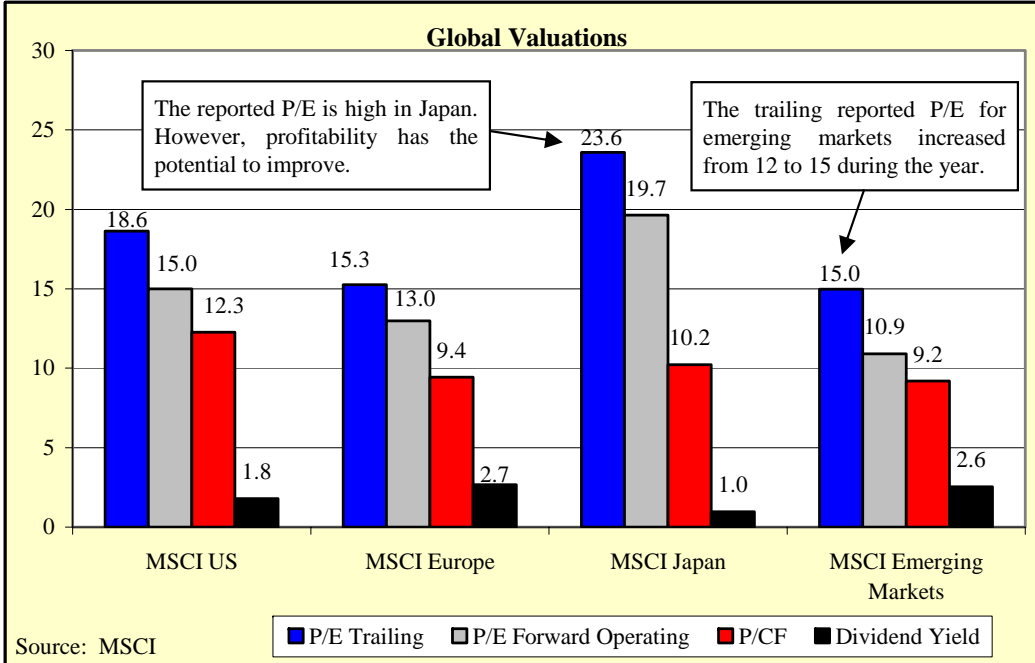
Large-Cap Quality Growth is Best Bet within the Market

- Within the domestic equity market, small-cap stocks underperformed the S&P 500 in 2005, and value tilts added only modest value versus the broad market. Both small-cap and value stocks appear expensive relative to the broad market. For investors who have tilted their portfolios to these areas, we recommend reducing or eliminating those bets.
- One can argue that now is a good time to overweight large-cap growth stocks. However, we shy away from this bet because it means overweighting some of the most speculative stocks in the market, where investor enthusiasm often results in overpaying for growth.
- Instead, we recommend overweighting high quality growth stocks, which are cheap relative to the broad market. These companies are typically large (often multinational) companies with stable, growing earnings. They tend to have sustainably high profit margins, strong balance sheets, and low debt.



Will International Equities Continue to Outperform?

- The MSCI EAFE index of international developed market stocks outperformed the S&P 500 for the fourth consecutive year in 2005, despite a sharp rise in the dollar. Emerging market equities continued to post gaudy gains. Since September 2002, emerging market equities have surged a cumulative 188%.
- Corporate earnings in international developed markets are booming. Reported earnings for Europe increased nearly 30% over the last year and Japanese profits surged almost 40%. In comparison, profits in the US rose about 20%. Profit growth in emerging markets, however, slowed to less than 10%. Based on the trailing reported P/E ratio, much of the appreciation in emerging markets in 2005 came from multiple expansion.
- As in the US, earnings in international markets are being supported by rising profitability. Profitability in Europe and emerging markets appears unsustainably high, but profitability in Japan could still move higher if the economic recovery continues.
- European stocks appear overvalued using normalized profits. They are still a better buy than domestic stocks, but the valuation gap is narrowing. Japanese stocks are a wild card, but upside potential remains if the economic recovery continues and profitability improves. We would not be surprised to see the dollar give back some of its gains from 2005 against the euro and yen, which would lead to a positive currency effect. **We expect the MSCI EAFE index to outperform the S&P 500 again in 2006, but we have less conviction in this call than in previous years.**
- The valuations of emerging market stocks appear stretched. They still offer the highest long-term return potential among equity asset classes, but the downside risk is increasing. **If the global economy meets growth expectations, emerging market stocks are likely to perform well again in 2006. However, they are particularly vulnerable to a slowdown in the global economy.**



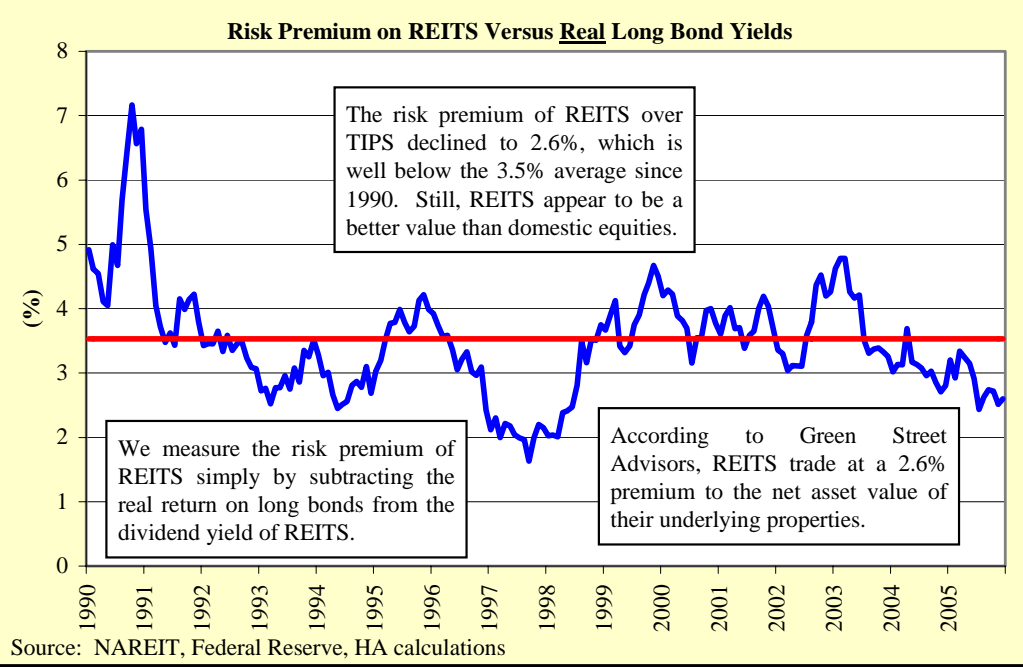
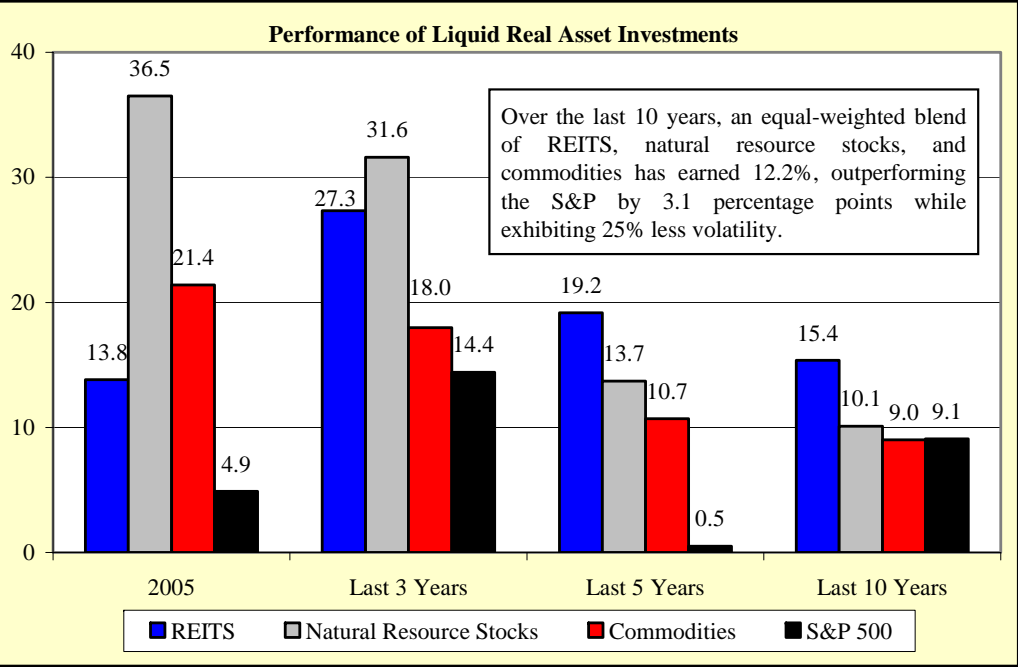
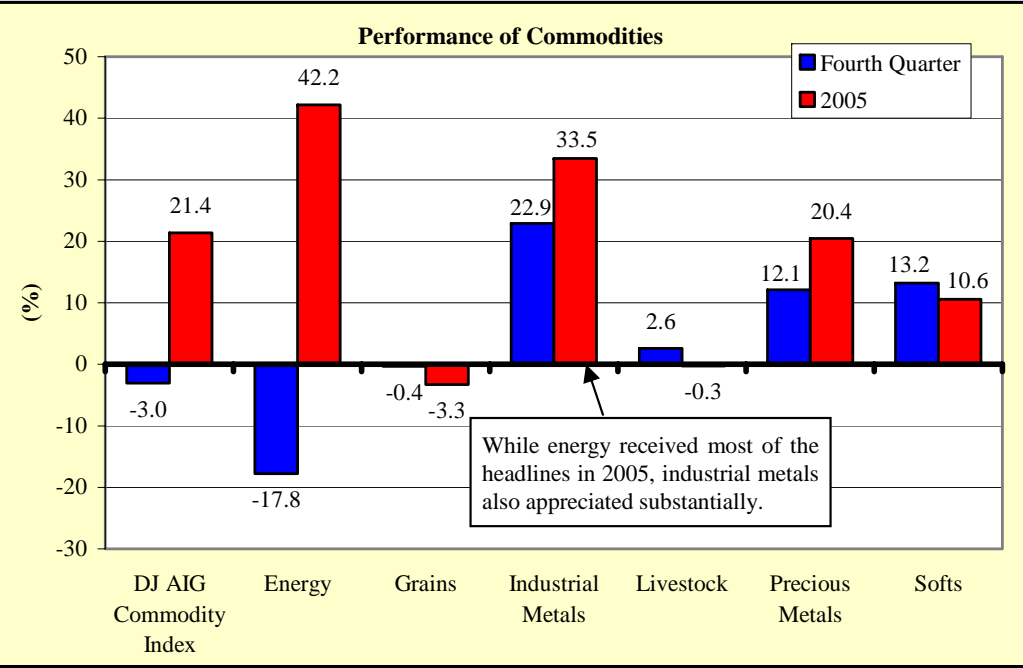
Real Asset Investments Have Another Banner Year

➤ Real asset-oriented investments posted strong returns again in 2005.

✓ Real estate investors continued to push capitalization rates down. For the twelve months ended September, the NCREIF Real Estate index (private, unleveraged real estate) earned 19%. REITS earned 13.8% in 2005.

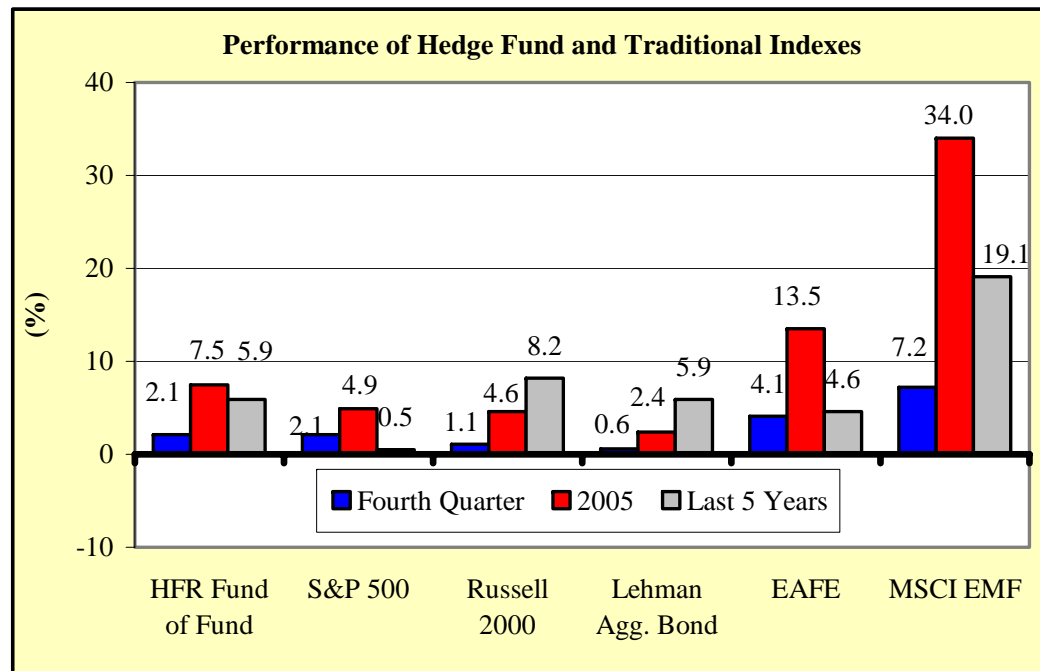
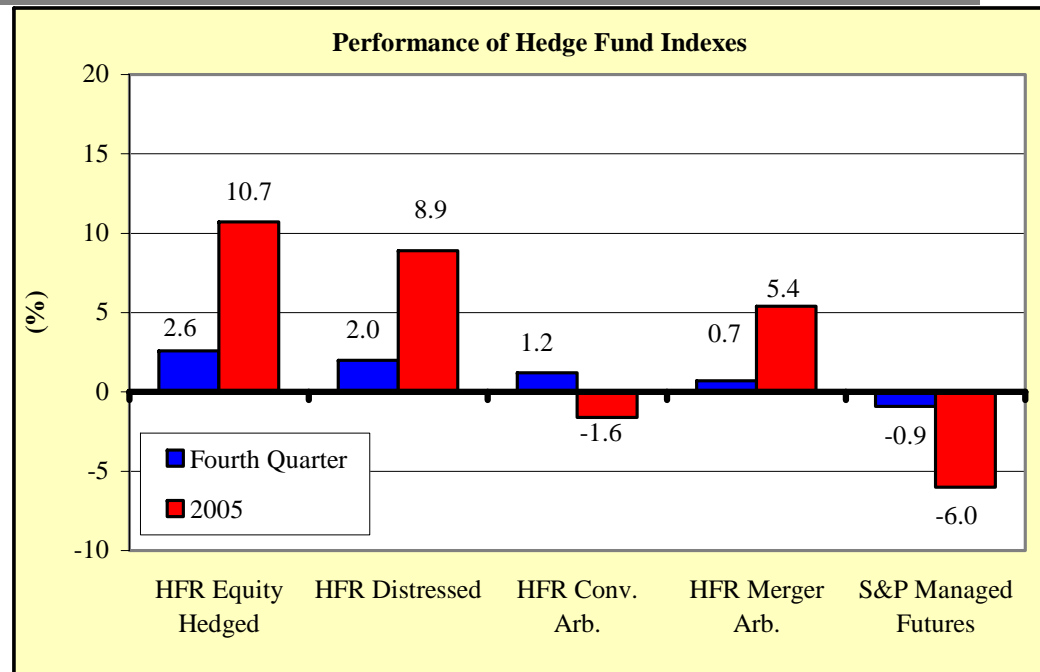
✓ Rising energy prices made commodity investing rewarding. The DJ-AIG Commodity index surged 21% on the back of a 42% increase for the index's energy sector. Natural resource stocks also had a strong year. The energy-dominated Goldman Sachs Natural Resources Index climbed 36.5%.

➤ The high returns experienced by real asset investments over the past few years are certainly cause for caution, but we still consider them an important part of a well-diversified portfolio.



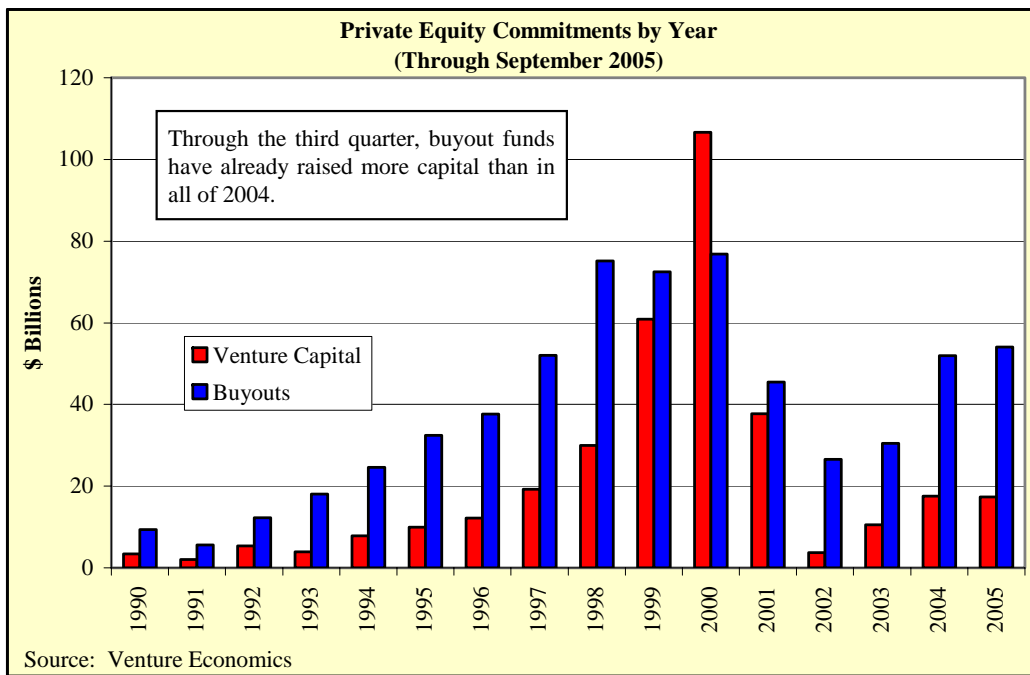
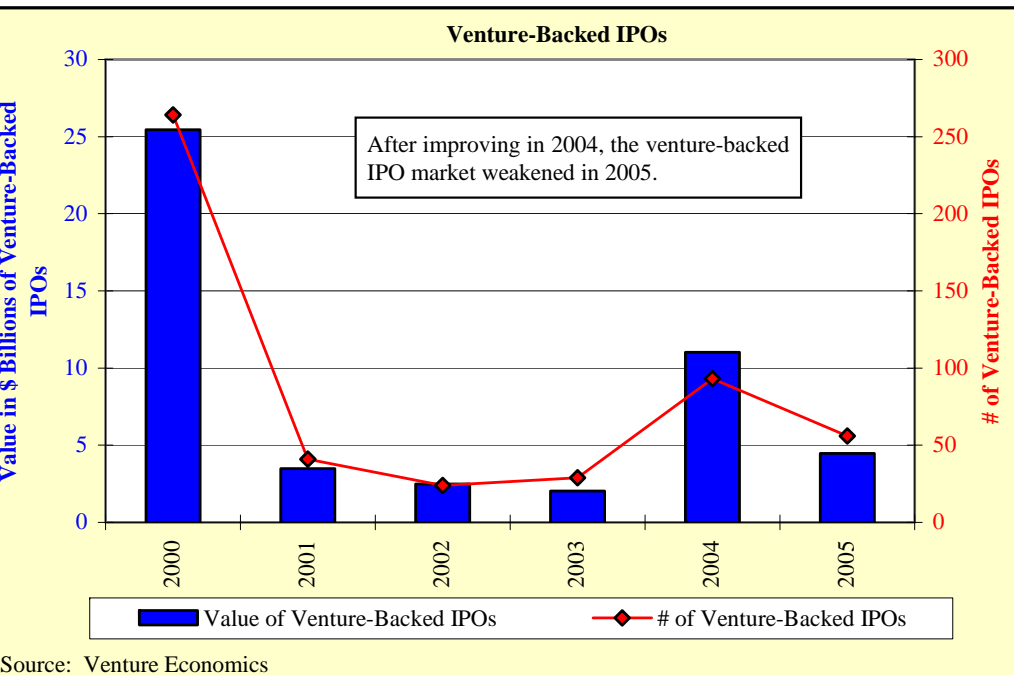
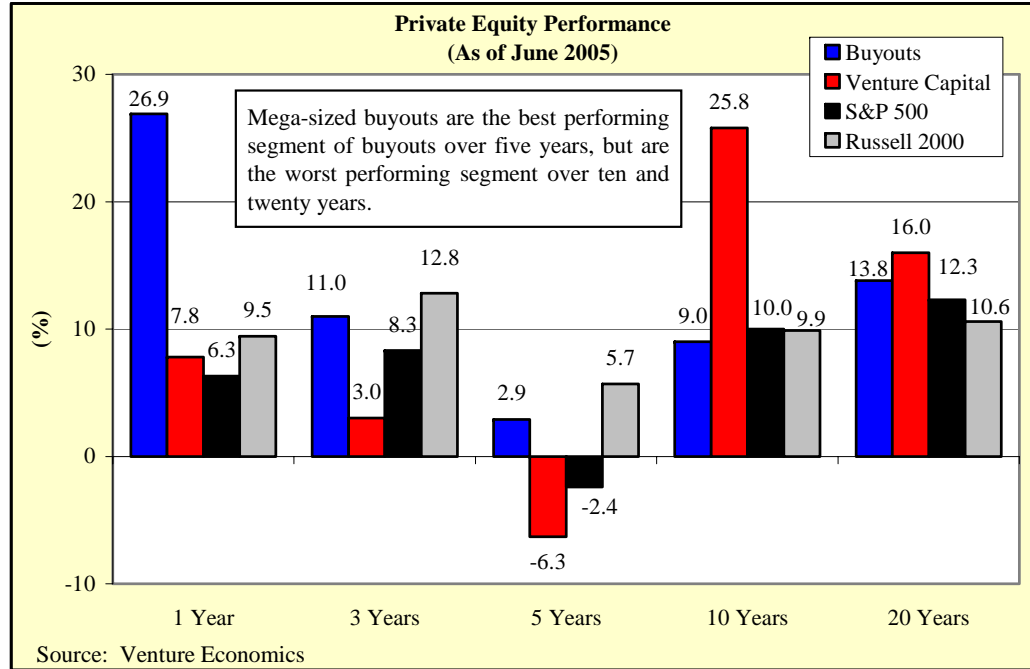
Hedge Funds: Volatile Headlines, Solid Returns

- Hedge Fund headlines in 2005 predicted the demise of hedged trading strategies. The top stories included the GM/Ford downgrades, which triggered shockwaves in the credit markets, the death of convertible arbitrage and the subsequent shuttering of a number of such funds, the encroachment of hedge funds into private equity investing, sharp-elbowed activist tactics employed by some managers, SEC registration, a number of unfortunate and well-publicized frauds, and “the disappointing returns of these once high-flying investment vehicles.”
- The news headlines didn’t focus on the fact that hedge funds had a solid year despite the challenges. In fact, the HFR Fund of Hedge Funds index outperformed domestic stocks and bonds. The average fund of funds gained 7.5% in 2005, according to HFR. The S&P 500, Russell 2000, and Lehman Aggregate Bond index increased 4.9%, 4.6%, and 2.4%, respectively.
- Long/short equity and distressed were the primary positive drivers across the mainstream strategies, as plain vanilla arbitrages and managed futures, in particular, generally detracted from the returns of diversified hedge fund programs.
- The results for diversified hedge fund portfolios were even more impressive on a risk-adjusted basis. However, as hedge funds become ever more mainstream, with increasing scrutiny, negative headlines will likely persist. Institutional investors should consider their tolerance for headline risk when making allocations.
- Hedge funds should not be expected to earn the returns they enjoyed in the 1990s. **However, in a world of low returns for traditional asset classes, superior hedge fund managers have as much place in institutional portfolios as ever.**



Private Equity: The Year of Mega-Buyout Funds

- The headline story for the year in private equity has been the incredible amount of capital being raised for mega-buyout funds. Up until recently, the largest buyout fund had total committed capital of roughly \$6 billion. The new benchmark looks to be \$12 billion, with Blackstone taking home the fundraising title. While final 2005 data are not yet available, this could have been the biggest fundraising year ever.
- Venture capital fundraising in 2005 was the highest since 2001, but is still a small fraction of 2000. The venture capital industry seems to be exercising restraint as a lot of capital is being turned away by the top funds. The investment pace is roughly in line with the fundraising pace.
- After a rebound in performance in 2004, VC funds have failed to maintain their performance momentum into 2005. The IPO market has been very selective about the quality of new offerings, and the M&A market has been spotty. There have been a few winners in all of this, but there have not been enough exits to boost overall VC returns.



Active Managers Generally Performed Well in 2005

*% of Surviving Mutual Funds that Have Outperformed Their Index
(As of 12/31/05)*

<i>Asset Class</i>	<i>Index</i>	<i>1 Year (%)</i>	<i>3 Years (%)</i>	<i>5 Years (%)</i>	<i>10 Years (%)</i>	<i>20 Years (%)</i>
US Large-Cap Growth	Russell 1000 Growth	57	56	58	62	48
US Large-Cap Blend	S&P 500	58	42	48	28	19
US Large-Cap Value	Russell 1000 Value	36	22	35	19	11
US Mid-Cap Blend	Russell MidCap	22	16	44	45	32
US Small-Cap Growth	Russell 2000 Growth	70	43	52	84	82
US Small-Cap Blend	Russell 2000	71	40	68	80	67
US Small-Cap Value	Russell 2000 Value	69	39	54	48	58
International Large Cap	MSCI EAFE	64	34	45	74	53
Emerging Market Equities	MSCI EME	42	50	49	64	N/A

Large-cap and mid-cap managers have posted disappointing long-term results.

Small-cap managers have performed well, but survivorship bias is likely skewing the results. (See below.)

The median emerging market manager has slightly underperformed the index. Considering that many of the top managers have closed, indexing is not a bad way to go.

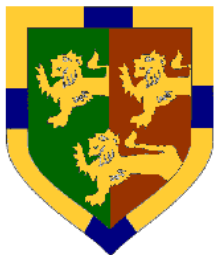
The median manager outperformed in 6 of 9 asset classes in 2005. We suspect large-cap and small-cap managers generally benefited by holding mid-caps. But, mid-cap managers did not do well versus the index. Many are only mid-cap *on average*, but also hold large-caps and small-caps.

In order to measure the potential affects of survivorship bias on mutual fund universes, we examined historical Morningstar data. We calculated the average return for 1996 in several Morningstar categories using their *year-end 1996 software*. (We used 1996 because that was the first calendar year-end that Morningstar classified funds into categories.) We then calculated the category average return for 1996 using the *December 2005 Morningstar software*.

<i>Morningstar Category Average Returns for 1996</i>			
<i>Asset Class</i>	<i>As Reported in 1996</i>	<i>As Reported in 2005</i>	<i>Difference</i>
US Large-Cap Growth	21.1	19.7	(1.4)
US Large-Cap Blend	20.6	21.3	0.7
US Large-Cap Value	19.9	20.4	0.5
US Mid-Cap Blend	19.1	20.0	0.9
US Small-Cap Growth	17.3	19.0	1.7
US Small-Cap Blend	21.2	21.8	0.6
US Small-Cap Value	22.1	23.2	1.1
Foreign Equities	12.4	14.8	2.4
Emerging Market Equities	12.3	14.0	1.7

The average return for 1996 did not increase very much for large-cap blend and value between 1996 and 2005 and actually fell for large-cap growth.

The return for mid-cap, small-cap, and foreign stocks increased substantially. The largest differences were for small-cap growth and foreign equities. The small-cap growth return for 1996 *as reported in 2005* was 1.7 percentage points higher than the 1996 return *as reported in 1996*. The foreign equities return was 2.4 percentage points higher.



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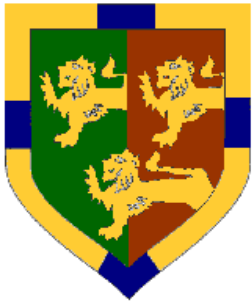
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Unless otherwise noted, asset class performance throughout this report is represented by the following indices: *US Large Stocks* – S&P 500, *US Large Value Stocks* – Russell 1000 Value, *US Large Growth Stocks* – Russell 1000 Growth, *US Mid Stocks* – Russell Mid-Cap, *US Small Stocks* – Russell 2000, *US Small Growth Stocks* – Russell 2000 Growth, *US Small Value Stocks* – Russell 2000 Value, *Intl Large Stocks* – MSCI EAFE, *Intl Small Stocks* – S&P/Citigroup EMI EPAC, *Intl Emerg Stocks* – Morgan Stanley Emerging Markets Free, *US Fixed Income* – Lehman Aggregate Bond, *US High Yield Fixed* – S&P/Citigroup High Yield Bond, *Inflation-Protected Bonds* – Lehman TIPS, *Cash* – Citigroup 3-Month T-Bill, *REITS* – Dow Jones Wilshire REIT, *Funds of Hedge Funds* – HFR Fund of Funds, *Commodities* – Dow Jones AIG Commodity, *Natural Resource Stocks* – Goldman Sachs Natural Resources Index



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