

HAMMOND ASSOCIATES

INSTITUTIONAL FUND CONSULTANTS, INC.

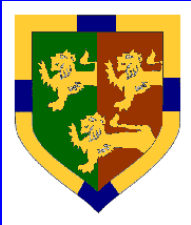
RESEARCH REPORT

First Quarter 2006

Table of Contents

✓ Inflation and the Implications for Asset Allocation	2 - 6
✓ First Quarter Executive Summary	7
✓ Risk Was Well Rewarded in the First Quarter	8
✓ Most Equity Indexes Well Ahead of March 2000 Levels	9
✓ Are Investors Overreaching for Returns?	10-11
✓ The Fed Drains Liquidity	12-13
✓ Economic Growth Slowed in the Fourth Quarter	14-15
✓ Another Crack in the Housing Wall	16
✓ Will Business Investment Pick Up the Slack?	17
✓ Japan—Is This Time for Real?	18-19
✓ Real Assets: Contango for Commodity Indexes	20
✓ Hedge Funds: A Return to Double Digits	21
✓ Private Equity: A Record Year for Buyouts	22





Hammond Associates

*Inflation and the Implications
for Asset Allocation*

April 2006

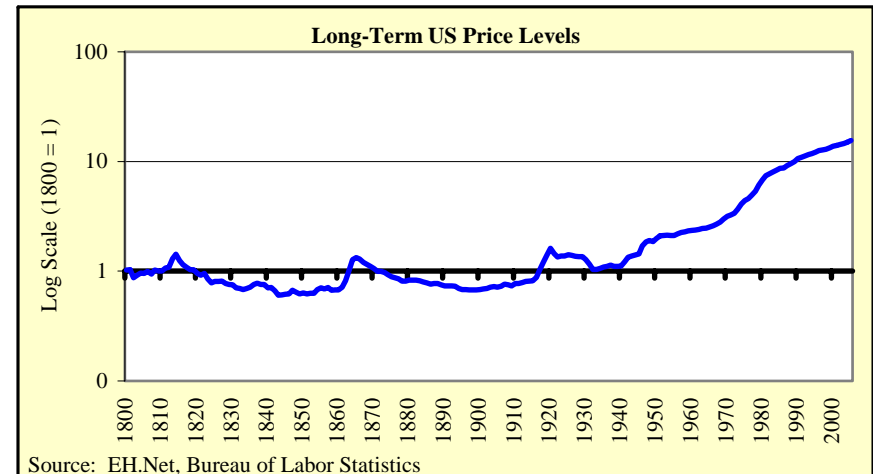
Inflation is an important consideration for investors and consumers. It erodes the purchasing power of assets and wages relentlessly. Over the last 50 years, the dollar has lost 87% of its purchasing power to inflation. Over the short- to intermediate-term, the inflation rate is affected by a number of factors, including the supply and demand for materials, labor, money, and goods. Taking a long-term view, inflation is mostly a function of money supply growth. Inflation occurs when money supply growth exceeds growth in economic output. Money supply growth is determined by central bankers and governments.

Unfortunately, inflation is a politically expedient way to “fix” problems for profligate governments. It has been referred to by many economists as the “most insidious tax.” Governments benefit from inflation in two ways. First, the real value of outstanding debt is devalued. Second, asset returns necessary to recoup inflation are subject to taxation, or put differently, are a source of revenue for cash-strapped governments. For instance, with a 2.5% inflation rate, a Treasury bond must pay a taxable investor almost a 4% coupon just to maintain the purchasing power of the corpus. Because unexpected inflation is such a boon to debtors (such as the US Federal Government) at the expense of lenders (such as holders of Treasury bonds), there is always a temptation to print money, thus lowering the real value of outstanding debt.

In this article, we begin by showing the history of inflation in the United States. Next, we look at recent inflation and speculate on prospects of future inflation, over both the short- and long-term. Finally, we comment on investing to hedge against unexpected inflation. Over the intermediate-term, our best guess is that inflation will be between 2% and 3%, but we believe the risks to this forecast are on the upside due to uncertainty over energy and the dollar. Looking into the next decade and beyond, our country’s heavy debt load (public and private) is a concern. Since the liabilities of many institutions are sensitive to inflation, investments in real assets make sense to hedge this risk.

A Historical Perspective

Since the Great Depression, inflation has been pervasive. Its severity has waxed and waned, but consumer price levels have risen in 64 of 66 years since 1940. This wasn’t always the case. Prior to WWI, periods of deflation were as common as periods of inflation. In fact, the 19th century saw deflation of 0.4%, annualized.



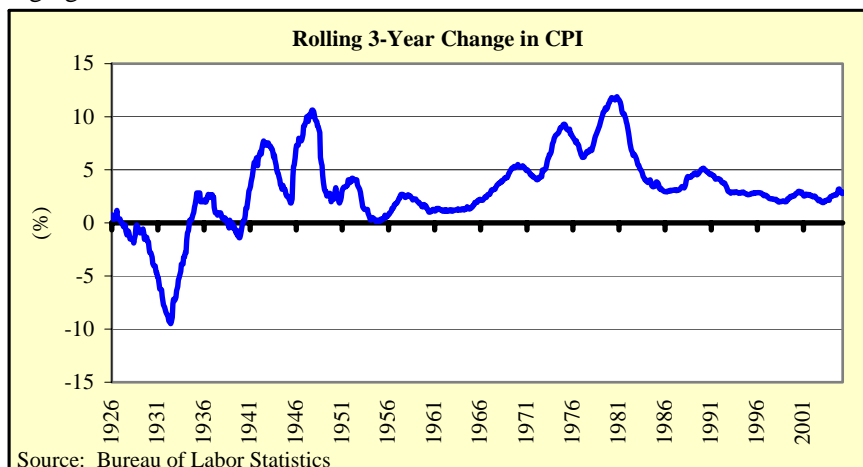
The reason for the shift from deflation to inflation can be traced to monetary policy. Throughout most of the 19th century, the US was on either the gold or silver standard. The currency was effectively tied to silver in the first half of the century, then gold in the second half. Money supply growth was limited to the growth in the supply of the metals. The growth in supply was less than the growth in economic output, so price levels declined throughout most of the century. The country experienced sharp inflation during the Civil War when President Lincoln suspended gold convertibility,¹ but price levels deflated after the war as the country returned to the gold standard. The next interruption of the gold standard did not come until World War I. A return to the gold standard was completed by 1922, but it lasted only a dozen years. The Great Depression brought deflation and the end of the official gold standard in the US. President Roosevelt and Congress outlawed the holding of gold bullion by US citizens in 1933 (which wasn’t rescinded until 1974). Roosevelt then devalued the dollar by 40% against gold in 1934 (from \$20.67 per ounce to \$35) to increase the money supply.

The Bretton Woods system, enacted after World War II, returned the country to a quasi-gold standard. Foreign central banks could exchange dollars for gold at \$35 per ounce, and the dollar became the dominant international reserve currency. This system allowed the US to expand the supply of dollars without the market check from gold prices since only foreign central banks could redeem dollars. This resulted in inflation. Inflation was modest from the mid-50s through the early-60s, but began to accelerate in the late 1960s when the US expanded the money supply at an increasing rate. The Bretton Woods system collapsed in the early 1970s as the dollar became substantially overvalued versus gold, resulting in a run on the currency by

¹The South experienced hyperinflation during the war as the Confederate government used the printing press to help fund the War. Inflation from the beginning of 1861 through 1864 was about 130%, annualized. Confederate notes, of course, were worthless after the war.

central banks. President Nixon suspended gold convertibility in 1971, ending the dollar's last link to the metal and switching to a fiat money system. When combined with the energy embargo, the 1970s saw a rapid increase in inflation, reaching a peak of 13% in 1979. By 1981, a dollar from 1934 was worth just \$0.12.

Paul Volcker took over the Chairmanship of the Federal Reserve in 1979 and helped to bring inflation back under control at the cost of a severe recession. Inflation averaged less than 4% from 1982 through 1989, and by the late 1990s, inflation was averaging close to 2%.



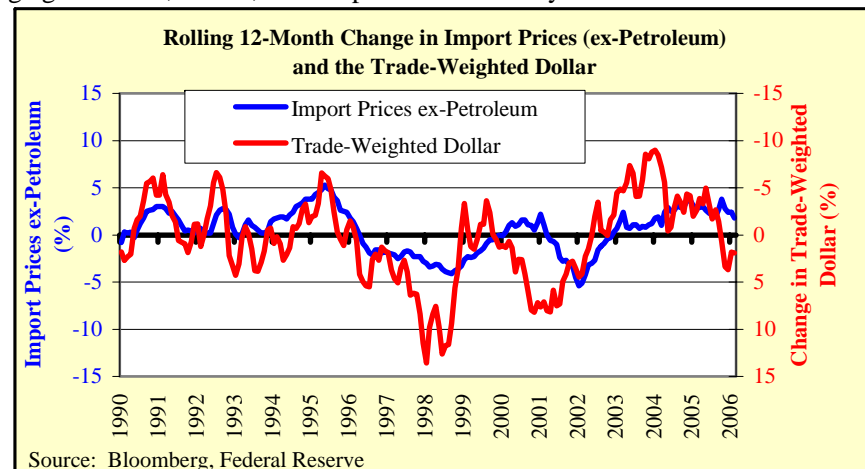
Inflation Outlook

The rate of inflation has been accelerating over the last few years. In 2005, headline CPI inflation was 3.4%, which was the highest rate for a calendar year since 1990. The increase in inflation has largely been driven by energy prices. The core CPI, which excludes food and energy, rose a more modest 2% in 2005. While the core CPI is not a useful long-term inflation measure, it is useful as a smoother measure of underlying price trends. If energy prices level off, the headline CPI rate should trend towards the core rate. Below we comment on some of the macro-economic factors affecting inflation.

Energy – Energy has been the primary cause of the recent spike in inflation. The surge in demand for oil from China and other emerging market countries in the face of tight supplies has driven prices higher. It's anybody's guess where prices are going from here. The good news is that high prices are attracting new investment. As new production comes on-line, price pressures may decrease. High prices are making "unconventional" oil projects profitable, such as Canadian oil sands, ultra-deepwater drilling, and coal gasification. Over the short-term, there will be a race between rising demand and new supply. A long-term concern is that some analysts believe we may be within a decade or two of peak worldwide oil production. The possibility of political upheaval in producing countries is an additional risk. With

little margin between capacity and demand, a political event (particularly in the Middle East) could send prices skyrocketing. Hints of this have been evident in 2006 with the situation in Iran, political upheavals in Nigeria, and the failed suicide attack in Saudi Arabia. Oil price risk appears skewed to the upside.

Global Labor Arbitrage – One deflationary force in the world is "global labor arbitrage," a term coined by Stephen Roach of Morgan Stanley. The abundant, low-cost labor force in emerging markets, particularly in China, has a couple of ramifications. First, it has a direct effect of encouraging a shift in jobs to these lower cost countries. These savings are passed along, at least in part, to consumers. Over the last decade, import prices (excluding petroleum) have declined 0.5%, annualized. At the same time, imports' share of the economy has increased by about 25%. A second indirect effect is that it acts to keep a lid on costs outside of emerging markets because of competition. Domestic companies competing against Chinese manufacturers, for instance, may not have the same pricing power as in years past. Furthermore, they must keep a lid on costs, particularly labor costs. Wage growth has, in fact, been depressed in recent years.



Dollar Weakness – Due to our massive current account deficit, we suspect that the dollar will resume its downward trend. It likely must become significantly undervalued to reduce the deficit to a more sustainable level. This will have an inflationary effect in the US because import prices will rise (or not fall as much as they would otherwise). The steep decline in the dollar since 2002 has already led to a modest increase in import prices, whereas import prices were declining before the dollar's depreciation.

Monetary Policy – As shown in the prior section, monetary policy is a key long-term determinant of inflation. Over the short-term, the effect is fuzzier because of all the other moving parts. Greenspan showed his willingness to ease aggressively to avoid any possibility of a Japan-styled deflation. Ben Bernanke's ascension to

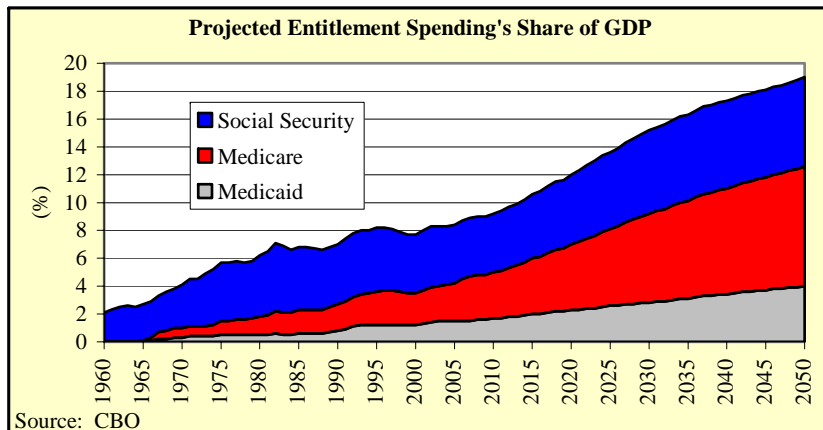
Federal Reserve Chairmanship will probably continue this trend. The recent increases in short-term rates notwithstanding, it seems likely that the Fed will err on the side of inflation over deflation to avoid Japan's experience.

Savings Rate – A potential deflationary factor is a rebound in the personal savings rate. The savings rate has been declining for the past two decades and is now negative. A sharp rate rebound because of a correction in housing prices or other events would reduce demand growth. A sharp decline in demand growth could lead to excess capacity and falling prices.

Market Expectations – The bond market does not appear concerned about inflation. The breakeven inflation rate on 10-year TIPs, which represents the difference in the Treasury yield and the real yield on TIPS, stands at only 2.5%. The rate on longer term TIPS is 2.6%. The breakeven rate should include not only expected inflation, but also an inflation risk premium. Over the intermediate-term, our best guess is that inflation will revert to 2.5%, but we believe the risks to this forecast are on the upside due to energy and the dollar.

Long-Term Outlook

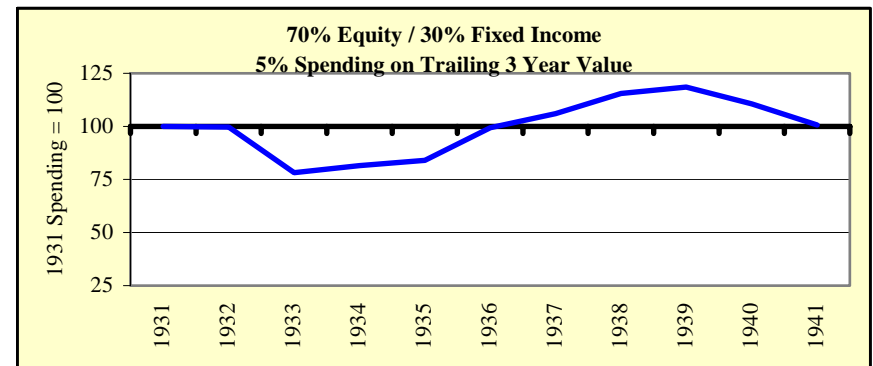
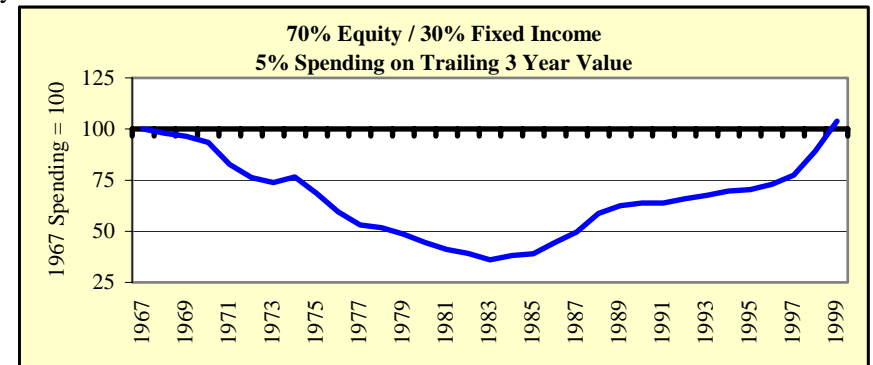
Looking into the next decade and beyond, the high debt load of the US economy is a concern. Over the next ten years, it seems likely that the Federal budget will remain deep in the red. Beyond that, demographics and entitlement spending could make matters even worse. Social Security and Medicare will become an even heavier burden for the Federal Government. Furthermore, US households are borrowing more than ever. An increasing portion of our debt load is funded by foreign investors. As a result, there may be a temptation to print money, thus lowering the real value of outstanding debt. We hope that the Federal Reserve retains its independence and does not resort to default through inflation. However, history is rife with examples of governments using the printing press (and debasement of coins in earlier times) to pay debts.



Investing to Hedge Against Inflation

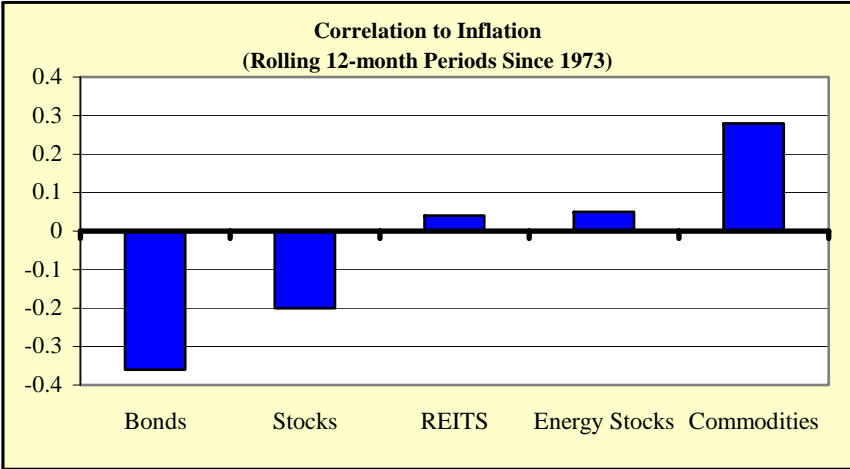
For many institutions, liabilities and the ease with which they are satisfied are largely affected by future price levels. Inflation is a significant risk for university endowments, for instance, because costs will increase, requiring ever larger distributions from the endowment (in dollar terms) to maintain present services. Deflation is positive in some ways, because it reduces cost pressures on the operating budget, so that distributions go further. Admittedly, this view is simplistic in some respects. However, we believe it is reasonable to assume that inflation is a larger risk than deflation for most institutions when liabilities are considered. For this reason, institutions with liabilities sensitive to inflation should tilt towards assets that protect against inflation.

Comparing real spending in the 1930s to the 1970s illustrates the impact of deflation versus inflation. An institution with a 70% equity and 30% fixed income portfolio and a 5% spending rate (on a trailing three-year market value) would have seen the real value of its spending drop by 65% from 1967 through 1983. The institution had to wait until 1999 to reach the real value of 1967 spending again. The Great Depression was comparatively mild because of deflation. The real value of spending declined by only 21% from 1931 through 1933 and completely recovered by 1936.



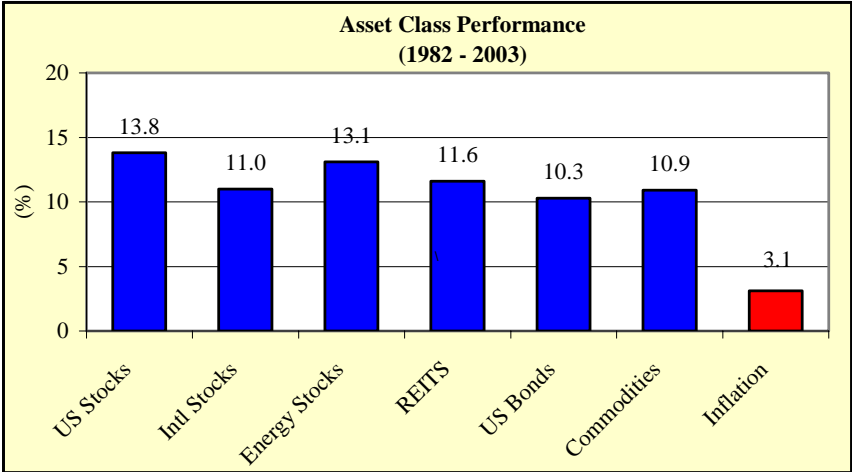
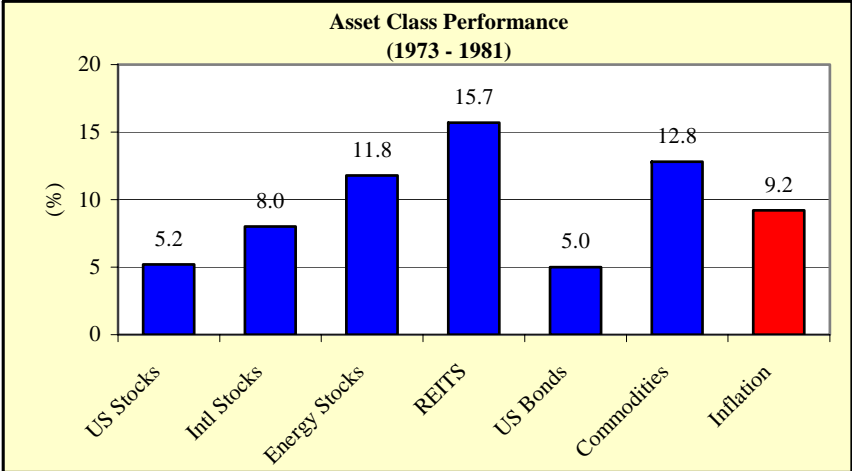
An institution that wants to protect its portfolio against unexpected inflation to hedge liabilities should underweight nominal bonds, especially those with long duration. TIPS are a better fixed income vehicle because they more closely match liabilities. Stocks are traditionally considered an adequate inflation hedge. From a theoretical perspective, this is sound. The real value of companies' property, plant and equipment is not affected by inflation. More importantly, companies should be able to pass along any inflation they experience in their costs of goods sold through higher prices on output, meaning real earnings should not be negatively impacted by inflation. This was the case in the 1970s. Earnings for the S&P 500 grew at a 10% annualized nominal rate during the decade and at 3% adjusted for inflation (slightly better than the long-term average). A problem with this is that the stock market has historically exhibited "money illusion"—valuations have been affected by inflation even though they shouldn't be. When inflation and nominal interest rates rise, the P/E ratio tends to fall. This helps explain why stocks were trading at single-digit P/Es in the early 1980s. Stocks are a good long-term inflation hedge, but they are deficient as a short- to intermediate-term hedge.

Historically stocks and bonds have exhibited negative correlations to inflation. Real asset-oriented liquid investments show improved correlations to inflation. REITs and energy stocks are virtually uncorrelated to inflation. REITs (and private real estate investments) should be able to pass along higher inflation through rents, and the earnings of energy stocks naturally receive a boost to the extent inflation is caused by higher energy prices. A direct investment in commodities represents the best inflation protection, since commodities are often the source of unexpected inflation. Commodities have exhibited a positive correlation to inflation of 0.3.



Correlations, however, may not show the full benefit of real assets as an inflation hedge. We examined the returns of asset classes during the inflationary period of 1973 to 1981. Here, the liquid real asset proxies performed well. Over this period,

inflation was 9.2% annualized. Stocks earned only 5.2% and bonds earned 5.0%. Energy stocks, REITs, and commodities all outperformed inflation, earning 11.8%, 15.7%, and 12.8% annualized, respectively. We strongly caution that this is only one observation. We do not have sufficient data to test the performance of real assets during previous secular inflationary environments. In the disinflationary period of 1982-2003, the liquid real asset proxies underperformed stocks, but not by an unreasonably wide margin.



A major determinant of how investments perform during an inflationary period is the source of inflation. For instance, if inflation is caused by strong economic growth pushing energy prices higher, then stocks could perform well. Economic growth may keep investors optimistic about future earnings growth. This is the environment we've experienced the last two years. Real estate may also perform well because employment growth should remain strong. Energy investments should also thrive in such an environment.

Alternatively, if inflation is caused by a dollar collapse or a supply shock in energy and it leads to another stagflationary period with high interest rates, then stocks would likely suffer as they did in the 1970s. We would also expect real estate to underperform past return levels because of slower employment growth and higher interest rates. (Real estate performed well in the 1970s, but there is less margin for error in pricing today.) Energy and other commodity investments should perform well in this environment because a weak dollar or a supply shock would likely push prices higher.

A concern regarding real assets in the current environment is their recent performance. REITS and private real estate investments have been very strong performers over the past five years, but dividend yields on REITS and capitalization rates on private real estate are now very low. If inflation causes a spike in interest rates, we would not be surprised to see both public and private real estate investments suffer. Commodities have also been strong performers since 1998, driven by the performance of energy and metals. A cyclical pullback is a distinct possibility. Nevertheless, in a world where nearly everything appears expensive, real asset investments still appear to be a prudent hedge to liabilities. Even in a modest inflation environment, we believe their returns will be competitive with traditional stocks.

Conclusion

The future course of inflation is unclear. However, based on implicit market forecasts, it appears there is more upside than downside inflation risk. Endowments and other institutions whose liabilities are sensitive to inflation should strongly consider a substantive real asset allocation to hedge against unexpected inflation. While stocks should act as a reasonable long-term inflation hedge, they have fallen short when needed most. In the 1970s, both stocks and bonds performed dismally versus inflation.

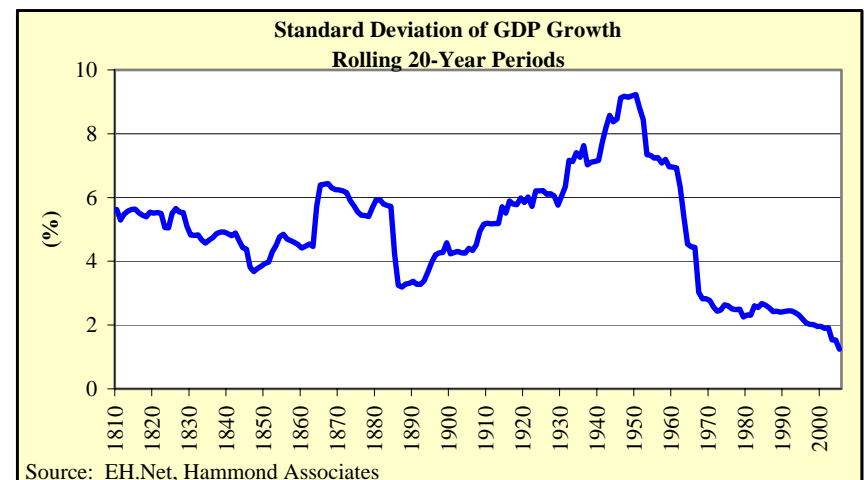
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Should We Return to the Gold Standard?

The failure of the Federal Reserve and other central banks to maintain the purchasing power of their currencies over the last half century has led a small minority of economists to advocate a return to the gold standard. The theoretical advantage is that it imposes discipline on central banks and governments by limiting money supply growth to growth in gold supply. The drawback to the gold standard is its inflexibility. During periods of financial stress, it is impossible to increase liquidity. In fact, the gold standard arguably amplified downturns because the resulting deflation increased the propensity to save. Furthermore, the supposed discipline is open to debate, since governments showed a tendency to abandon the gold standard when convenient.

Many economists believe that the return to the gold standard in the US and other countries following World War I contributed to the onset of the Great Depression. There were also numerous depressions in the 19th century. Economic volatility has been much lower since the Great Depression. It is difficult to say to what extent that has been a function of flexibility under Bretton Woods and a fiat currency. There are a number of other possible contributors, such as better information available to business managers and a more developed financial system. Still, the removal of gold shackles has almost certainly contributed to the reduction in economic volatility.

Its historical use as money notwithstanding, gold is nothing more than a rare metal. Linking a nation's currency to the metal has little theoretical justification in today's world. A fiat currency is the lesser of two evils. Investors and consumers just need to realize the potential for abuses raised by fiat currencies.



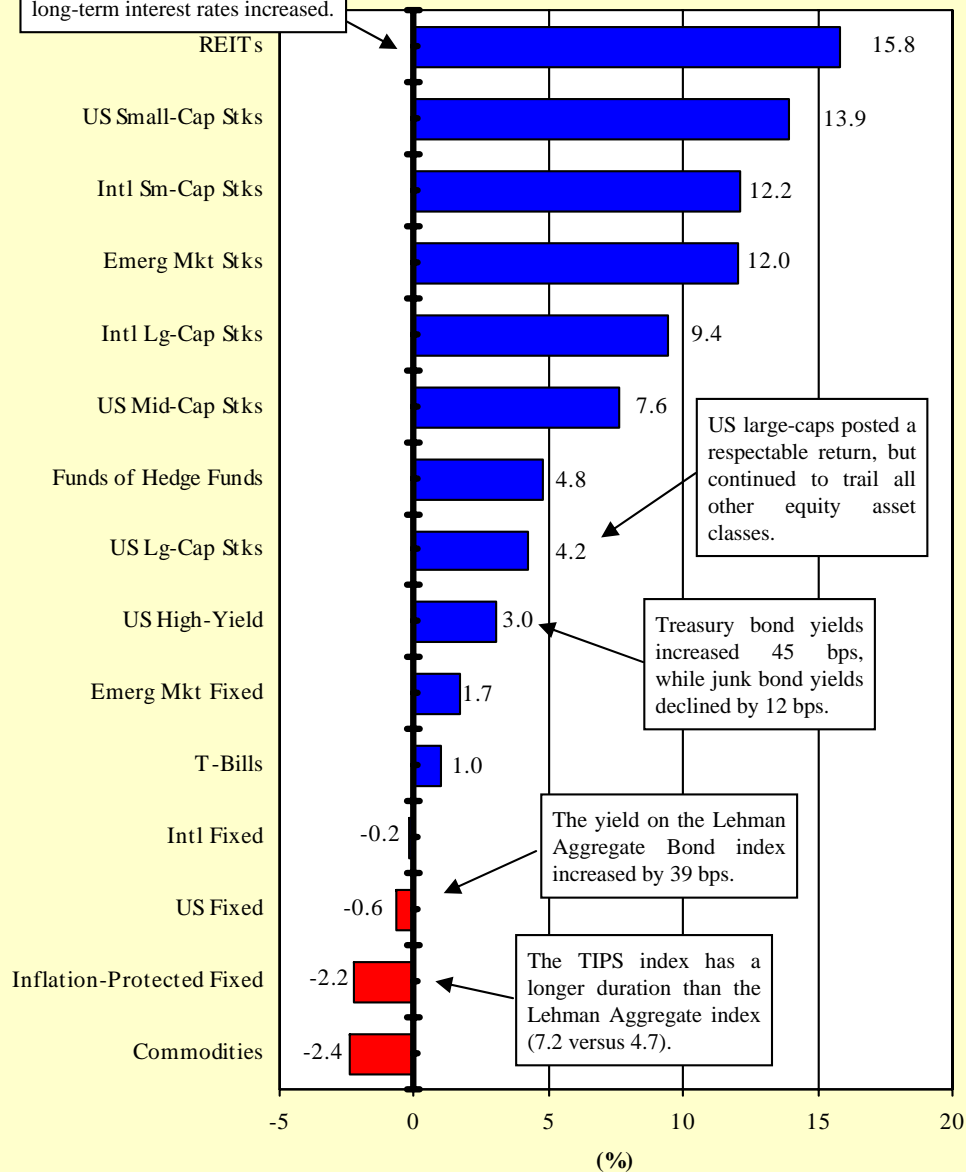
First Quarter Executive Summary

- Markets were very kind to investors in the first quarter. In general, riskier asset classes performed the best. The S&P 500 earned 4.2% for the quarter, while REITs, US small-cap stocks, and emerging market stocks earned 15.8%, 13.9%, and 12.0%, respectively. Most fixed income asset classes struggled as intermediate- and long-term interest rates rose. The Lehman Aggregate Bond index lost 0.6%.
- Many investors have accepted that a portfolio of US large-cap stocks and bonds is unlikely to provide required return needs and have been looking elsewhere to enhance returns. Magnified by a glut of liquidity, this has compressed risk premiums on global assets. Increasing risk exposure to reach a required return is questionable in this environment of low risk premiums. The risk in these assets may manifest itself soon, as the Fed seems intent on removing excess liquidity. **We do not advocate wholesale shifts in asset allocation for institutional portfolios with a long-term horizon. However, it seems a prudent time to reduce risk at the margin.**
- As expected, the Federal Reserve raised the Fed Funds rate from 4.25% to 4.75% in the first quarter. Fed Funds futures predict that a 5% overnight lending rate is very likely after the May meeting, and the chances of a 5.25% rate after the June meeting are now above 50%. In contrast to 2005, long-term rates rose along with short-term rates during the quarter. The yield curve made nearly a parallel shift upwards.
- Economic growth in the fourth quarter of 2005 was disappointing at only 1.7%, annualized. Nevertheless, the economy grew at a respectable 3.5% pace for the full year. Economists expect first quarter growth to come in around 5%. Consumption growth has been driven by a reduction in savings and high debt growth. With interest rates rising and the housing market slowing, consumption growth seems likely to fall below income growth to restore the savings rate.
- With record profits for US corporations, some hope that business investment will keep the economy growing strongly if personal consumption slows. It's not clear that businesses need to increase the investment pace. The current level relative to the overall economy is slightly above the long-term average. Furthermore, if consumption slows, it will mean slower demand for business output
- It appears that Japan's decade-plus economic slump may finally be coming to an end. Japan's economy grew 2.7% in 2005 on top of 2.3% in 2004. This was the strongest two-year period since 1990-91. Equity markets already appear to be pricing in a strong recovery.
- Commodity futures investors face stiff headwinds. The roll yield on the DJ-AIG Commodity index and other commodity indexes has turned negative in recent years and is worsening. **We still suggest commodity exposure as an inflation hedge, but investors with the means should consider direct investments in commodities, as well.**
- On the wings of a strong quarter where virtually every hedge fund strategy experienced success, hedge funds posted a return of 11.7% for the 12-months ended March 2006. In the past when hedge funds produced double-digit returns, they did so through a balanced exposure to arbitrage and directional strategies. Today, hedge funds, in the aggregate, have become much more directional. As a result, the double digit returns seen today have come through the acceptance of greater risk.
- According to Venture Economics, buyout fundraising reached a record level of \$86 billion in 2005. The question now is whether this money can be put to work earning attractive returns. Distressed debt managers are eagerly awaiting an increase in default rates. However, the next cycle may not prove to be as rewarding as the last, as there seems to be far more money on the sideline waiting to pounce than in 2002.

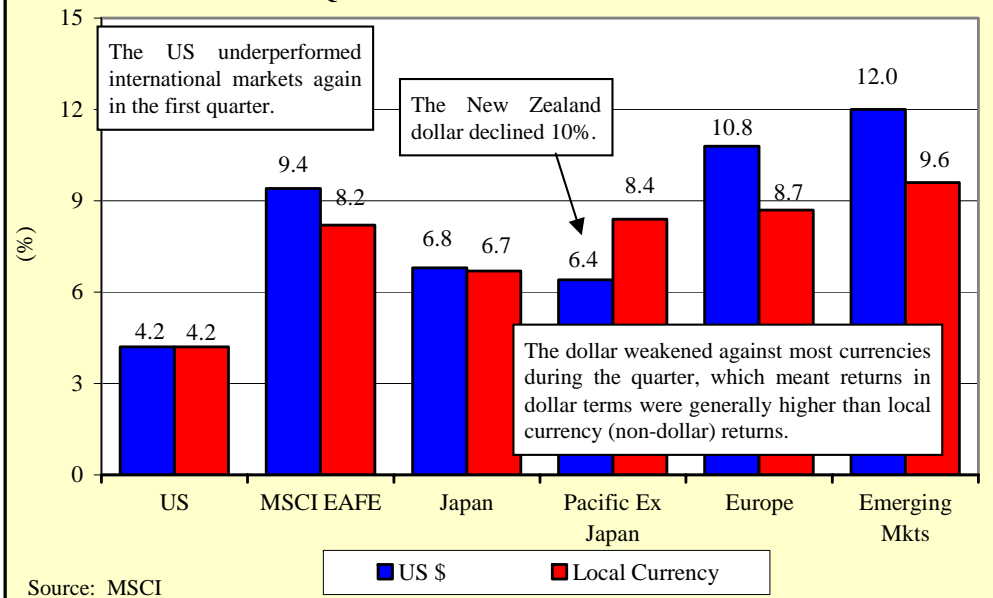
Risk Was Well Rewarded in the First Quarter

The strong performance for REITs during the quarter was particularly confounding since long-term interest rates increased.

First Quarter 2006 Performance

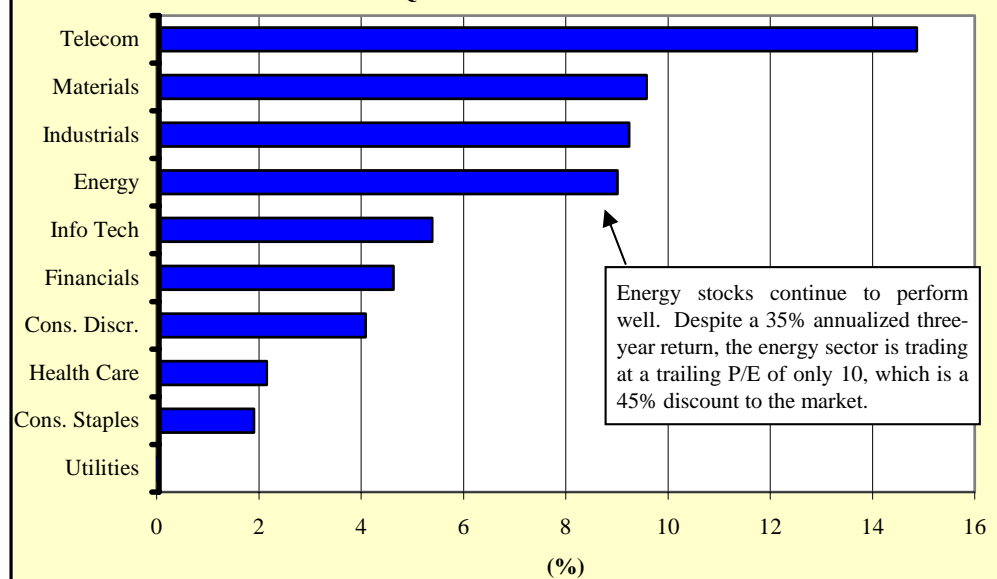


First Quarter 2006 Returns for Global Markets



Source: MSCI

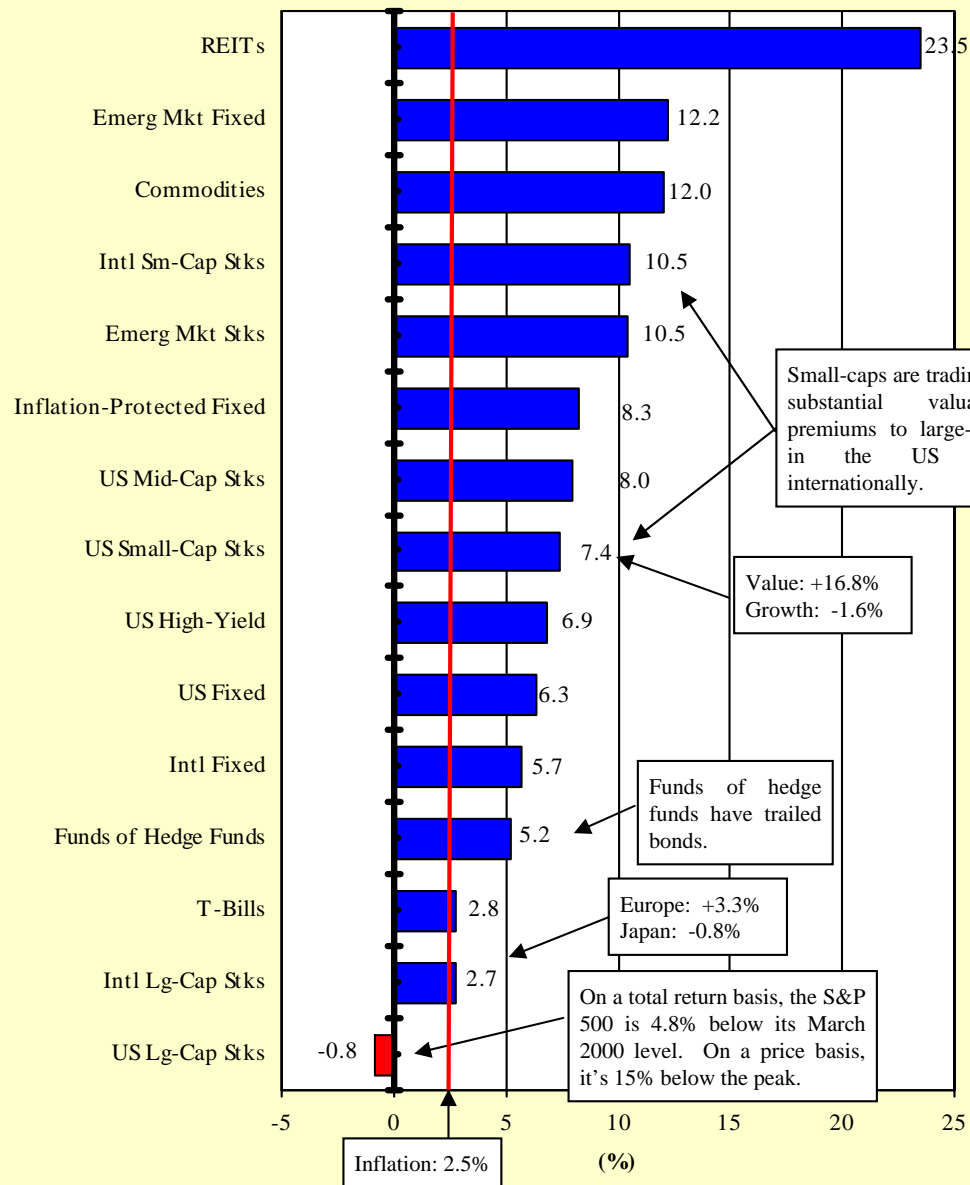
First Quarter 2006 Sector Performance



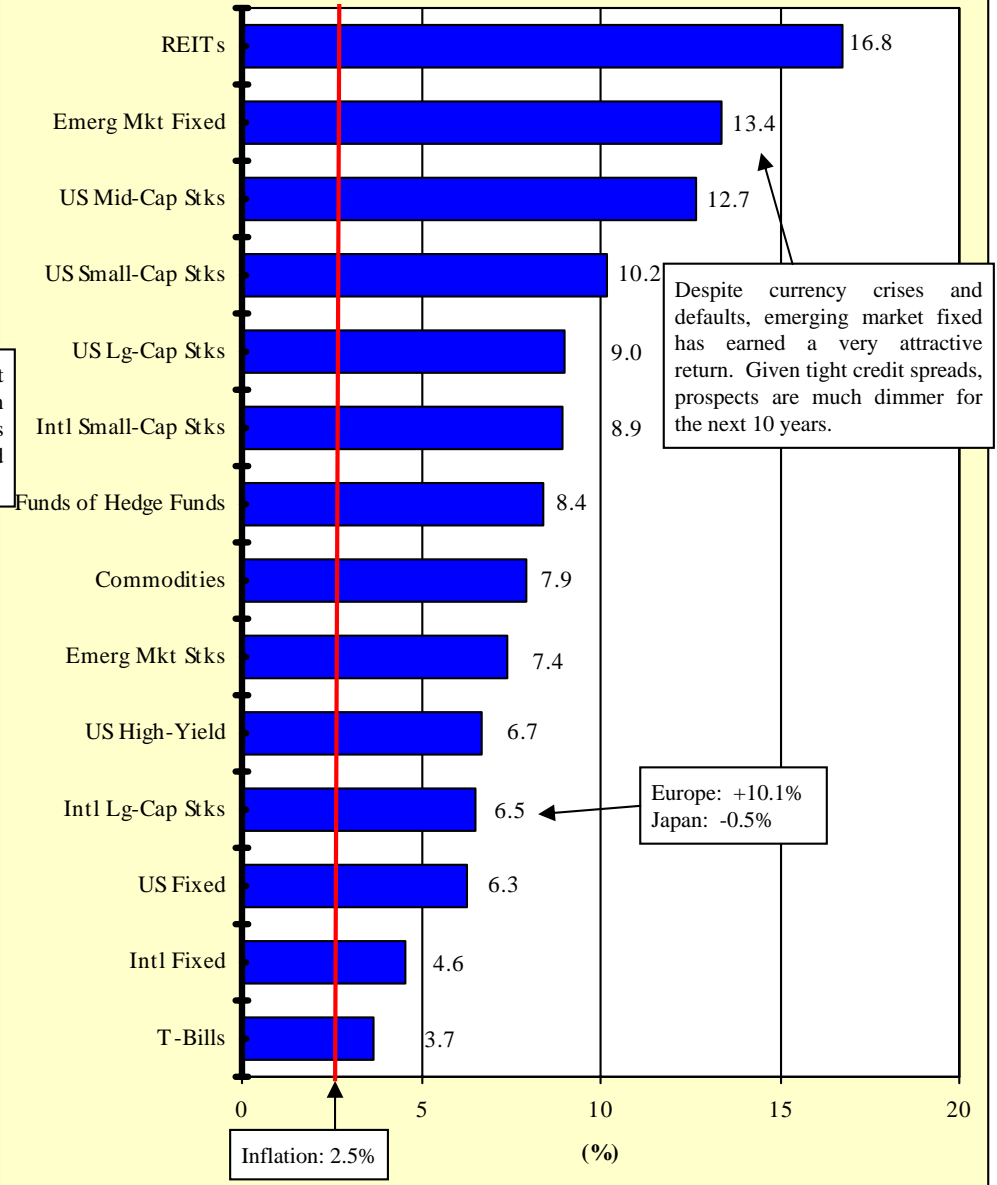
Source: MSCI

Most Equity Indexes Well Ahead of March 2000 Levels

Since March 2000

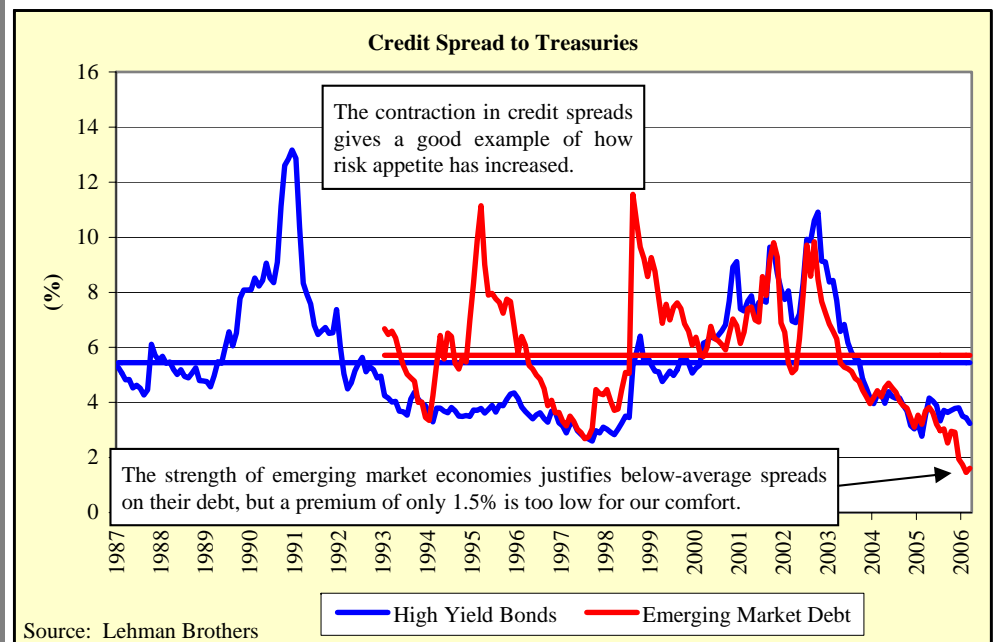
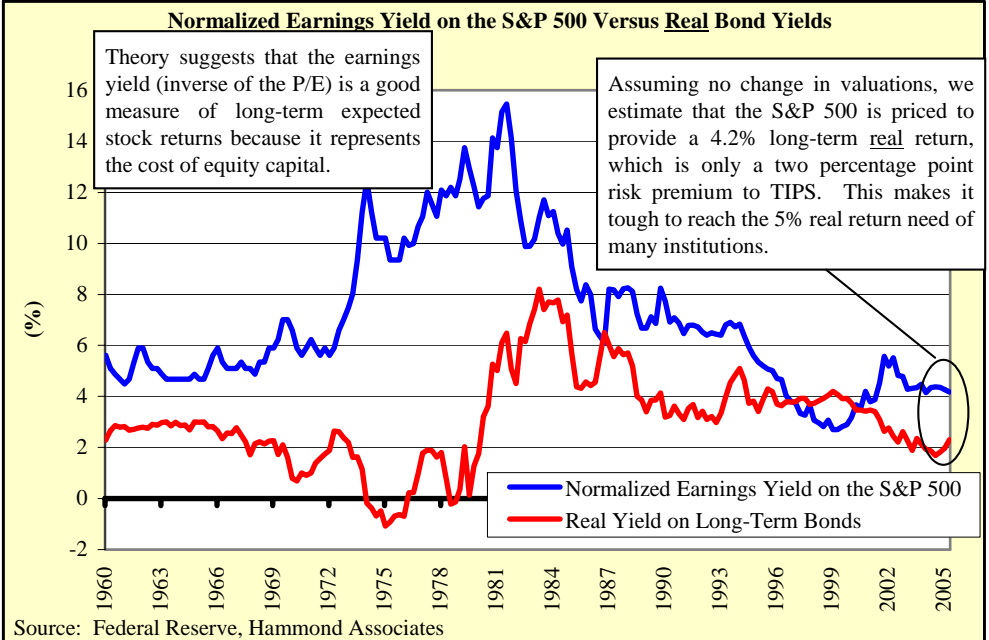


Trailing 10-Year Performance

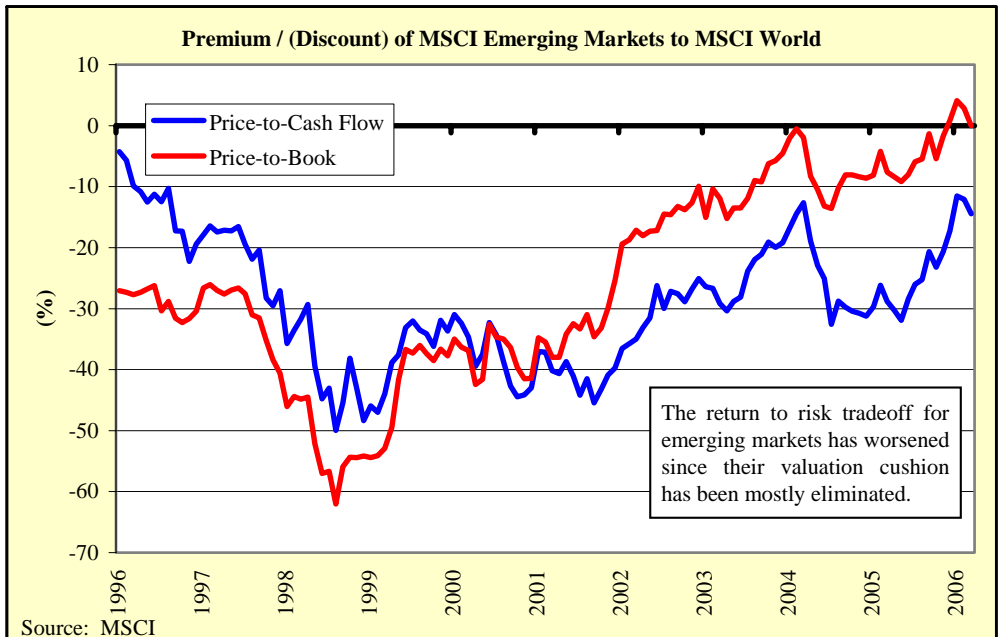
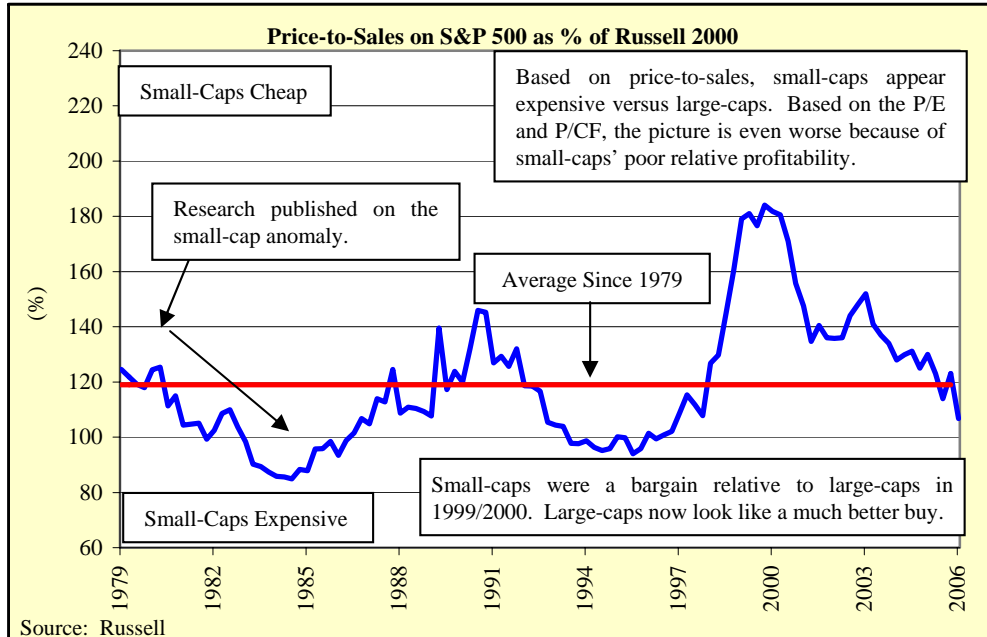
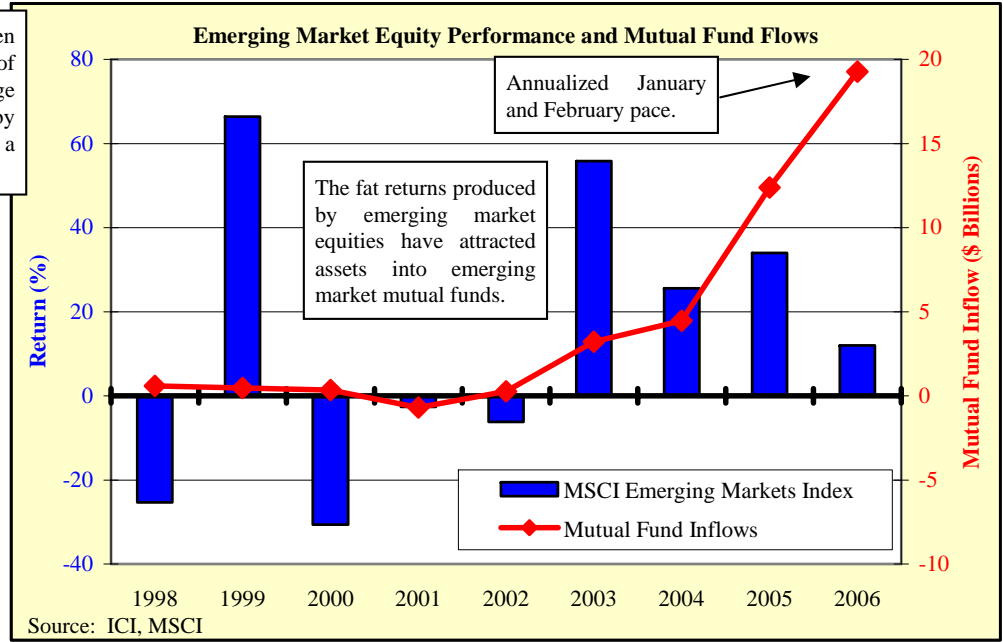
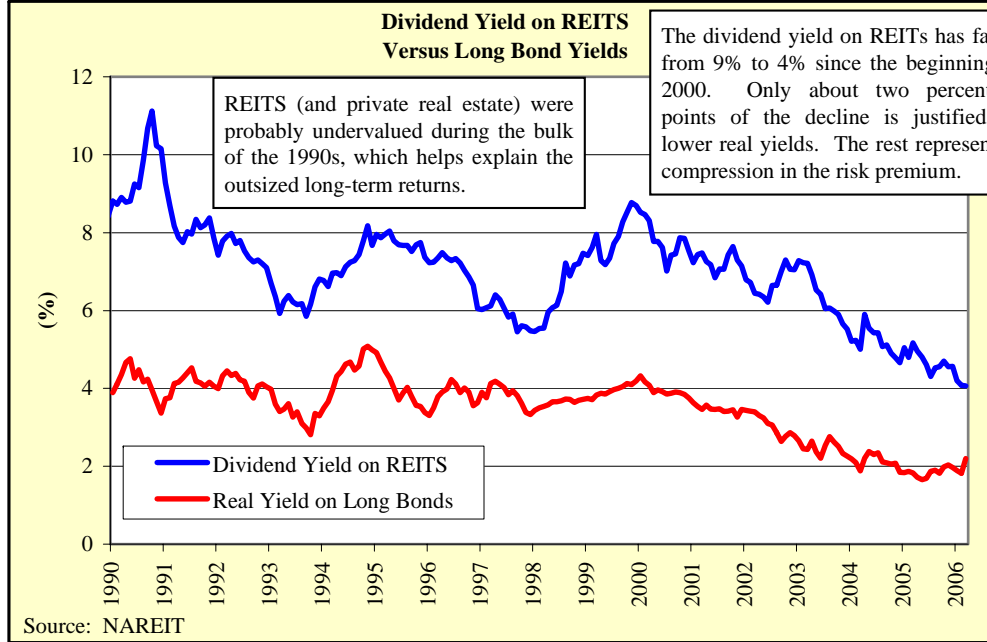


Are Investors Overreaching for Returns?

- Many investors have accepted that a portfolio of US large-cap stocks and bonds is unlikely to provide required return needs and have been looking elsewhere to enhance returns. Magnified by liquidity, this rush of money has reduced risk premiums (the expected return above the risk-free rate) on global assets and benefited those who were early to the party.
 - ✓ Investor's hunger for yield has pushed credit spreads on high yield bonds to paltry levels. Emerging market bonds offer only a 1.5% premium to Treasury bonds, which is a record low. The dividend yield on REITS has plummeted from almost 9% at the beginning of 2000 to just 4.1%. This is less than a 2% premium to TIPS. Private real estate has seen a sharp fall in capitalization rates.
 - ✓ Emerging market stocks were a bargain in 2002 and were trading at a steep discount to the US market and other developed markets. With a 40% annualized return since October 2002, that discount has been slashed. Small-cap stocks, both in the US and internationally, were cheap relative to large-caps at the beginning of this decade. They now appear expensive.
 - ✓ Alternative investments have seen massive inflows. Buyout fundraising reached a record in 2005 and hedge fund assets have reached \$1.5 trillion. Financial investments in commodities have exploded.
- Increasing risk exposure to reach a required return is questionable in this environment of low risk premiums. The optimal response to falling risk premiums is to reduce risk exposure, not increase it. Of course, the problem is return needs have not fallen along with risk premiums.
- The risk in these assets may manifest itself soon. The Fed seems intent on removing excess liquidity (see page 12). The European Central Bank is also tightening, and the Bank of Japan may later this year. This isn't good for assets driven by liquidity and momentum.
- We do not advocate wholesale shifts in asset allocation for institutional portfolios with a long-term horizon. However, it seems a prudent time to reduce risk at the margin. While cash and intermediate-term TIPS won't help reach a 7% or 8% return need, they are relatively attractive since risky assets aren't providing appropriate risk premiums. They also provide dry powder for when premiums return to reasonable levels.

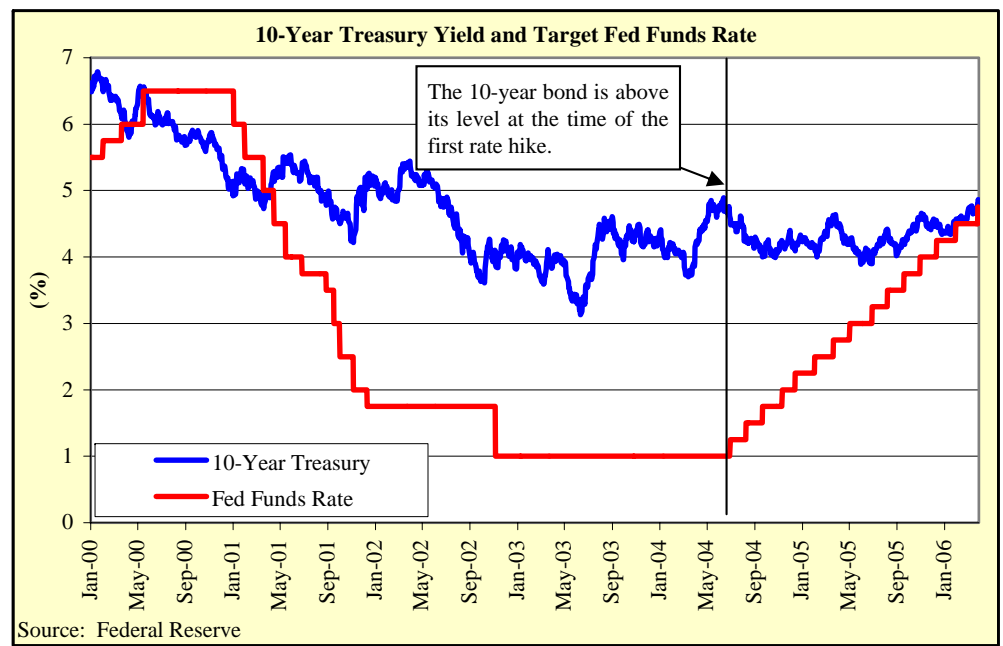
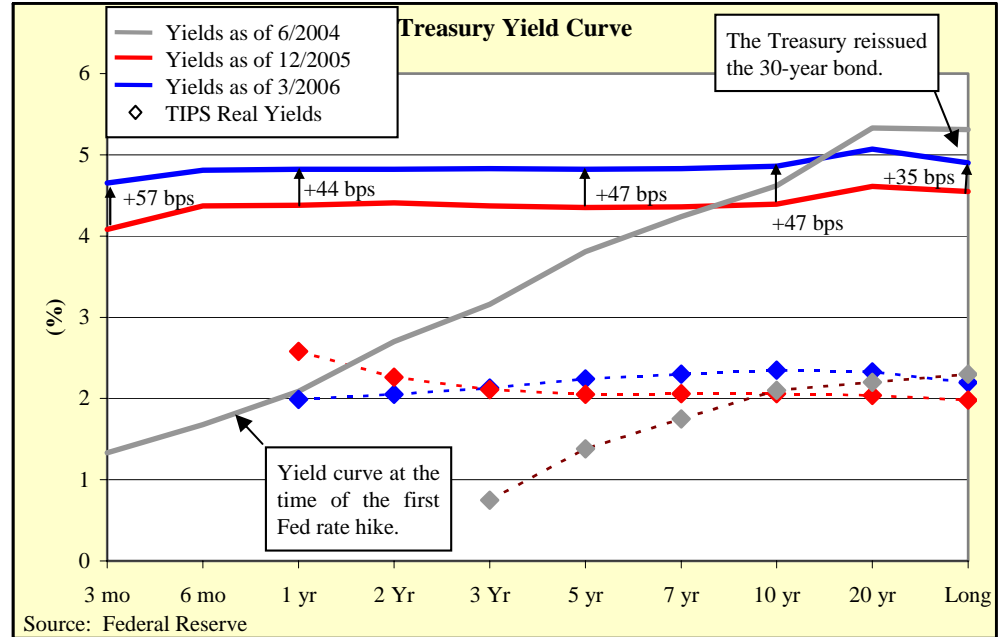


Are Investors Overreaching for Returns? (cont.)



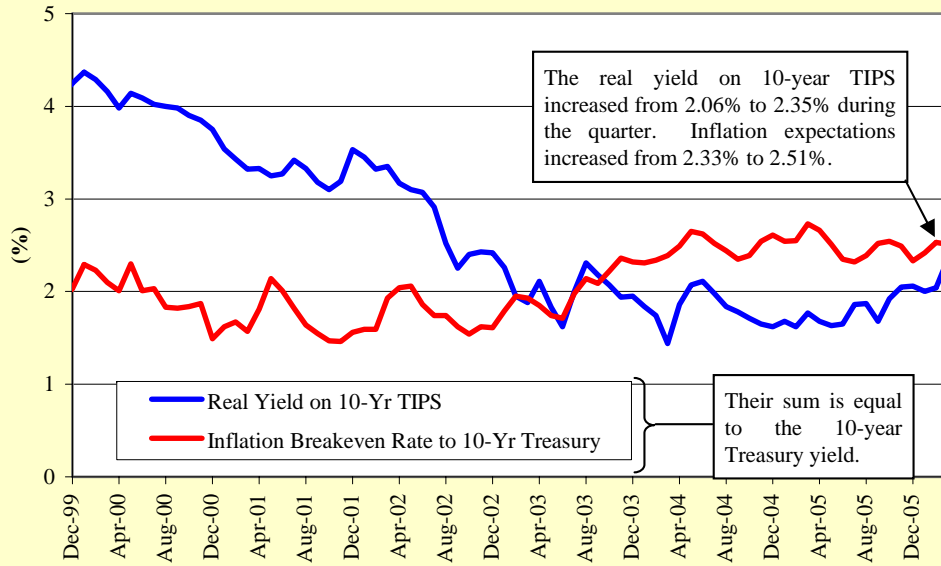
The Fed Drains Liquidity

- As expected, the Federal Reserve raised the Fed Funds rate from 4.25% to 4.75% in the first quarter. At the beginning of the year, the Fed Funds Futures market expected a 4.75% peak for this cycle. Now, futures suggest that the Bernanke-led Fed will be more aggressive. They predict a 5% overnight lending rate is very likely after the May meeting, and the chances of 5.25% rate after the June meeting are now above 50%.
- The Fed's aggressive stance on short-term rates is apparently an effort to push up long-term rates, and it finally seems to be working. In contrast to 2005, long-term rates rose along with short-term rates during the quarter. The yield curve made nearly a parallel shift. The 10-year bond yield rose by 47 bps to 4.85%. This is highest yield for the 10-year since spring 2004. Based on the pricing of TIPS, most of the increase in the 10-year bond yield was due to higher real interest rates.
- The economy and asset markets have been boosted by liquidity and debt growth. While the latest available data show that liquidity and debt growth remain high, the steep increase in short-term rates over the last 21 months and the bump in longer-term rates may finally begin to stem the flow. Household debt growth will be more sensitive to increases in long-term rates than short-term rates because the bulk of borrowing still occurs through fixed rate mortgages.
- The Fed has a delicate balancing act. It cannot control long-term rates directly, so it must use the blunt tool of short-term rates. Using short-term rates to influence long-term rates risks an overshoot, which would put the housing market and other asset markets at risk. With the global imbalances, the economy may be more accident prone than usual.
- A continued gradual increase in real interest rates should be positive for the long-term health of the economy because it should lead to higher savings and reduced debt growth. This would eventually reduce the current account deficit. However, it could prove a difficult environment for assets heretofore propelled by excess liquidity.



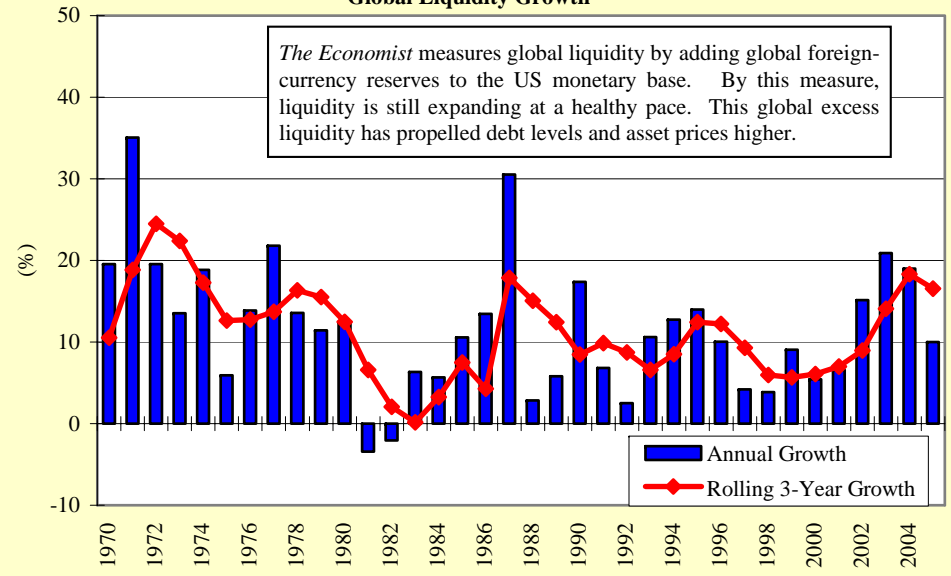
The Fed Drains Liquidity (cont.)

Decomposition of 10-Year Treasury Yield



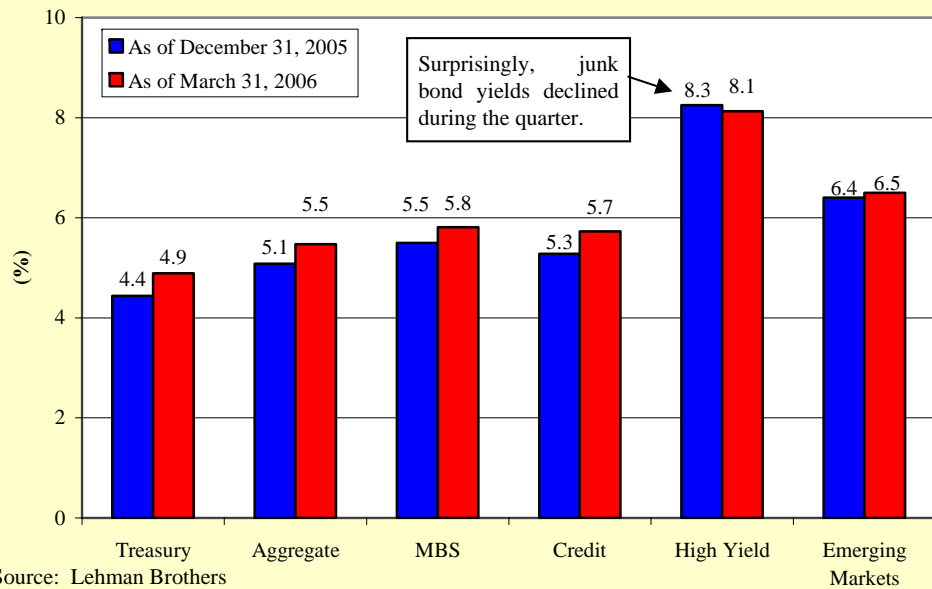
Source: Federal Reserve

Global Liquidity Growth



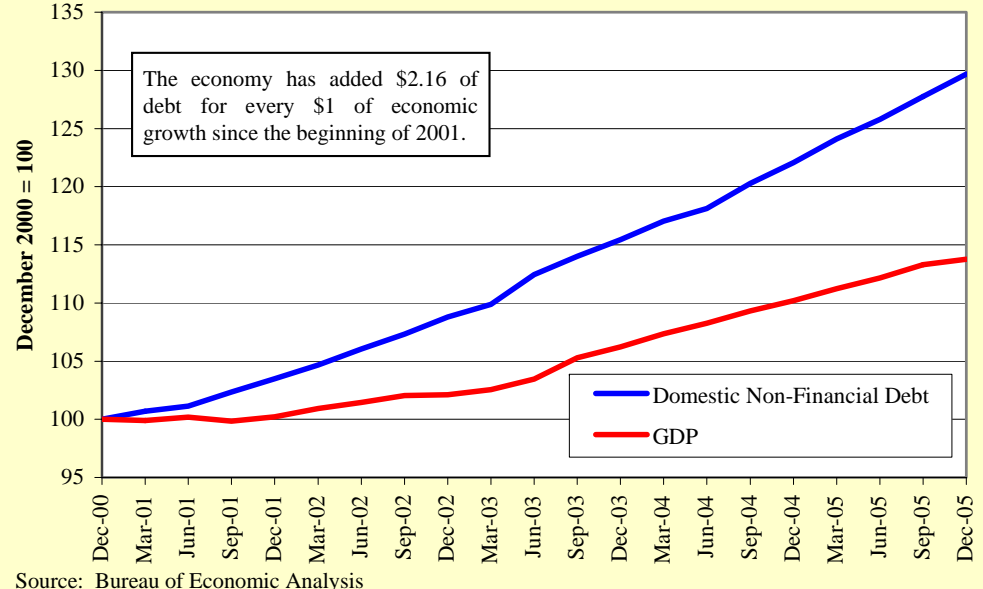
Source: IMF, Federal Reserve, Hammond Associates

Yields on Lehman Bond Indices



Source: Lehman Brothers

GDP Growth Versus Debt Growth

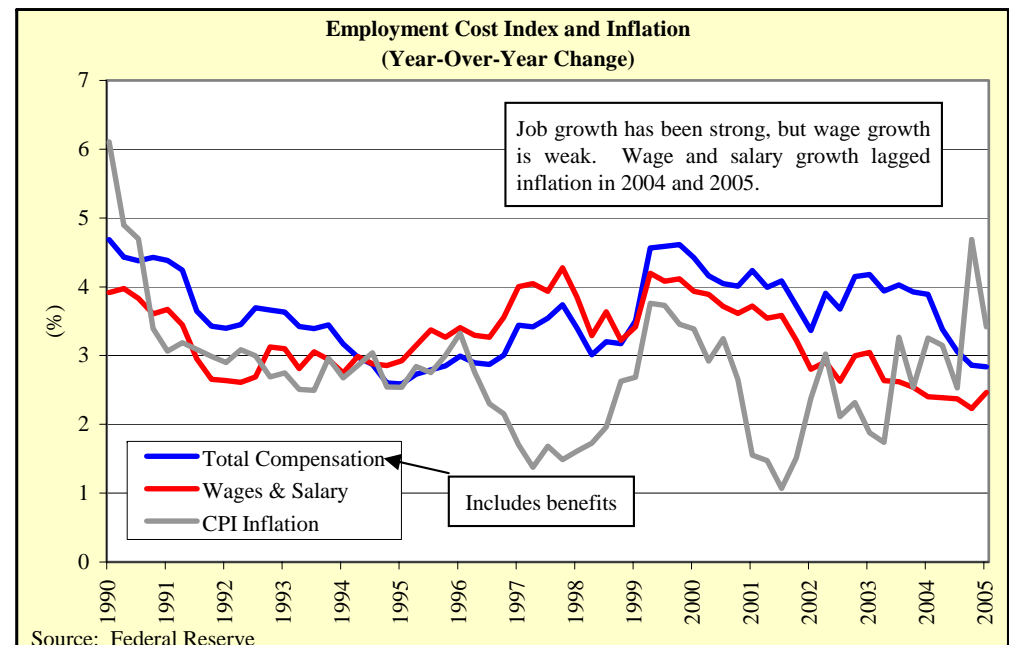
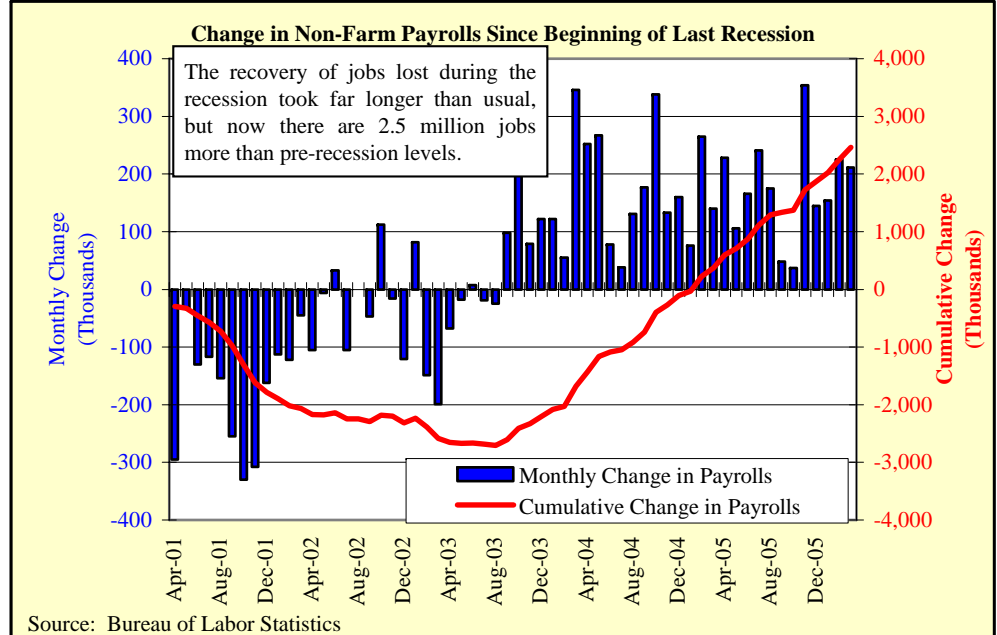


Source: Bureau of Economic Analysis

Economic Growth Slowed in the Fourth Quarter

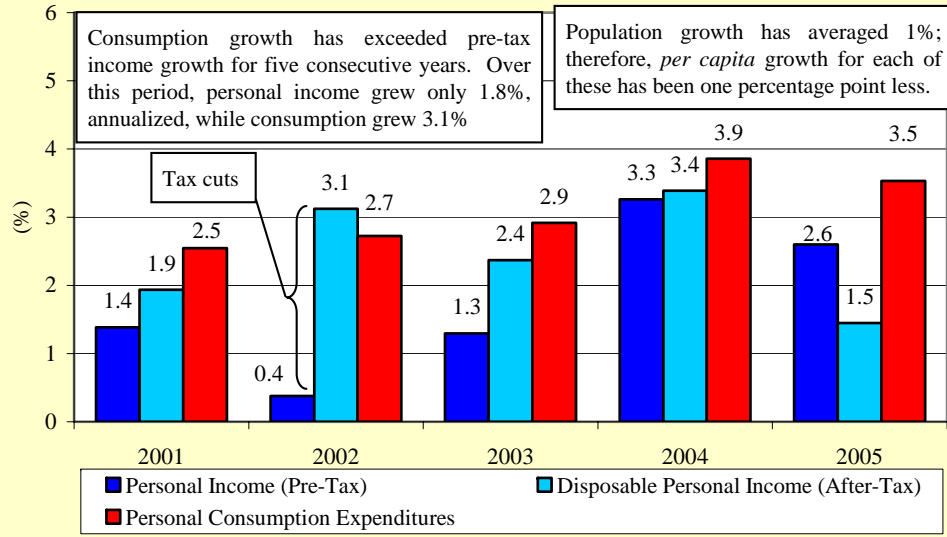
- Economic growth in the fourth quarter of 2005 was disappointing at only 1.7%, annualized. Nevertheless, the economy grew at a respectable 3.5% pace for the full year. First quarter 2006 growth was likely very strong, thanks in part to a warm January and a catch-up from weak fourth quarter growth. Economists expect first quarter growth to come in around 5%.
- Employment growth remains strong. The economy added 590,000 jobs during the first quarter, and the unemployment rate fell to 4.7%. However, strong job growth is not yet translating into real wage growth. Wage growth has trailed inflation over the last twelve months.
- Natural gas prices plummeted thanks to the warm January. As a result, winter heating bills weren't as high as expected. However, oil prices rose during the quarter from \$60 to \$66 per barrel, due in part to the situation in Iran and instability in Nigeria. This, along with refinery closures for maintenance, has sent gasoline prices upward. It looks to be an expensive summer driving season for motorists.
- Consumption growth has been driven by a reduction in savings and high debt growth. With interest rates rising and the housing market slowing (see page 16), consumption growth seems likely to fall below income growth, restoring the savings rate. This could mean consumption growth of 2% or less over the next several years. Since personal consumption makes up 70% of economic activity, this would be a significant drag on economic growth.

	2005 Growth (%)	Contribution to 2005 Growth (%)
Personal Consumption Expenditures	3.5	2.5
Residential Fixed Investment	7.1	0.4
Non-Residential Fixed Investment	8.6	0.9
Change in Inventories	-	(0.3)
Government Consumption	1.8	0.3
Trade Balance	-	(0.3)
GDP	3.5	

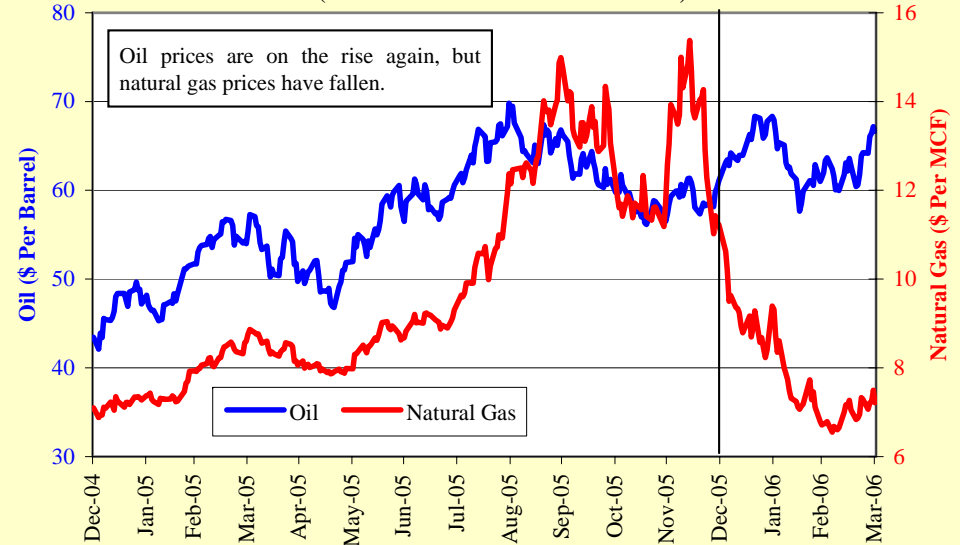


Economic Growth Slowed in the Fourth Quarter (cont.)

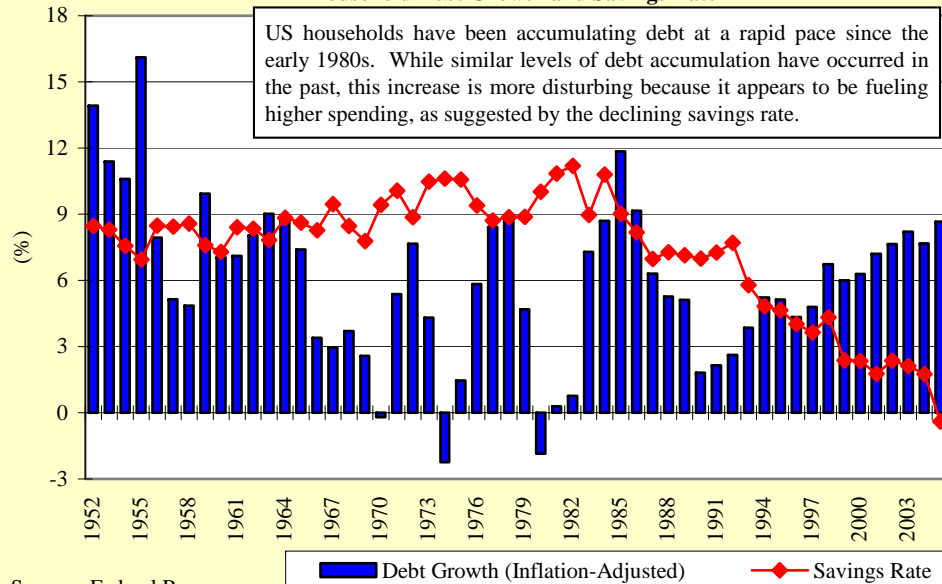
**Annual Growth in Personal Income and Consumption
(Inflation-Adjusted)**



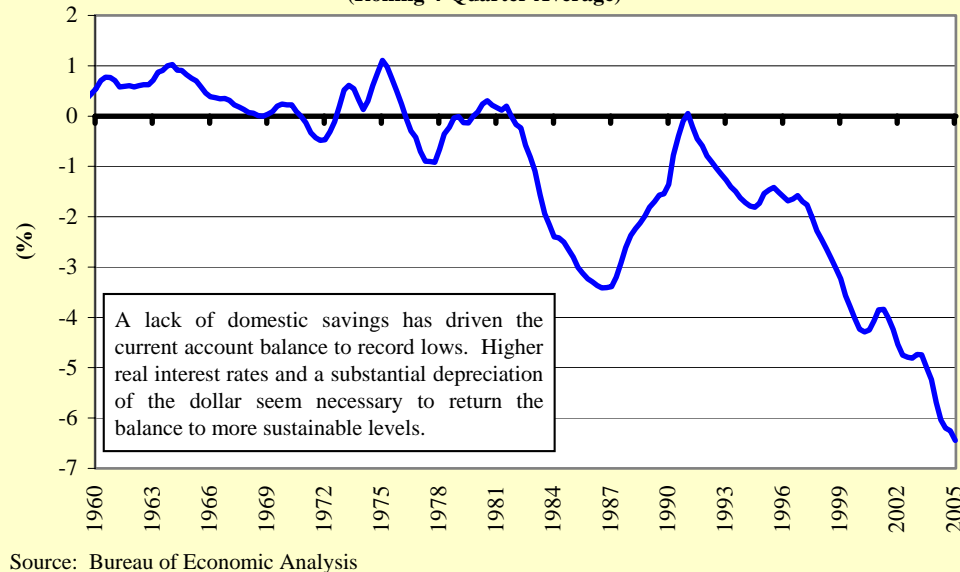
**Oil and Natural Gas Prices
(Forward Month NYMEX Contracts)**



Household Debt Growth and Savings Rate

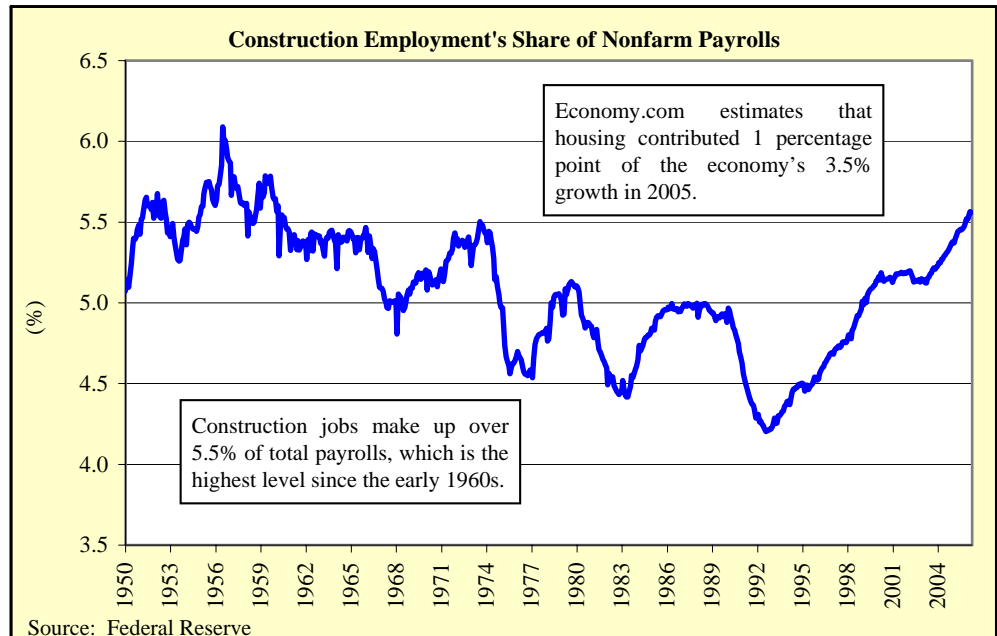
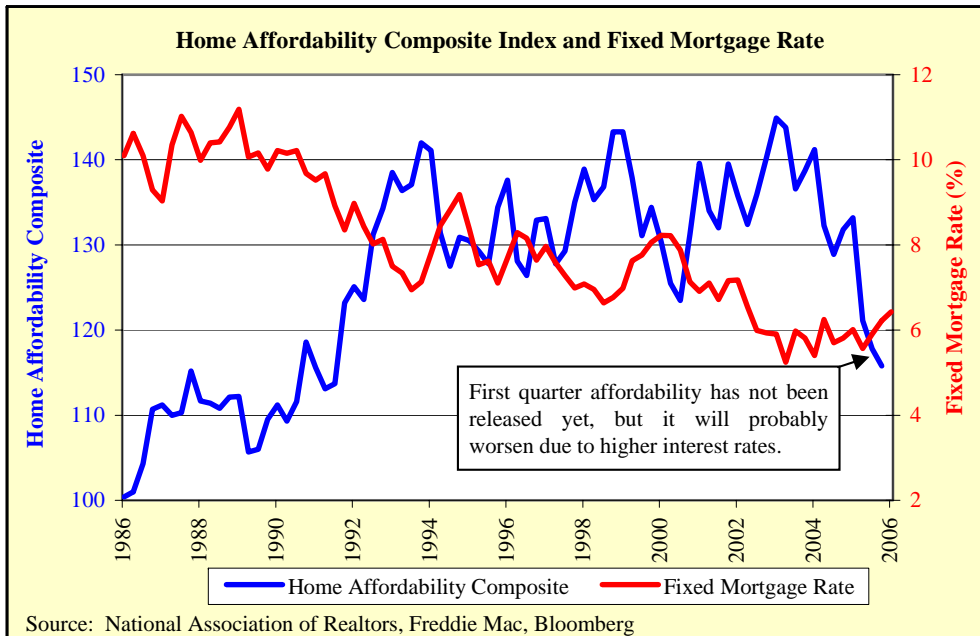
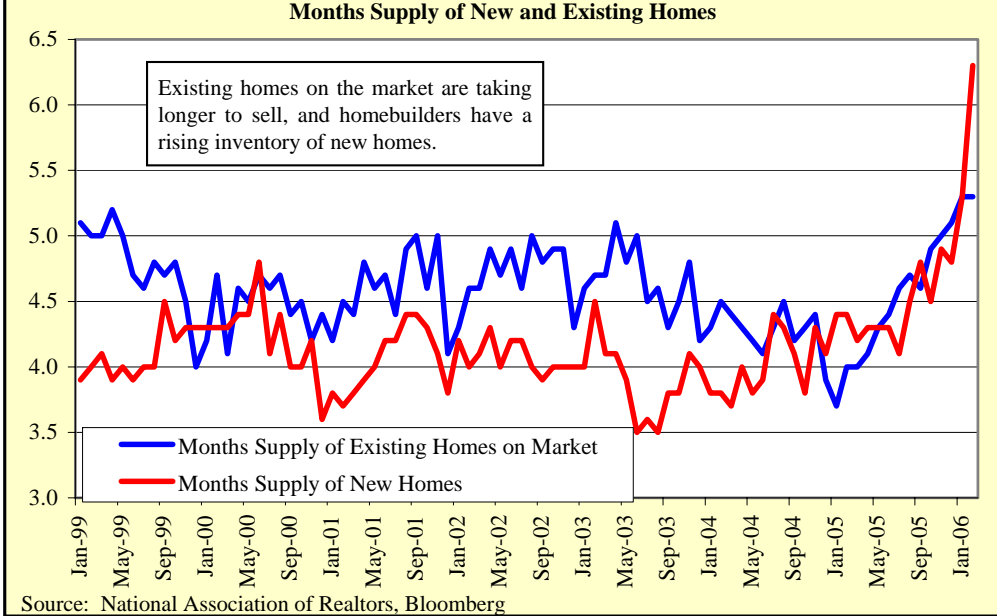


**Current Account Balance as a % of GDP
(Rolling 4-Quarter Average)**



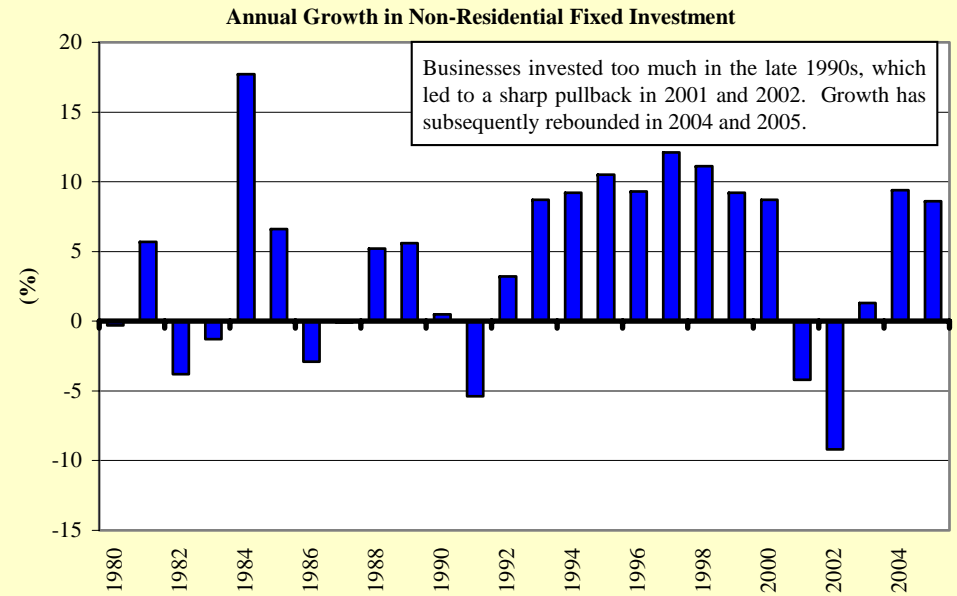
Another Crack in the Wall

- 2005 was another great year for the housing market. According to Freddie Mac, prices appreciated 13%.
- However, housing activity is showing clear signs of slowing. The inventory of new and existing homes has risen sharply. Home affordability hit a 14-year low last quarter due to exploding prices. Now, fixed mortgage rates are drifting upwards, which will further deteriorate affordability. The 30-year mortgage rate has risen from 6.22% to 6.43% this year. Residential real estate investment currently makes up 6% of the economy, and it seems very likely to decline.
- The run-up in housing prices has encouraged debt expansion and contributed to the falling savings rate. It looks increasingly likely that residential real estate prices have topped out, and a fall in nominal prices can't be ruled out (especially in the hottest markets). We could be in for a decade or more of stagnating prices. This will require households to truly save, instead of allowing asset prices to substitute.

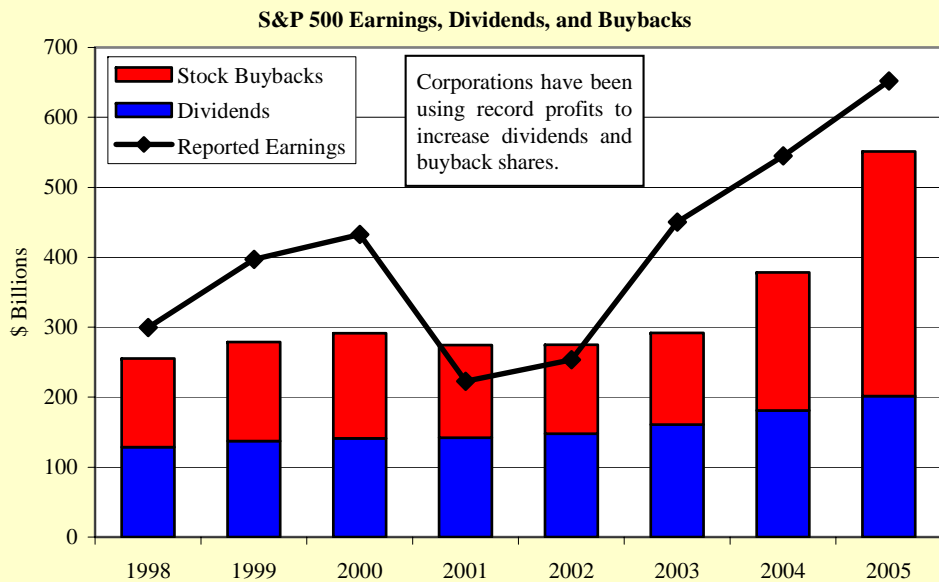


Will Business Investment Pick Up the Slack?

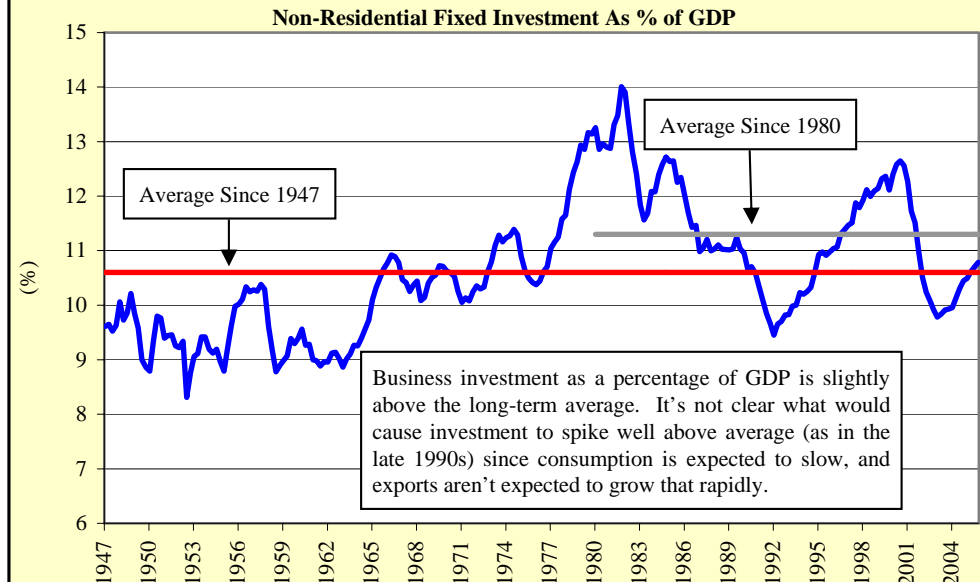
- Personal consumption growth seems likely to slow in the coming years. With record profits for US corporations, some hope that business investment will keep the economy growing strongly.
- Personal consumption makes up 70% of the economy (and residential fixed investment an additional 6%), while business investment makes up less than 11%. Therefore, it takes about a 6% increase in investment to offset a 1% decline in consumption growth.
- It's not clear that businesses need to increase the investment pace significantly. If personal consumption growth slows, it means slowing demand for business output. Furthermore, business investment has already been growing at a healthy pace over the last two years, and the level relative to the overall economy is slightly above the long-term average (albeit below the average since 1980). Higher export growth could lead to a ramp-up in business investment. However, until the dollar weakens, US businesses will be more likely to satisfy foreign demand with foreign direct investments.



Source: Bureau of Economic Analysis



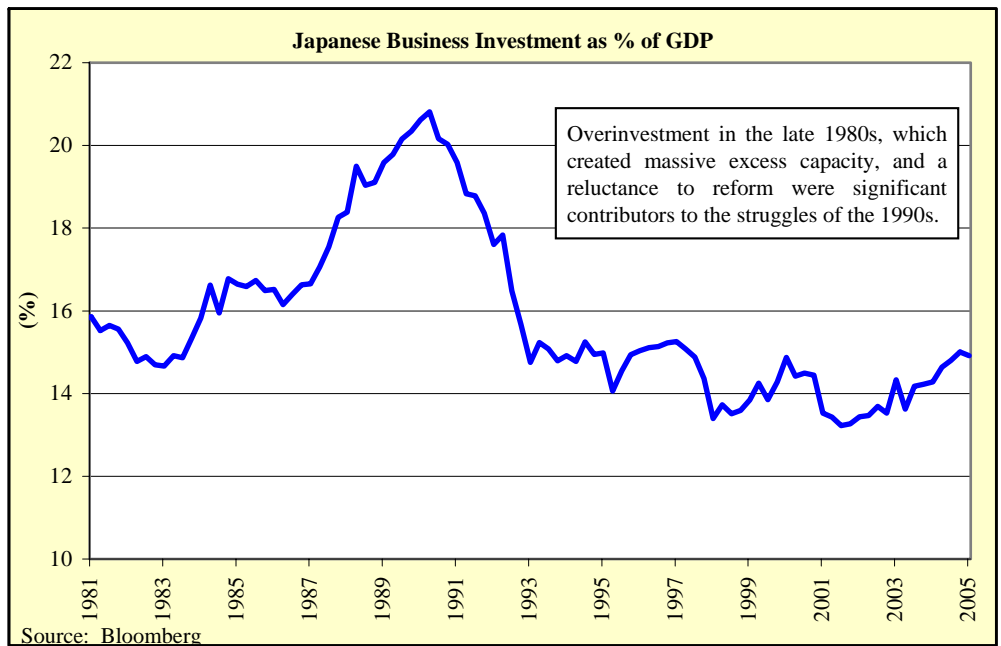
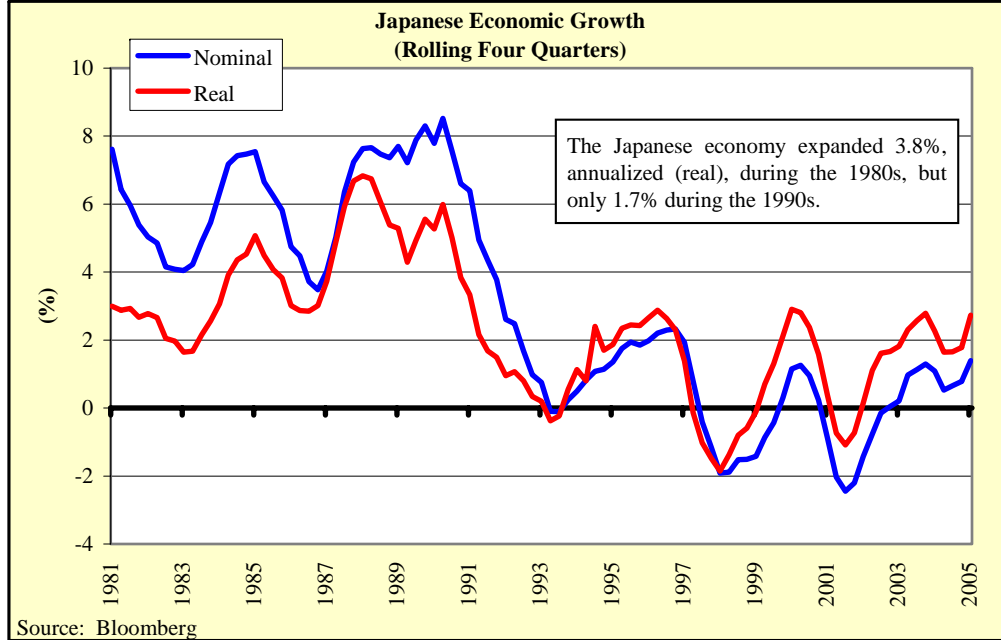
Source: S&P



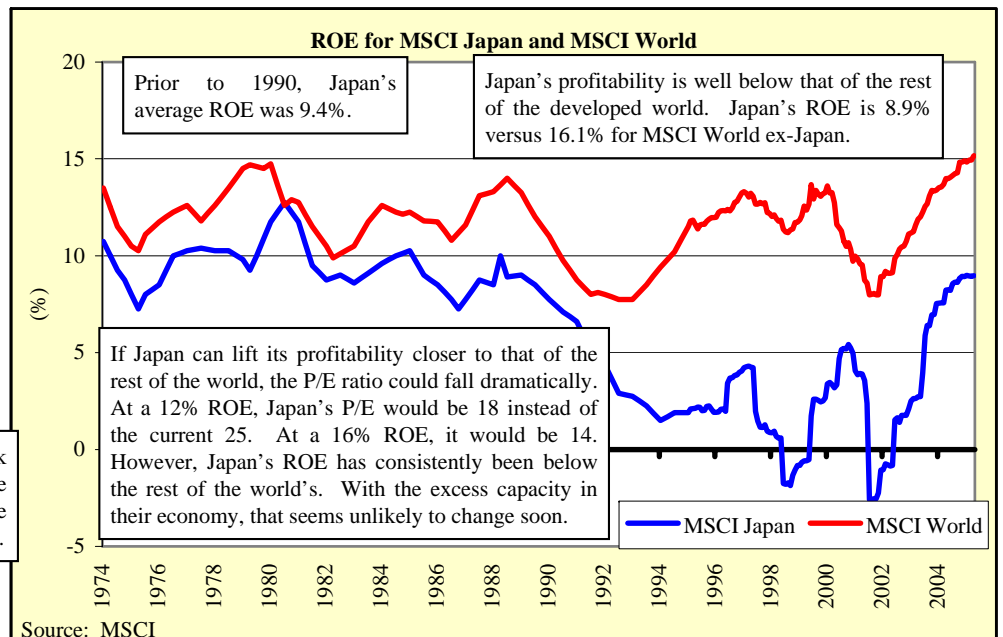
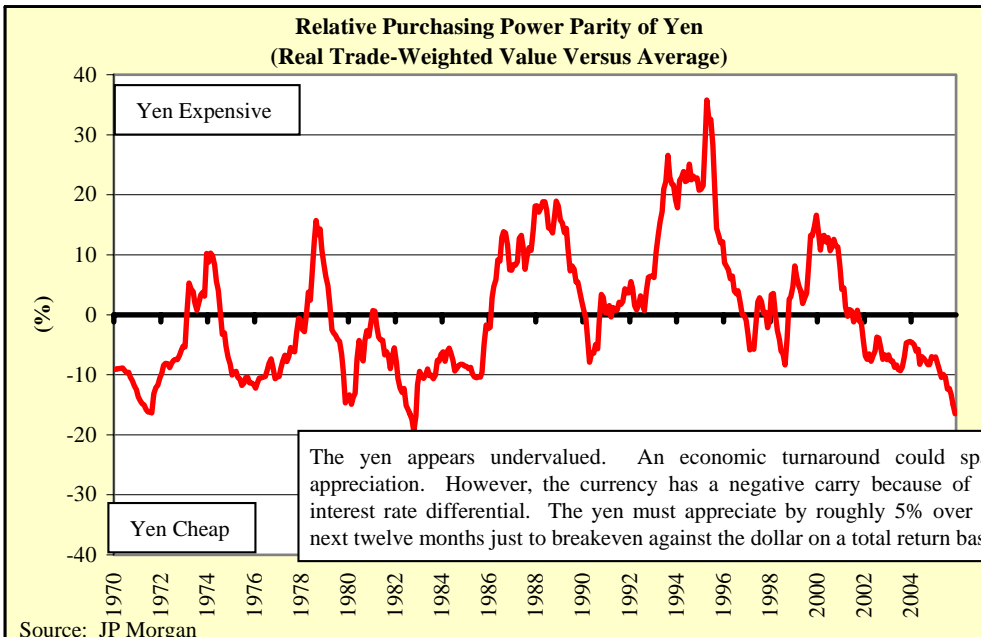
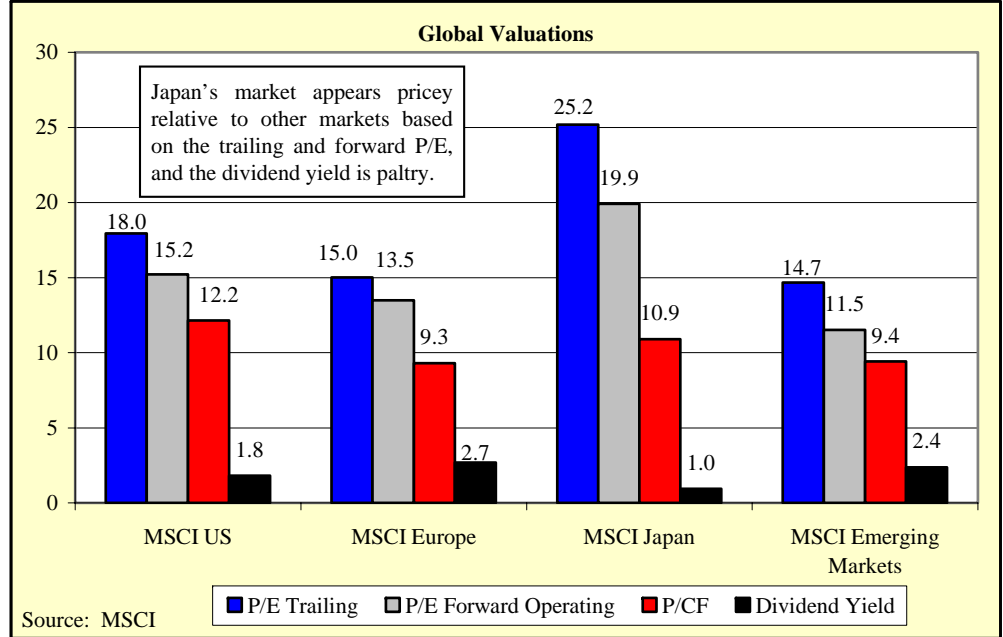
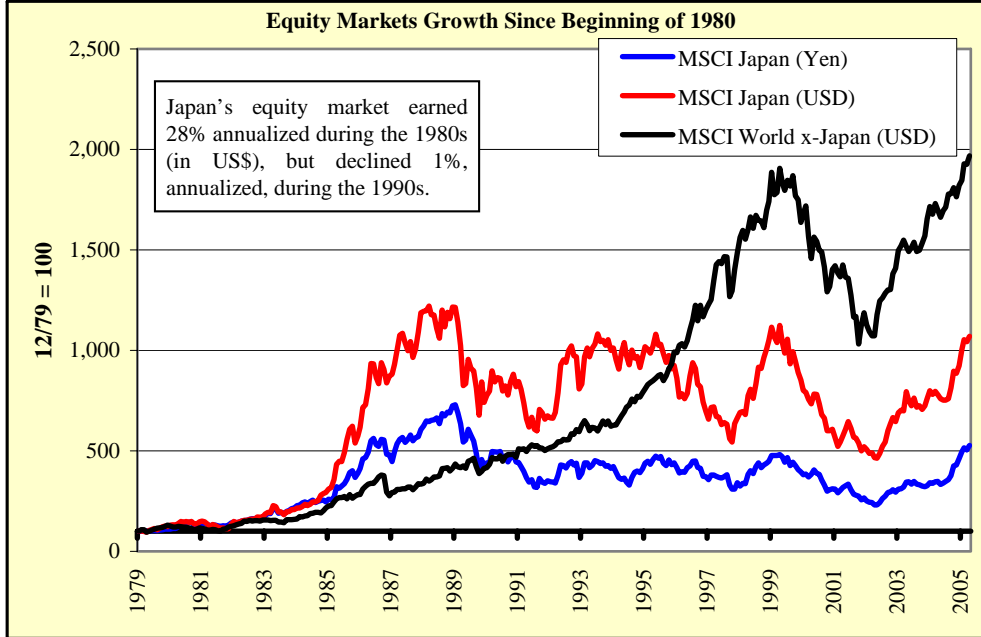
Source: Bureau of Economic Analysis

Japan—Is This Time for Real?

- It appears that Japan's decade-plus economic slump may finally be coming to an end. The economy grew at 2.7% in 2005 on top of 2.3% in 2004. This was the strongest two-year period since 1990-91. The latest Tankan business survey reached its highest level since 1991.
- The Bank of Japan announced a halt to its quantitative easing policy. This policy meant flooding the banking system with money to encourage loans and end deflation. Markets now anticipate the Bank of Japan will lift overnight interest rates from zero later this year. The yield on the 10-year bond has risen from 1.48% to 1.78% this year.
- The economy still faces challenges. There remains excess business capacity. Government debt to GDP is very high at 160% of GDP (although Japanese households are the creditors). In contrast, the US public government debt is 40% of GDP. This suggests tax increases will be necessary. Another challenge is demographics. Japan has an aging population and birthrates are very low. The working age population is currently contracting and that is expected to continue.
- Japan's economy is the second largest in the world. A growing Japanese economy could help to ease pressures on global growth if US consumption slows. Which economies will benefit the most?
 - Our country's share of Japanese imports has been in decline for the last seven years. In 1998, our share of Japanese imports was 24%. Today, it is just 12%. China, in contrast, has seen their import share rise from 14% to 21%. Other Asian economies have a 24% share.
 - Our exports to Japan should rise if the recovery continues, particularly if the yen appreciates. However, it probably won't be enough to push the needle significantly since exports to Japan make up only 0.4% of our economy. It appears that China and other Asian countries will continue to be the biggest beneficiaries.
- Since the beginning of 2005, Japan's equity market has gained 34% versus 9% for the US and 21% for Europe. On a current valuation basis, Japan looks expensive to the rest of the world with a trailing P/E of 25. Equity markets already appear to be pricing in a recovery.

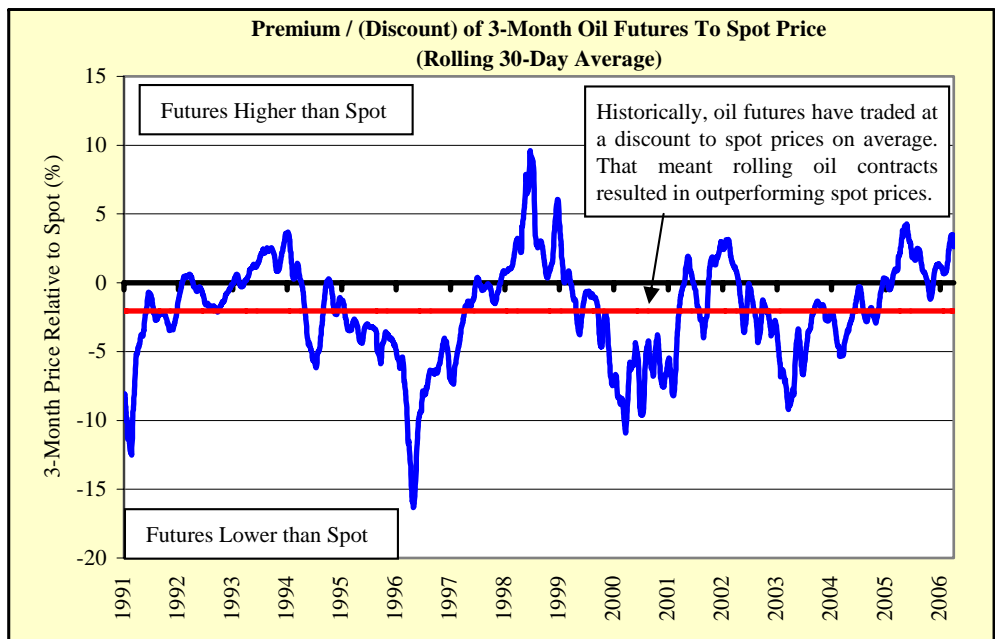
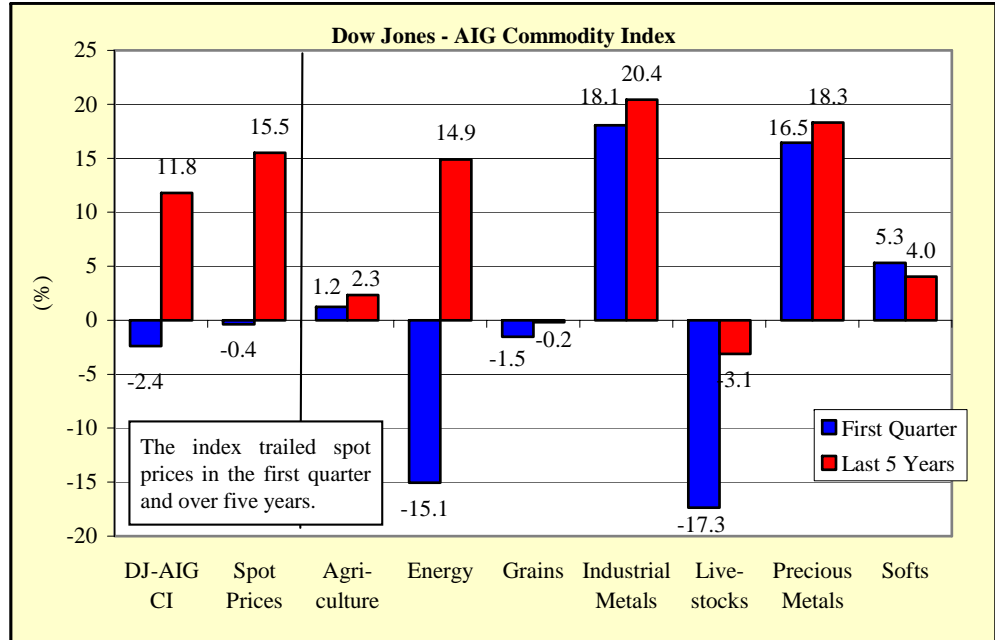


Japan—Is This Time for Real? (cont.)



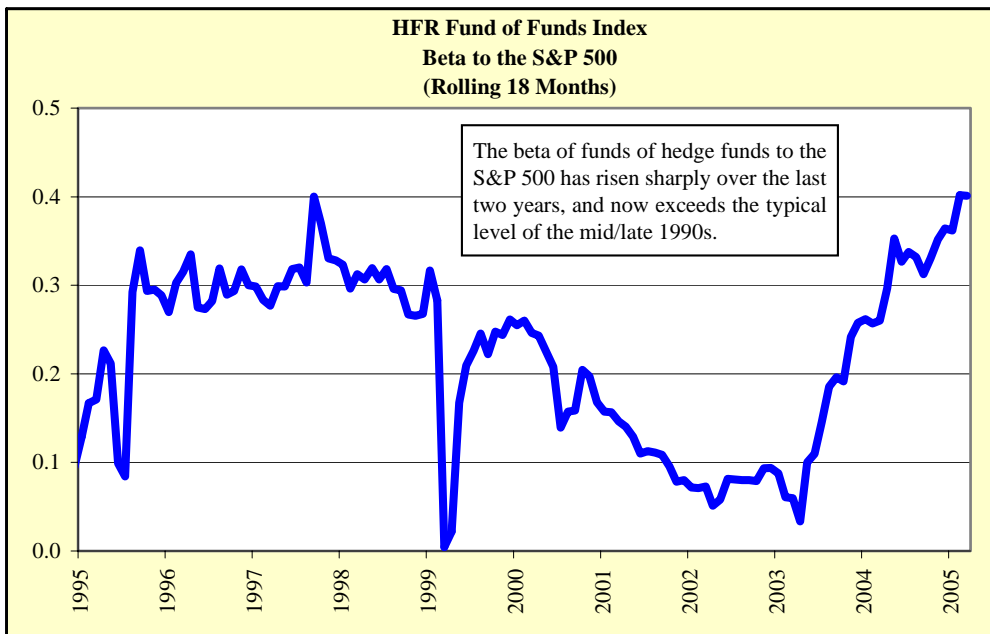
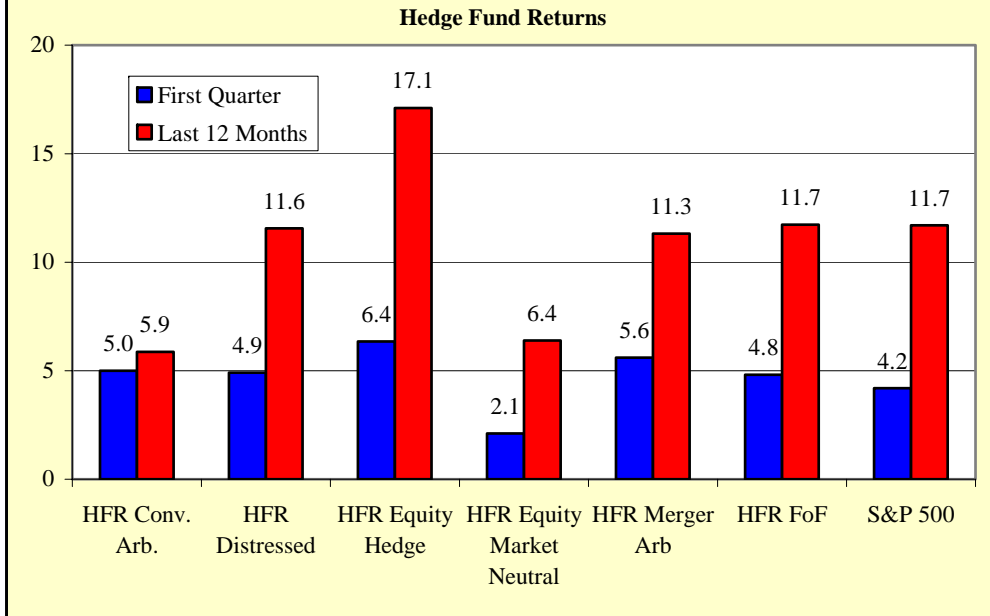
Real Assets: Contango for Commodity Indexes

- The Dow Jones-AIG Commodity Index fell 2.4% during the quarter. While the industrial and precious metal components surged, the energy index fell 15% due to plummeting natural gas prices.
- The roll yield on the DJ-AIG Commodity index and other commodity indexes has turned negative in recent years and is worsening. The roll yield represents the return of investors rolling futures relative to spot (current delivery) prices. The roll yield is negative when rolling commodity futures results in underperforming the underlying commodity.
- Historically, the roll yield has usually been positive. Investors have been able to purchase futures contracts on commodities at a discount to spot prices (called backwardation). The justification for this is that producers are usually willing to give a discount to lock-in future prices. Therefore, the roll yield is considered a risk premium for providing the price protection to hedgers.
- Many commodity futures are now trading at a *premium* to spot prices (called contango). This is most evident in energy markets. Three-month crude oil futures are trading at a 2.4% premium to spot (adjusted for implied financing rate), or 10% annualized. If this holds, oil has to rise 10% over the next year for an investor rolling 3-month contracts just to break even. There are a couple of possible explanations:
 - ✓ This may reflect the expected future supply and demand situation for oil and other commodities. Participants may rationally expect the supply and demand situation to be tighter a few months out.
 - ✓ Another possibility is that financial buyers are distorting the market and eliminating the risk premium available to long only commodity investors. Assets tracking commodity indexes, such as the DJ-AIG CI and GSCI, have risen from \$5 billion in 2000 to \$80 billion. Hedge funds and other speculators are also long commodities.
- Commodity index investors face stiff headwinds. We still suggest commodity exposure as an inflation hedge, but investors with the means should consider direct investments in commodities, as well.



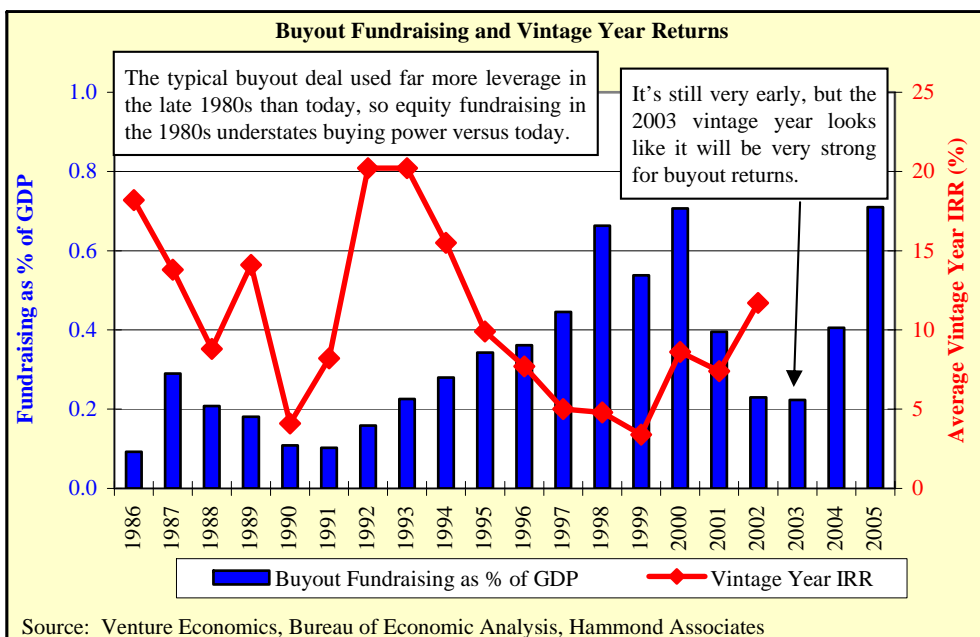
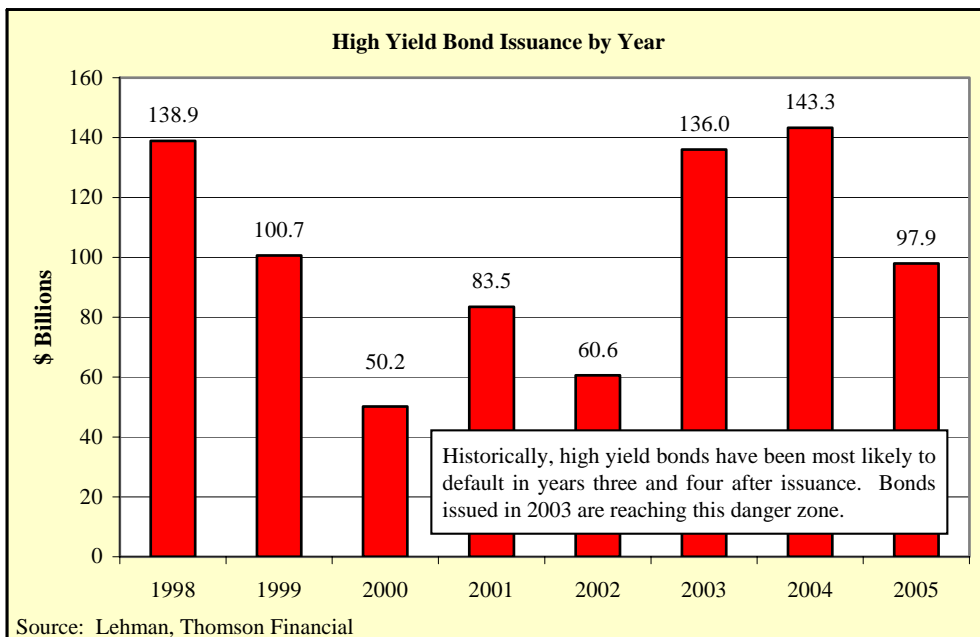
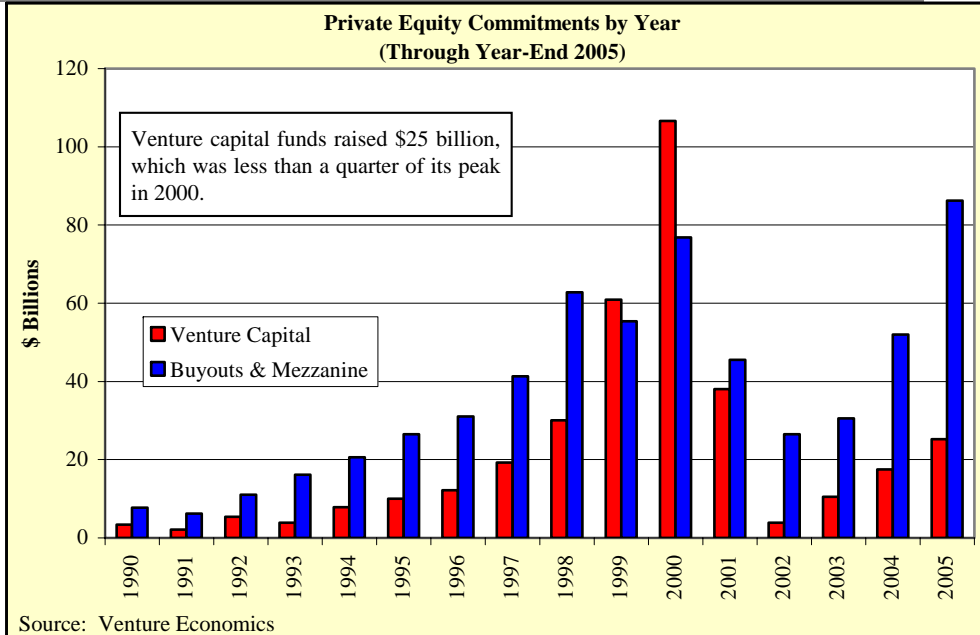
Hedge Funds: A Return to Double Digits

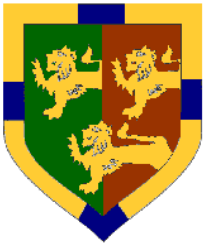
- On the wings of a strong quarter where virtually every strategy experienced success, hedge funds have returned to double digits, posting a return of 11.7% for the 12-months ended March 2006. With the exception of the rally of April 2003 through March 2004 where everything advanced, hedge funds have not seen double digits since the bear market began.
- Today's double digit returns, however, look much different than those of the past.
 - ✓ Hedge funds traditionally produced consistent double digit returns through a balanced exposure to arbitrage and directional strategies. Convertible arbitrage, merger arbitrage, and statistical arbitrage were some of the largest contributors to hedge fund returns through the 1990s, providing investors a lower risk route to achieving these types of returns.
 - ✓ Hedge funds, in the aggregate, have become much more directional. The opportunity in the lower risk strategies has dissipated as investors flooded the marketplace. As a result, the double digit returns seen today have come through the acceptance of greater risk.
- The takeaway here is that it is important for investors to be aware of their manager's underlying source of returns. The current environment does not look friendly to what we perceive to be the aggregate positioning of the hedge fund marketplace. Credit spreads are as tight as they were just prior to the liquidity crisis in the fall of 1998. Equity valuations are high globally, and current corporate profit margins (a typically mean reverting metric) are very high. Volatility is low and investor complacency is high. Finally, the Fed continues on its march to remove liquidity from the marketplace.
- These characteristics have presented challenges to those with directional risk in the past, and they all exist at once in the current environment.



Private Equity: A Record Year for Buyouts

- According to Venture Economics, buyout fundraising reached a record level of \$86 billion in 2005. The question now is whether this money can be put to work earning attractive returns.
- Mega buyout funds are targeting larger prey, which may make this capital easier to deploy. However, history suggests caution. As a percentage of GDP, similar fundraising occurred in 1998 through 2000, and those proved to be disappointing years for the average buyout fund. The average IRR was less than 10% in all three years.
- Distressed debt managers are eagerly awaiting an increase in default rates. The high issuance of junk bonds in 2003 and 2004 should provide opportunities before long, particularly if there is an economic hiccup. However, the next cycle may not prove to be as rewarding as the last. There seems to be far more money on the sideline waiting to pounce than in 2002.





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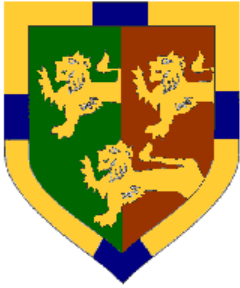
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