Hammond Associates
INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

Second Quarter 2006

In this report . . .

✓The Return of Volatility
✓The Global Liquidity Drain Continues
✓Stagflation on the Horizon?
✓Emerging Markets: A Risk of Contagion?

Second Quarter Research Report Overview

Table of Contents

Executive Summary

- Equity markets finished the second quarter lower as volatility returned. The S&P 500 slipped 1.4% and the Russell 2000 dropped 5%. The MSCI EAFE index gained 0.7% (in US$) thanks to the weak dollar. In local currencies, the index fell 4.2%. Emerging market stocks ended the quarter 4.3% underwater after being up as much as 12% and down as much as 15%. All major equity asset classes remain in the black year-to-date.
- The Fed lifted the Fed Funds rate from 4.75% to 5.25% during the quarter. We're likely to see at least one more quarter point increase in this cycle. Other central banks around the globe are also tightening monetary policy.
- The US economy grew at a 5.6% annualized rate in the first quarter of 2006. However, growth looks to have slowed in the second quarter. The headwinds facing consumers may finally be impacting spending.
- Oil prices continued their upward march. Light crude oil finished the quarter at $74 per barrel. Prices should moderate or even decline as new capacity comes on-line and demand growth slows in reaction to higher prices. Nevertheless, we recommend meaningful energy exposure in portfolios as a hedge against a major supply shock.
- With the economy at risk of slowing, there are rising concerns that we may experience a stagflationary environment, similar to the 1970s. Absent a significant energy supply shock, 70s-styled stagflation does not seem likely over the short- to intermediate-term in this era of globalization. Despite this, inflation-protected bonds seem a better value than nominal fixed income securities, because inflation-protected bonds offer cheap insurance against inflation.
- The dollar weakened against most major currencies in the second quarter. The dollar still looks vulnerable because of the huge current account deficit. We continue to recommend substantial exposure to foreign currencies that will benefit from a secular depreciation of the dollar.
- We continue to believe that equities and other risky asset classes face a challenging environment as risk premiums appear too low. The withdrawal of global liquidity and potentially weaker global economic growth will likely continue to roil markets.
- The performance of emerging market equities during the quarter is a reminder of how volatile this asset class can be. We believe emerging market equities still offer attractive long-term return opportunities, but investors should be prepared for a bumpy ride along the way. We are concerned about their reliance on US consumption growth, and current valuations leave little room for error.

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Market Commentary: The Return of Volatility July 2006

The second quarter began much the same way the first quarter ended, as the seemingly indiscriminate buying of the riskiest asset classes intensified. Emerging markets equities surged an eye-popping 12% during the first 5½ weeks of the quarter, lifting their year-to-date return to 25%. The S&P 500, meanwhile, was plodding along with a 2% return for the quarter and a 7% return for 2006. The good times ended on May 11 when markets globally began a nose dive. Over the next month, the S&P 500 shed 7%. The index turned out to be a *relative* safe haven. Riskier markets that enjoyed the run-up earlier in the year suffered the most. The MSCI Emerging Markets index tumbled 24%. The MSCI Japan index fell 19%, and the Russell 2000 index lost 13%. The last two weeks of June brought a rebound, which turned an awful quarter for many equity asset classes into a merely disappointing one. Major equity markets remain in the black year-to-date.

	Jan. 1 to May 10	*May 11 to June 13*	*June 14 to June 30*	*2006 YTD*	*Second Quarter*
S&P 500	6.7	(7.3)	3.9	2.7	(1.4)
Russell 2000	15.6	(13.2)	7.8	8.2	(5.0)
MSCI Japan	14.3	(19.1)	10.2	1.9	(4.6)
MSCI Europe	20.5	(12.9)	8.2	13.6	2.5
MSCI Emerging Markets	25.5	(24.1)	12.5	7.2	(4.3)
MSCI Invest. Hedge Funds	6.0	(4.3)	1.5	3.0	(0.6)
Industrial Metals	63.2	(19.0)	12.2	48.8	26.1
Oil	18.2	(4.9)	7.8	21.1	11.0
Gold	36.9	(20.6)	9.6	19.1	5.5

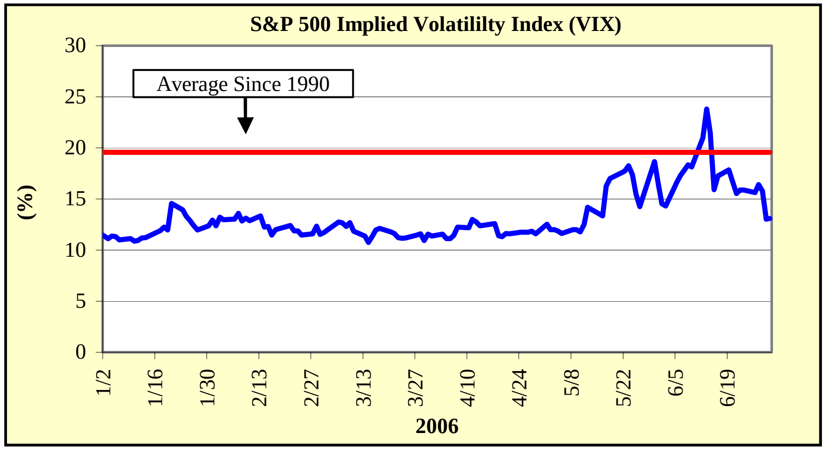
Commodity markets followed a similar path. Industrial metals and gold both experienced substantial gains for the year until May 10, but gave some of those gains back over the next month. Gold fell 21% from May 11 to June 13, failing to live up to its reputation as a hedge. Still, gold is up 19% so far in 2006. The performance of industrial metals has been particularly surprising. They surged 63% for the year until May 10, and fell 19% over the next month. So far in 2006, industrial metals are ahead a staggering 49%.

The day-to-day movements in markets became a lot choppier in May and June. The S&P 500 moved by 1% or more in 27% of the trading days in May and June (12 of 44), compared to just 9% in January through April (7 of 81). The S&P 500 had a 2% move day on June 15 (+2.3%) for the first time since 2003, and there was a second 2% move (again positive) that occurred on June 29.

Risk Aversion Returns

Renewed risk aversion appears to be a contributor to the turmoil during the quarter. In general, the riskier the asset, the more it lost after May 10. As we pointed out in this report last quarter, investors have pushed risk premiums (the expected return above the risk-free rate) on global assets to razor-thin levels. Low risk premiums mean there is very little margin for error in asset pricing.

One measure of the market's risk tolerance is the VIX index. The VIX index measures the implied volatility in option prices on the S&P 500. The higher the VIX index, the more it costs to buy portfolio protection. The VIX had been trending downward over the last few years and that continued through the first four months of this year. The VIX was trading around 10% at one point this year, suggesting that the S&P 500 had an expected annualized standard deviation of 10%. Since 1990, the VIX has averaged 19%. The VIX rose sharply beginning on May 11, and hit a high of 24%, suggesting that investors were willing to pay much more for portfolio protection. The index settled down towards the end of the month and finished the quarter at 13%, well below average, as markets rebounded.



The Drain of Global Liquidity

The reevaluation of risk tolerance occurred as the Federal Reserve and other central banks continued to lift interest rates. Central banks globally are tightening their monetary policies to sop-up excess liquidity resulting from abnormally low interest rates and ballooning debt levels. This excess liquidity played a key role in the run-up of risky asset classes and housing markets over the last few years. Liquidity is the fuel of momentum-driven asset pricing.

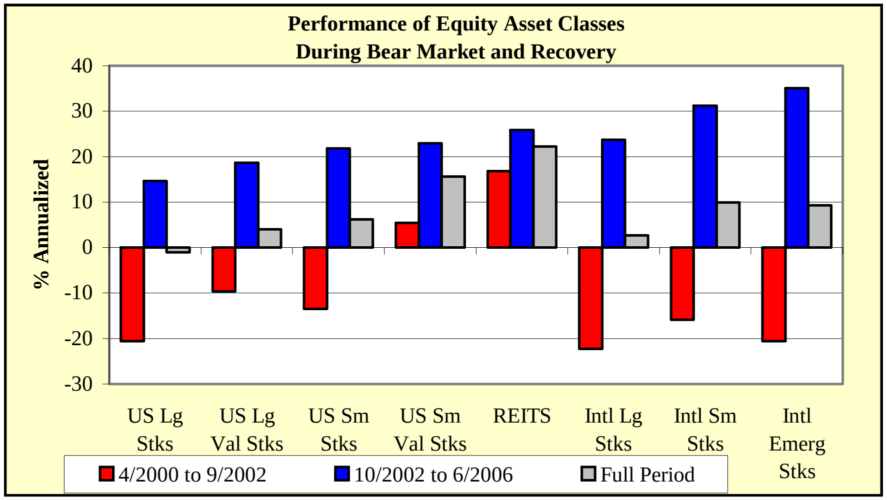
This reduction in liquidity certainly shouldn't have surprised the market. The Federal Reserve has been moving in this direction since June 2004, when it lifted the Fed Funds rate from the floor of 1%. Granted, the Fed has been more aggressive than expected in 2006. At the beginning of the year, the market expected the Fed to stop at 4.75%. It was after the May 10 meeting, when the Fed lifted the overnight rate to 5% and hinted that more increases may still be forthcoming, that markets seemed to begin paying attention to the potential decline in global liquidity.

The actions of the Bank of Japan may have been the most significant to asset markets during the quarter. On March 9, Japan, perhaps the largest supplier of global liquidity, announced the end of its quantitative easing policy. With interest rates already at zero, the quantitative easing policy was enacted to inject additional liquidity into the economy in an attempt to end deflation. Between March and June, the Bank of Japan removed about 20 trillion yen from the banking system, or about $174 billion. This was a substantial liquidity drain in such a short span. The speculation has been that hedge funds and others were engaging in the yen carry trade—borrowing yen at near zero rates to invest in higher yielding, riskier assets. This removal of bank reserves drained the amount of yen available to borrow. Still, the Bank of Japan announced this would happen two months before equity markets peaked.

The liquidity environment is not likely to improve anytime soon. The European Central Bank has increased interest rates three times since last December, and two more increases are expected in 2006. The Federal Reserve is nearly finished, but one or two increases may still be in store. After ending its quantitative easing policy, the Bank of Japan is just beginning to lift interest rates. It finally ended its zero interest rate policy on July 14 by lifting the overnight lending rate to 0.25%.

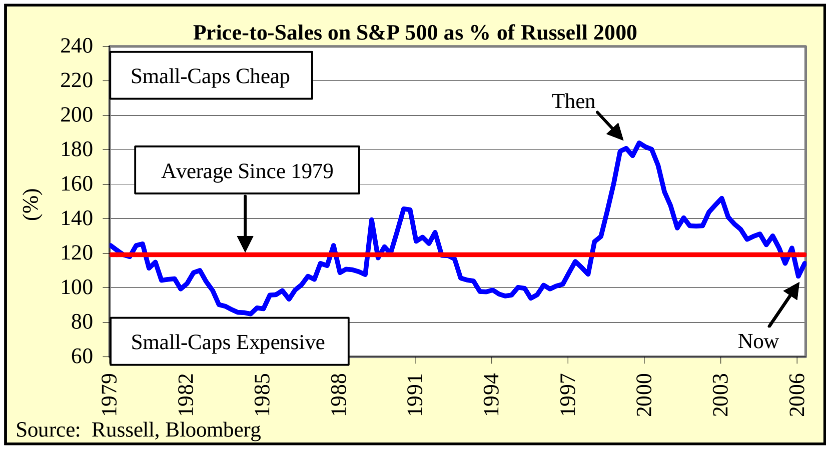
Diversification Isn't What It Used to Be

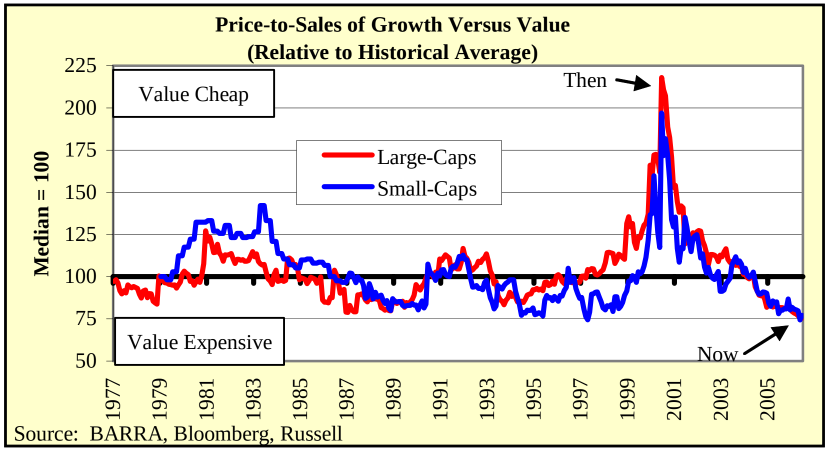
It remains to be seen whether the turmoil during the second quarter marks the beginning of a new bear market or just a minor correction. If this does mark the start of a new bear market, it will be much harder to hide from using traditional equity asset classes than the last one. In March 2000, the dominant equity asset class, US large-cap stocks, was among the most expensive in the world. Many other equity asset classes were comparative bargains. Value stocks were trading at deep discounts as their tech-dominated growth counterparts were driving the S&P's performance. Small-cap stocks were trading at much more attractive valuations than large-cap stocks. The combination of small-cap and value proved to be a particular bargain. REITS were trading at a dividend yield of 8%. Emerging market stocks were also inexpensive relative to domestic large-cap stocks.



Because of these valuation disparities, diversification away from the S&P 500 paid off during the bear market and the subsequent rebound. The S&P 500 declined an annualized 21% from March 2000 through September 2002. Large-cap value stocks (Russell 1000 Value) suffered less than half the decline. Small-cap stocks (Russell 2000) declined 13%. Small-cap value stocks *gained* 5% and REITS surged 17%. These investments also outperformed the S&P 500 substantially during the recovery. REITS have earned a stunning 22%, annualized, since March 2000. Emerging market stocks declined as much as the S&P 500 during the bear market, but they were such bargains at the bottom that they've been the top performing asset class since then. Emerging market stocks have earned 9% annualized since March 2000.

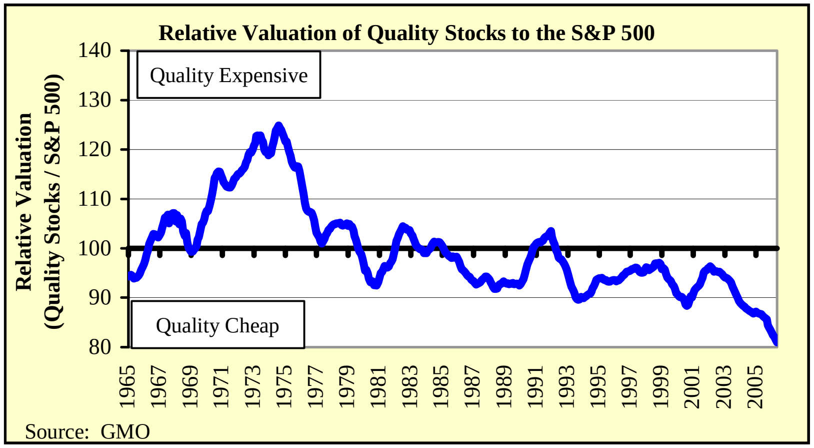
The picture today is completely different. The relative performance over the last six years has mostly corrected, and in some cases overcorrected, the valuation disparities. Nearly every equity asset class now appears expensive. Small-cap stocks are very pricey relative to large-cap stocks. In absolute terms, small-caps are more expensive today than in March 2000. Value stocks look rich versus growth stocks, so value stocks aren't likely to provide as much protection in the next downturn. The dividend yield on REITS has plunged from 8% to 4%. In March 2000, the S&P 500 was one of the riskiest equity asset classes because it was among the most overvalued. Today, it is among the least risky equity asset classes because other asset classes are even more overvalued. The S&P 500 is far from cheap, but we expect the index to be among the better performing asset classes in the event of a new bear market, as it was over the May 11 to June 13 period.





As we have outlined in previous editions of this report, one segment of the equity market that looks relatively attractive is high quality 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 tend to hold up better than the market during recessions and bear markets because their earnings are less sensitive to the economy. From March 2000 to September 2002, a proxy for this universe, the Oakbrook Stable Growth index, declined only 5%, annualized, versus a 21% decline for the S&P 500.

Currently, these stocks appear inexpensive relative to the market because they have underperformed significantly during the recovery. Since September 2002, they have earned only 10% annualized, compared to 15% for the S&P 500. GMO figures they are currently nearly 20% undervalued relative to the S&P 500. Quality stocks outperformed modestly during the second quarter. The Oakbrook Stable Growth index was virtually flat, compared to the 1.4% decline for the S&P 500. We expect quality stocks to outperform the market over the next five to ten years and to provide downside protection in the event of a new bear market.



Conclusion

The second quarter was an excellent reminder to investors that there are still risks in global equity markets. We hope that the tough sledding during the quarter will turn out to be a blip, but it is more likely that we're entering a more volatile market phase. Global markets must now face a world with less liquidity, and potentially weaker global economic growth. If this does turn out to be a new bear market, it will be much harder to avoid than the last one. Asset classes globally offer low risk premiums, and therefore, little room for error. Diversification away from domestic large-cap stocks won't be as beneficial as it was beginning in March 2000 because it is now one of the better relative values in the world. Nevertheless, we believe, now more than ever, one must diversify globally, beyond traditional asset classes, and be constantly looking for innovative approaches to global markets.

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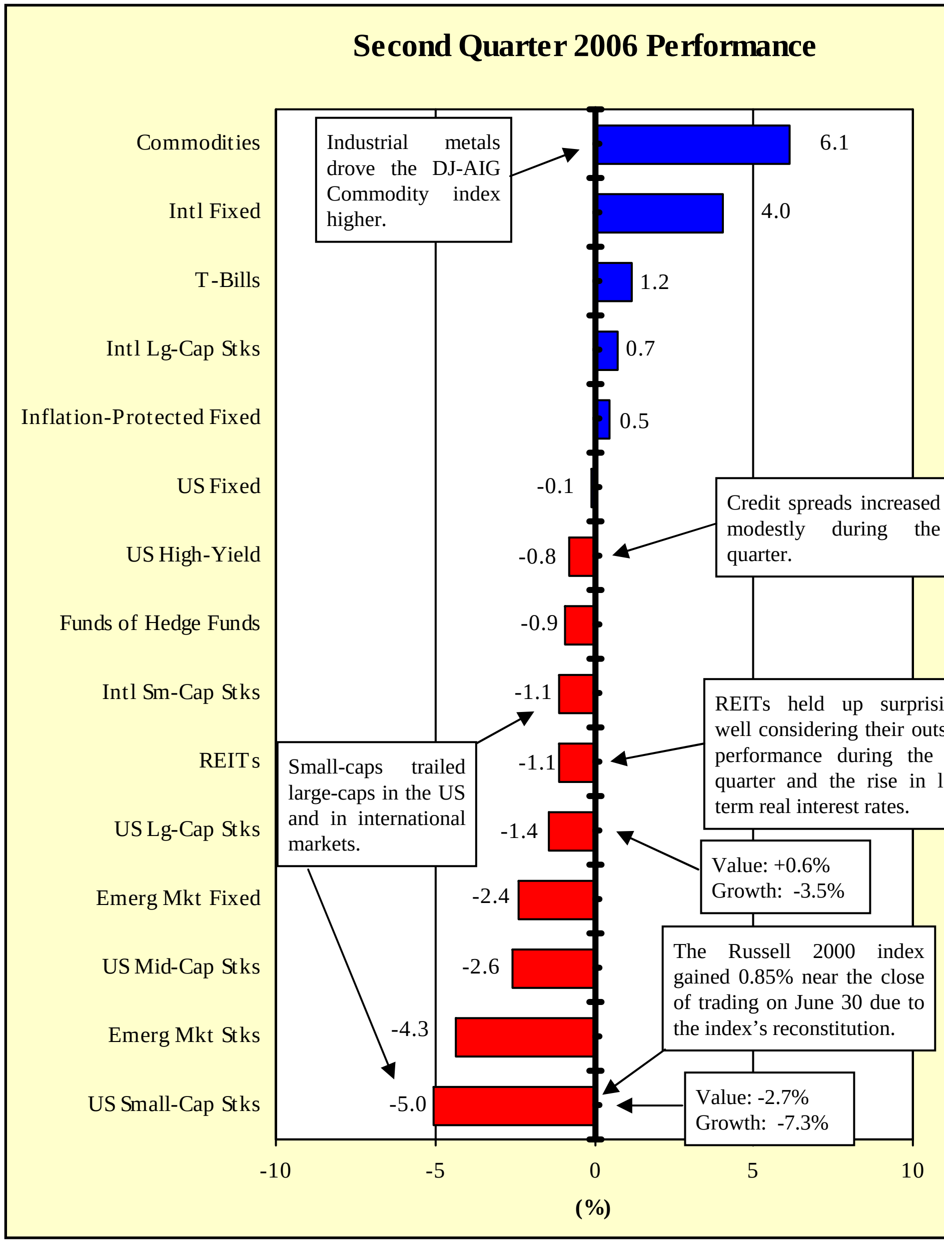
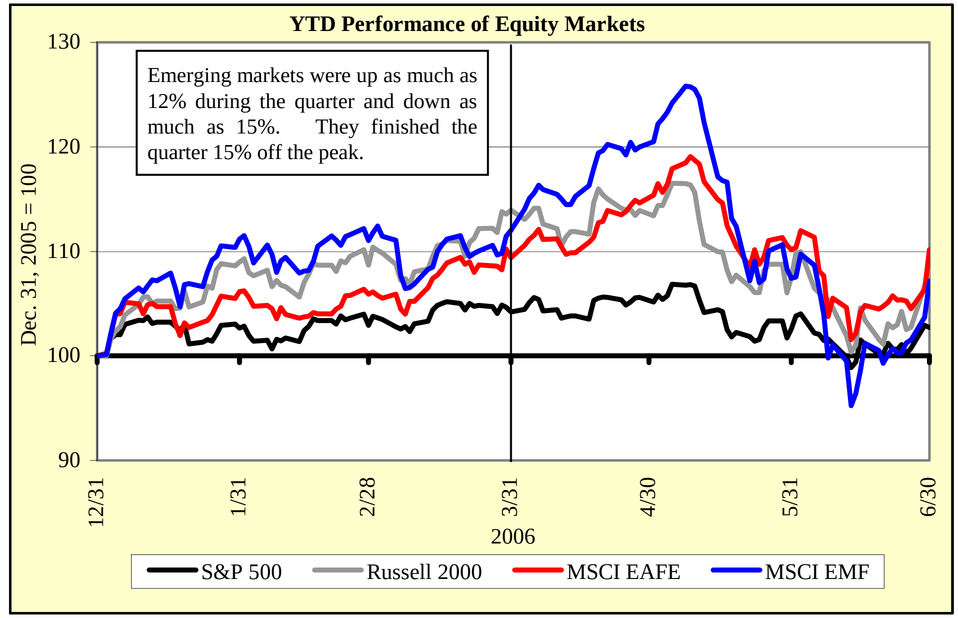
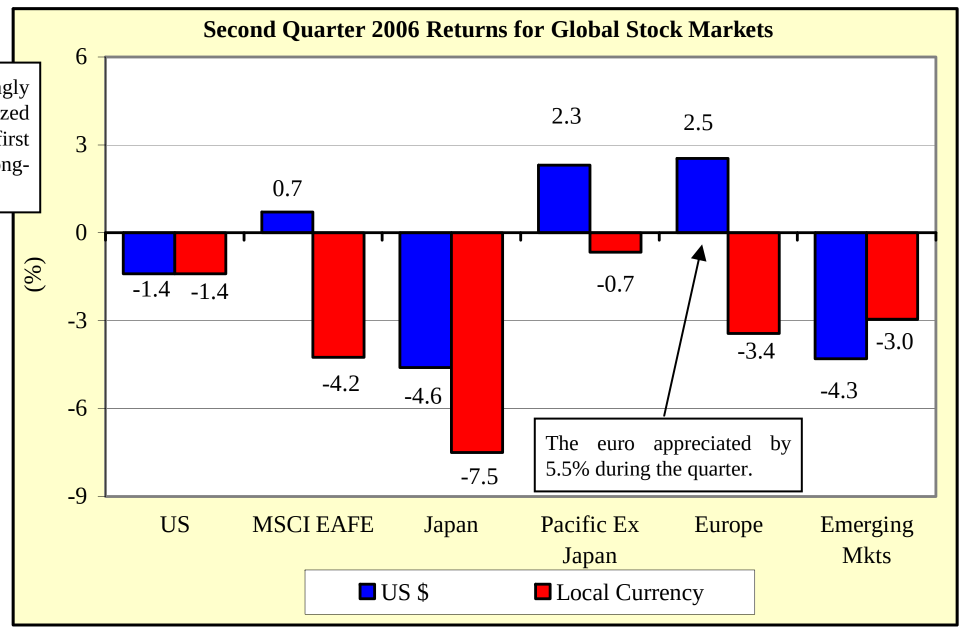
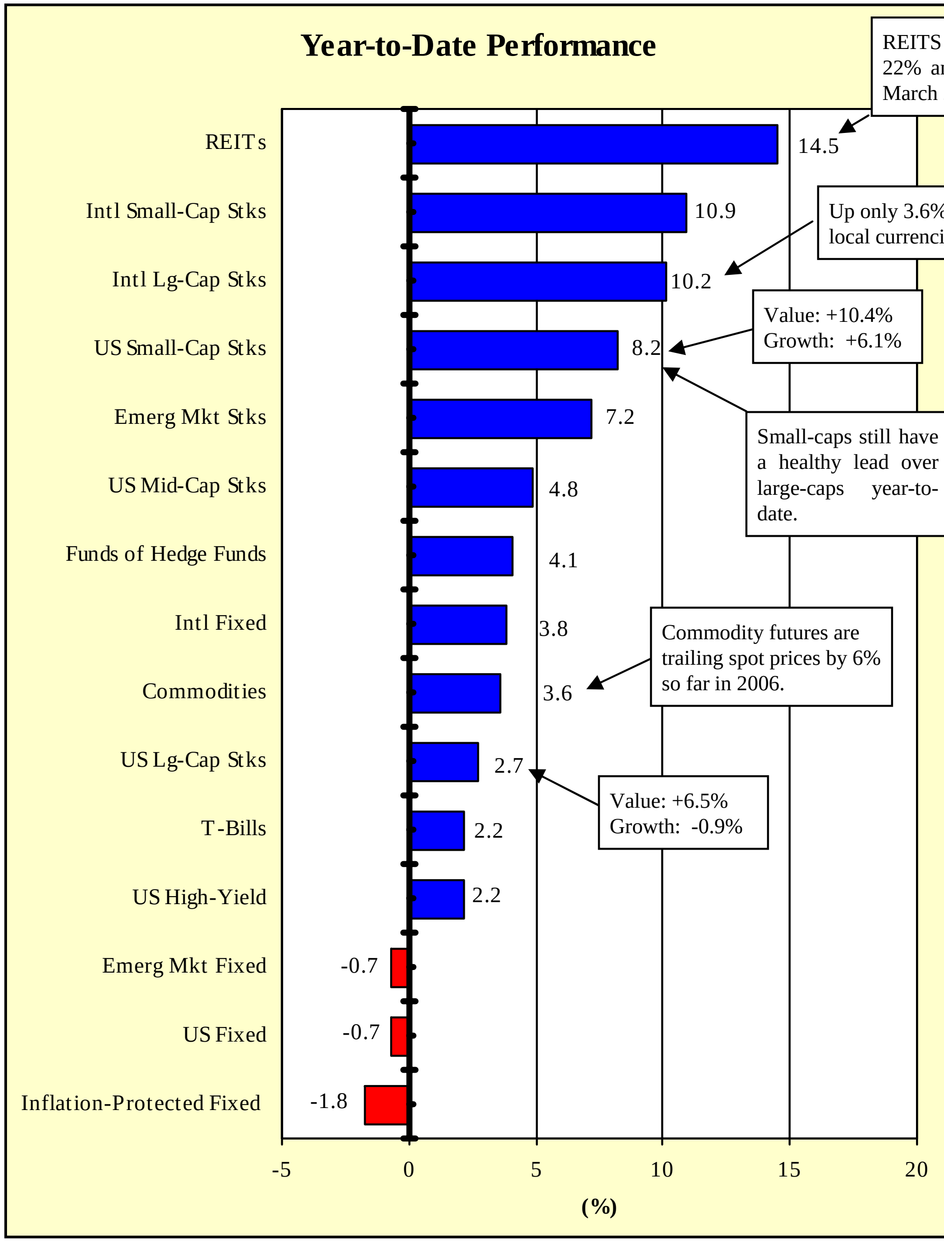
Riskier Assets Fell Most During the Quarter

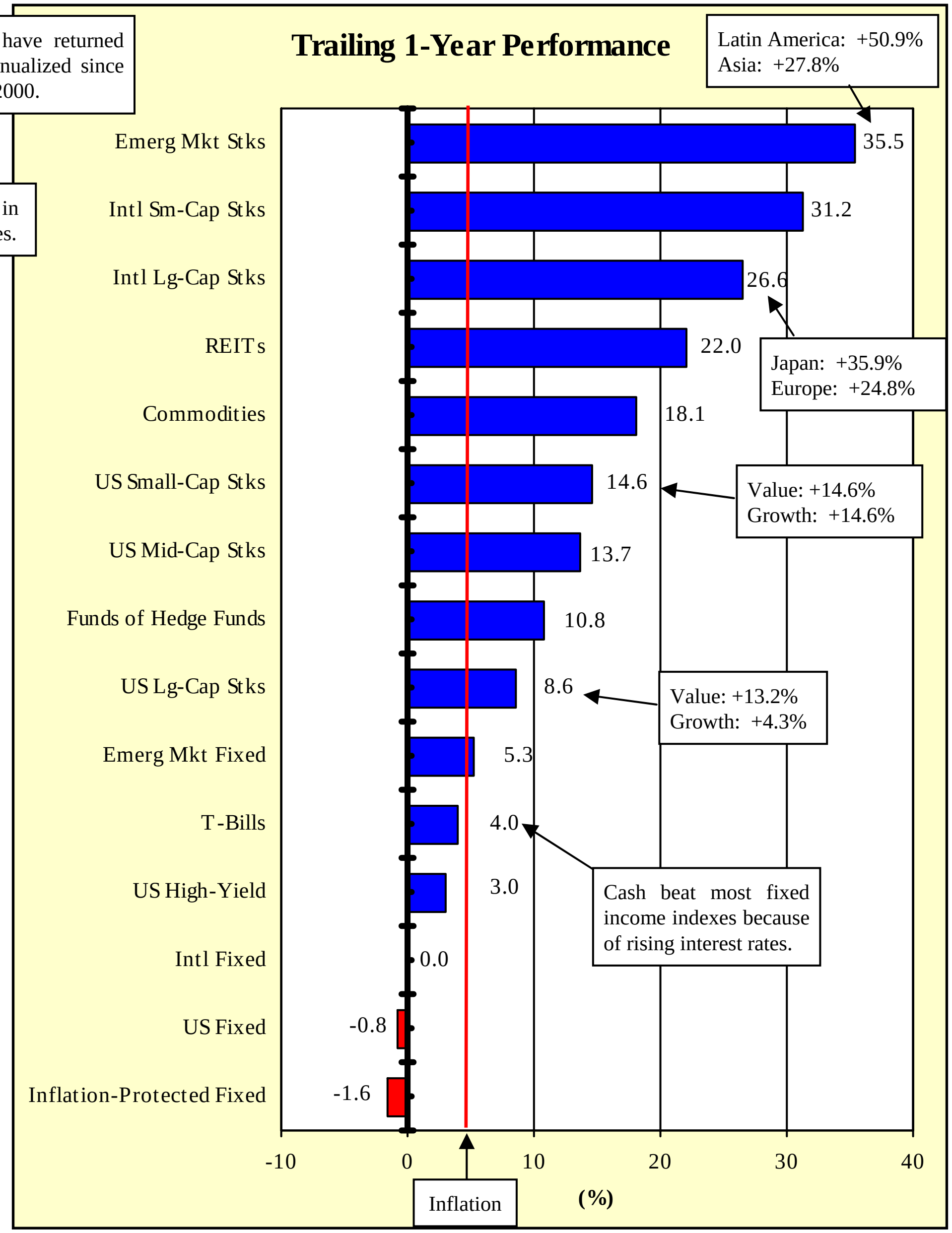






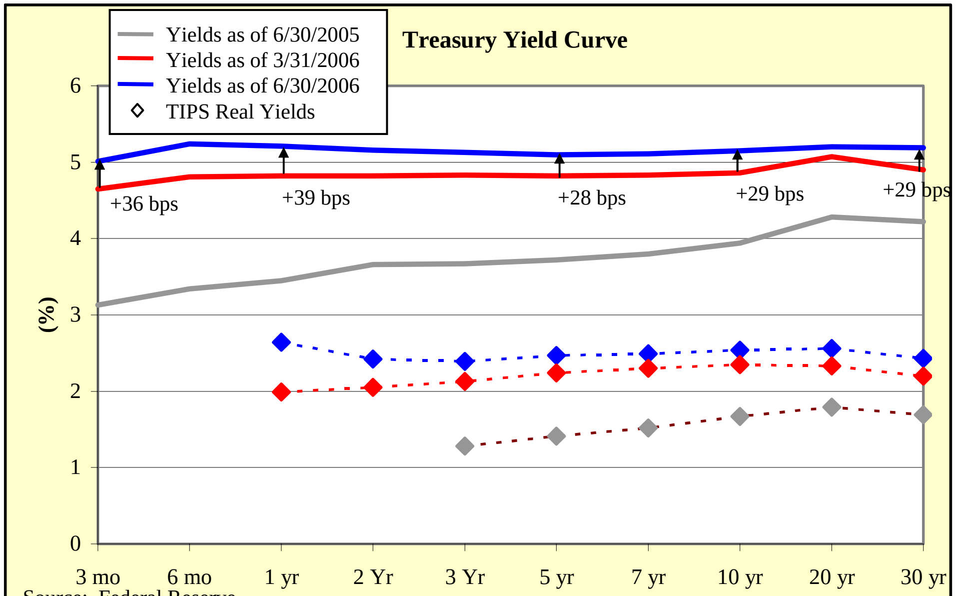
2006 Global Equity Returns Still Strong



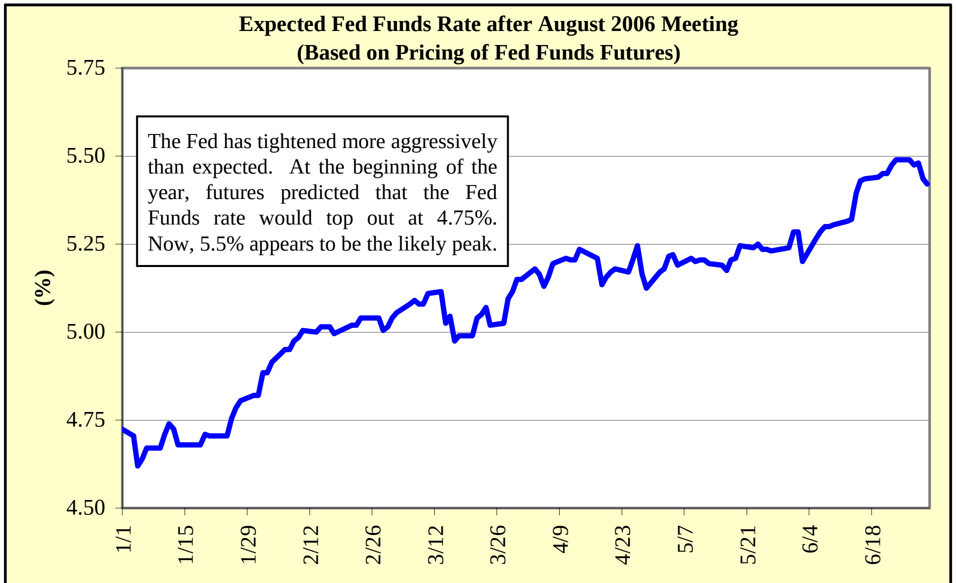


The Global Liquidity Drain Continues

- The Fed lifted the Fed Funds rate from 4.75% to 5.25% during the quarter. Options on Fed Funds futures suggest that we are likely to see at least one more quarter point increase in this cycle, coming at either the August or September meeting. There is about a one-in-three chance that the Fed will lift rates at both meetings.
- Intermediate and long-term interest rates continued to move higher. The 10-year bond yield increased from 4.86% to 5.15% during the quarter. Since the beginning of the year, the 10-year bond has moved 76 bps higher. Naturally, mortgage rates are rising as well. The 30-year mortgage rate has risen from 6.22% to 6.78% so far in 2006.
- The Fed is far from alone in tightening interest rates. Central bankers around the globe are tightening monetary policies as inflationary pressures mount. While the Fed appears to be approaching the end of this easing cycle, other central banks have further to go.
  - ✓ Japan has been a significant source of global liquidity because of its ultra-easy monetary policy. The Bank of Japan ended its quantitative easing policy in March. This policy meant flooding the banking system with money to encourage loans in an attempt to end deflation. The end of this policy led to a sharp contraction in Japan's monetary base. It is estimated that the Bank of Japan removed 20 trillion yen ($174 billion) from the banking system from March through June. On July 14, Japan finally ended its zero interest rate policy by lifting its short-term lending rate 0.25%.
  - ✓ The European Central Bank has lifted interest rates three times since December 2005, and a fourth increase is widely expected in August.
  - ✓ China is trying to tighten monetary policy to slow its potentially overheating economy through higher interest rates and lending controls, but the currency's tight linkage to the dollar is hampering the efforts.
- **The implications are unsettling for global asset markets whose current pricings have been boosted by the extraordinary amount of liquidity in the world.** The decline in global liquidity was a significant contributor to the market turmoil during the second quarter.

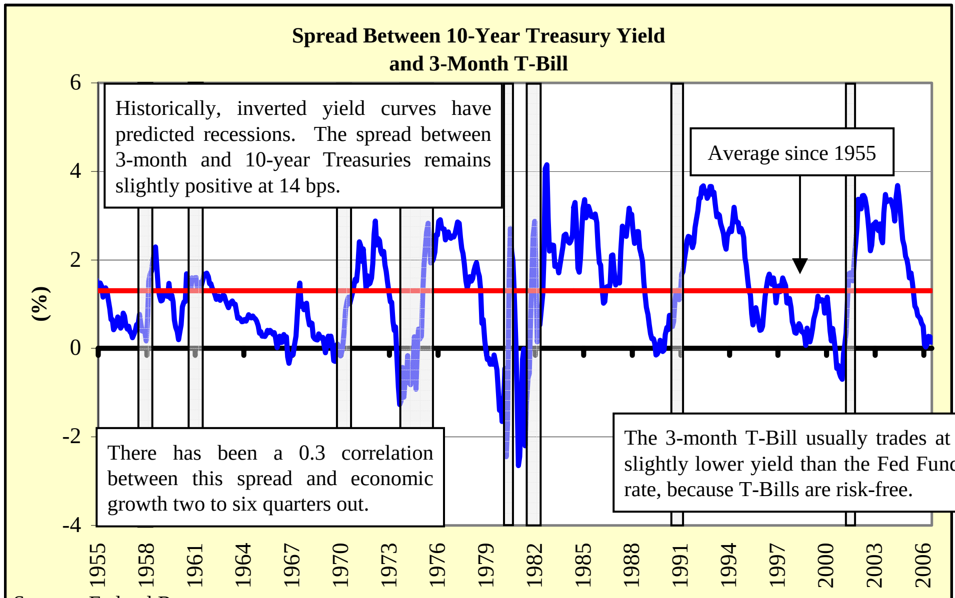


Source: Federal Reserve

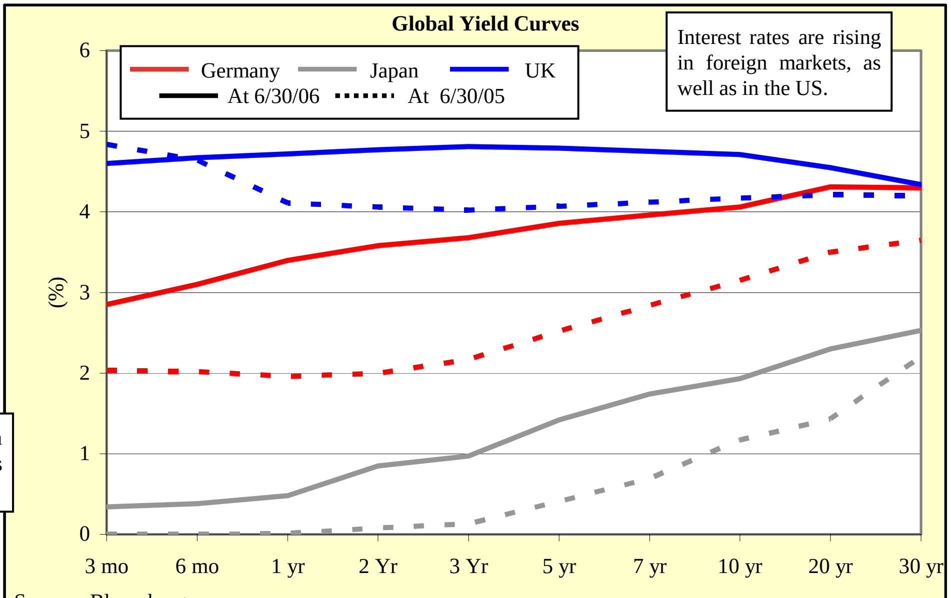


Source: Bloomberg

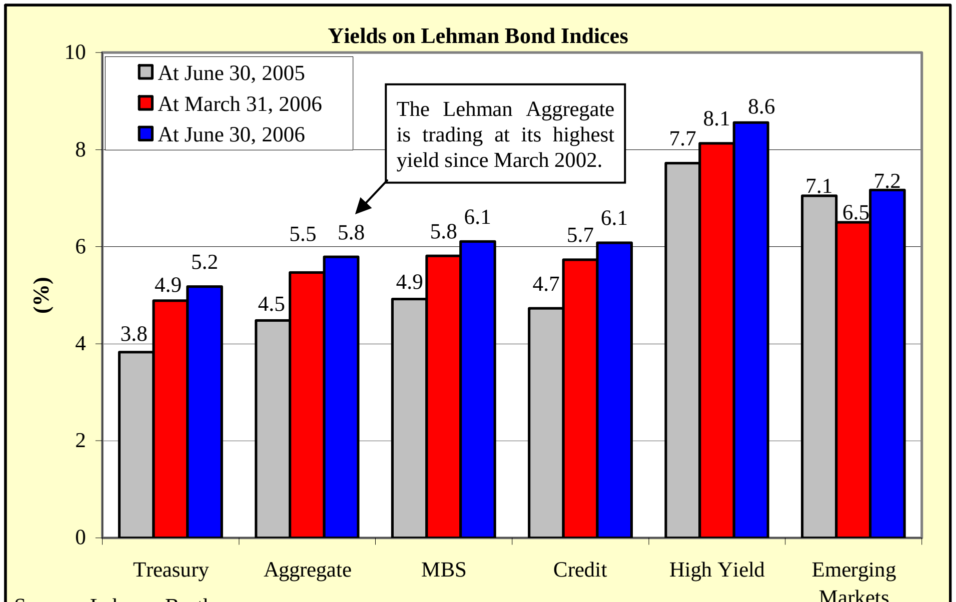
The Global Liquidity Drain Continues (cont.)



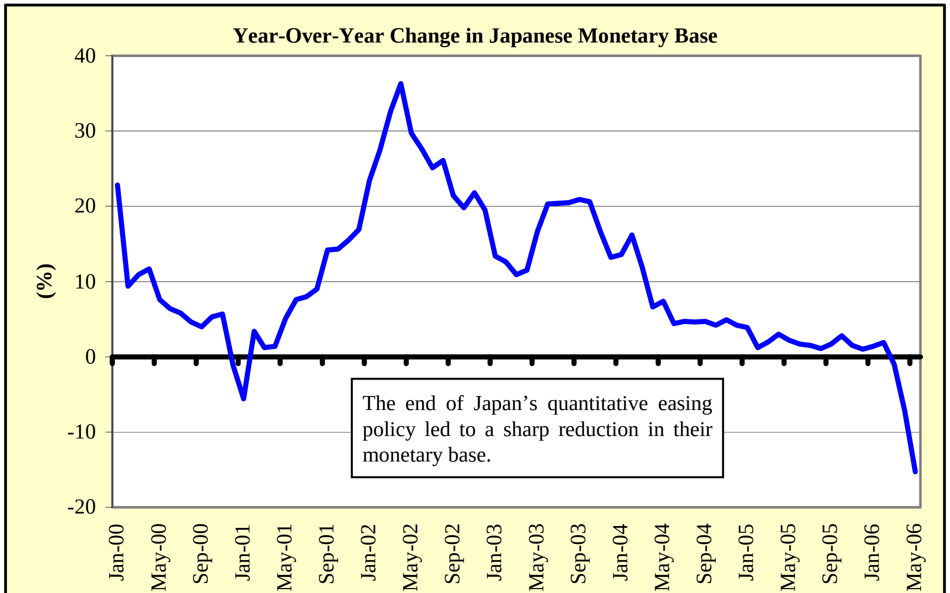
Source: Federal Reserve



Source: Bloomberg



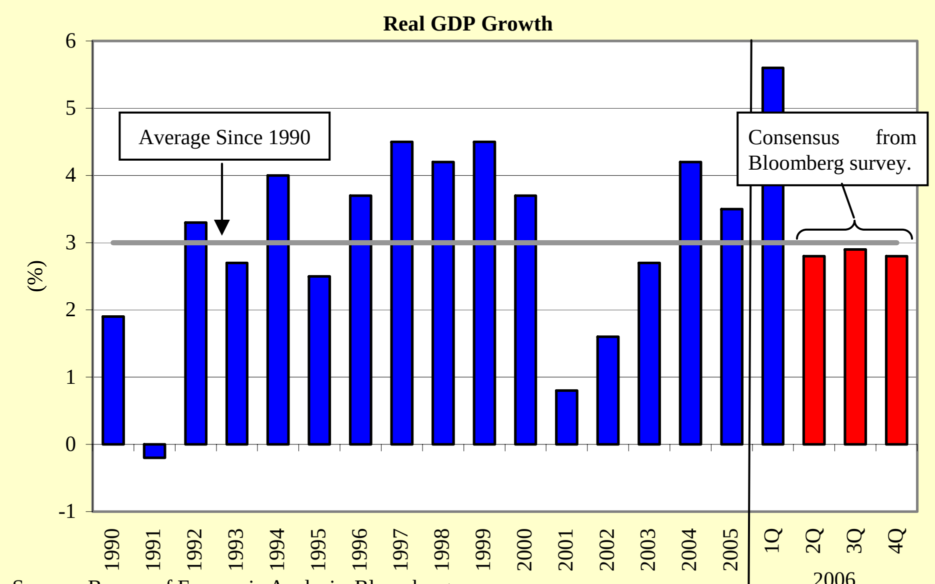
Source: Lehman Brothers



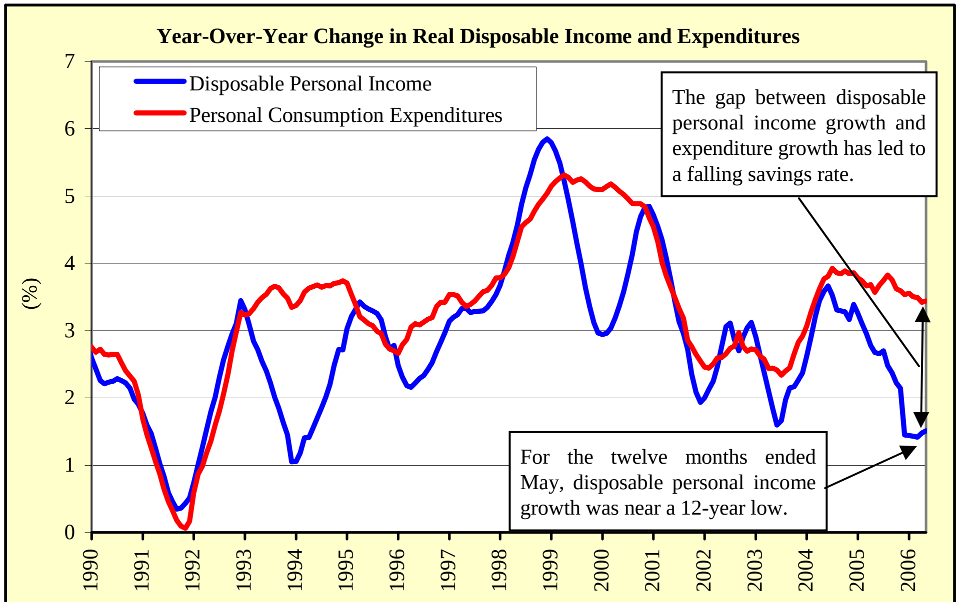
Source: Bloomberg

Signs of a Slowdown in Consumer Spending

- The economy grew at a 5.6% annualized rate in the first quarter of 2006, which was an impressive rebound from the hurricanes-dampened fourth quarter 2005 pace of 1.7%. However, growth looks to have slowed in the second quarter. Economists surveyed by Bloomberg expect second quarter GDP growth to come in at 2.8%.
- The headwinds facing consumers may finally be impacting spending. Consumer spending growth likely fell to about 2.5% in the second quarter, compared to 3.4% growth over the previous year. While this may be a temporary decline, we suspect instead that this is the beginning of a trend.
  - ✓ Compensation growth remains very weak. High energy prices are cutting into real wages. Real hourly earnings have risen just 0.6% over the last four quarters (through Q1). Another wage measure, the Employment Cost Index, shows income growth has trailed inflation over the last year.
  - ✓ Housing activity continues to slow and prices have probably topped out. The inventory of new and existing homes on the market has spiked, and home affordability is near a 16-year low. Housing activity has been a significant contributor to job growth since the end of the recession.
  - ✓ Higher interest rates will increase an already high debt service burden. Most debt is still in the form of fixed rate mortgages. However, floating rate debt has been on the rise. Home equity loans, which are usually tied to the floating prime rate, exceed $1.1 trillion. Furthermore, roughly 20% of mortgage debt is in ARMs. Many ARMs are issued with three- to five-year horizons before the interest rate is reset. Some of those issued in 2003 will reset this year.
- On a bright note, business investment remains strong. However, since personal consumption represents 70% of the economy and residential real estate investment another 6%, it's unlikely that business investment will increase enough to keep total economic growth strong if personal consumption slows.

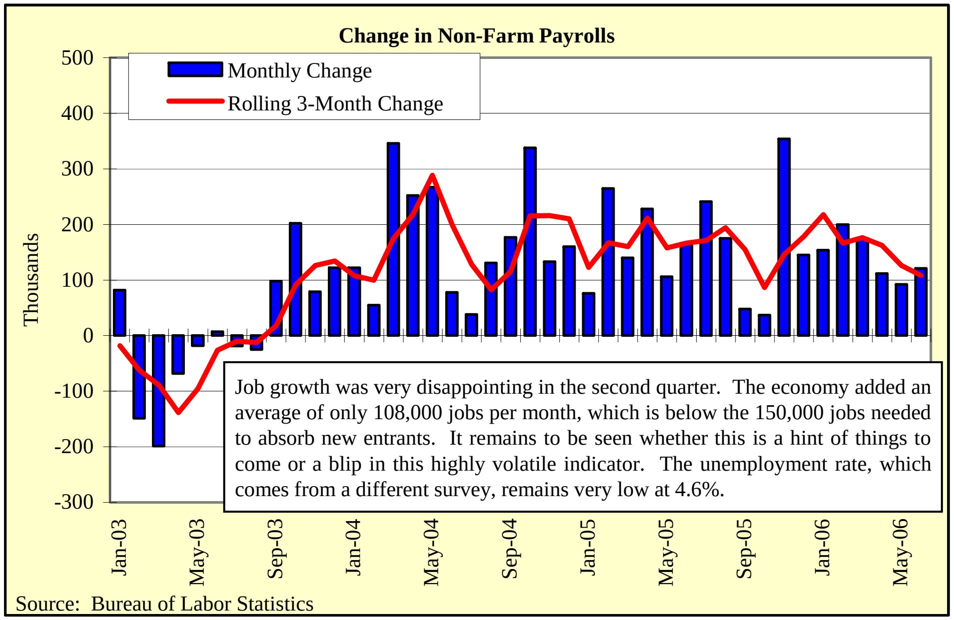


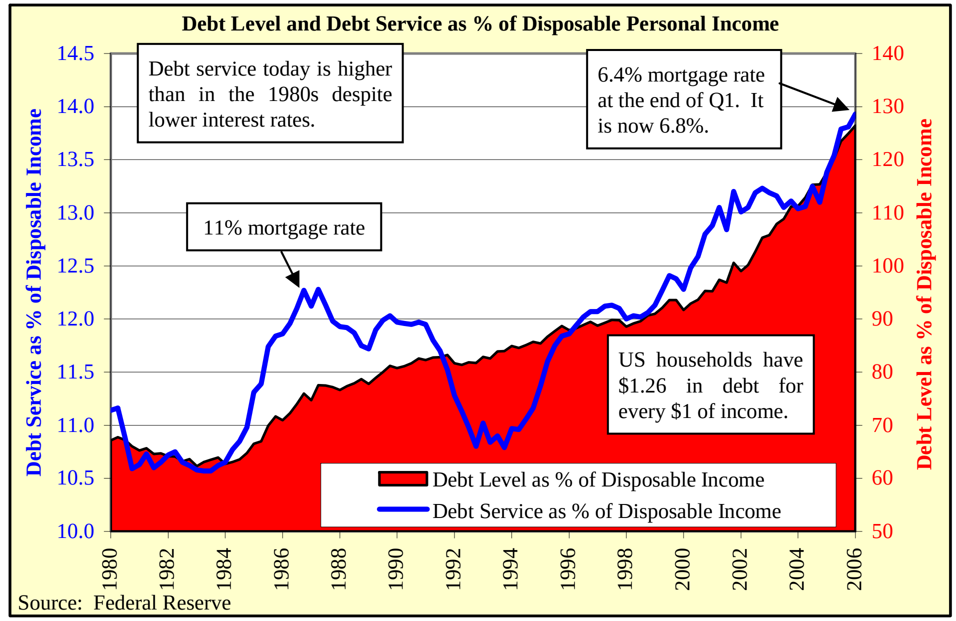
Source: Bureau of Economic Analysis, Bloomberg

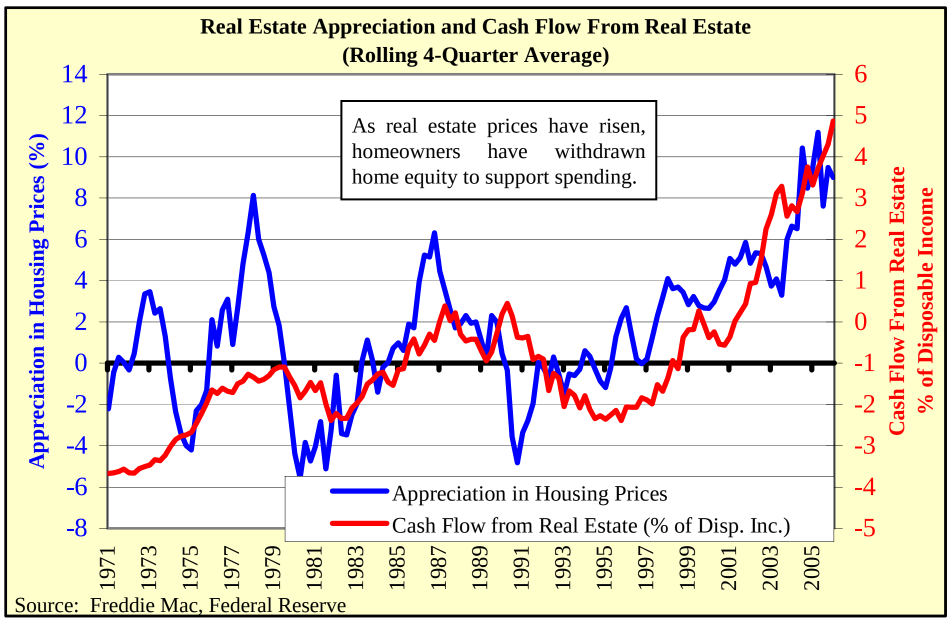


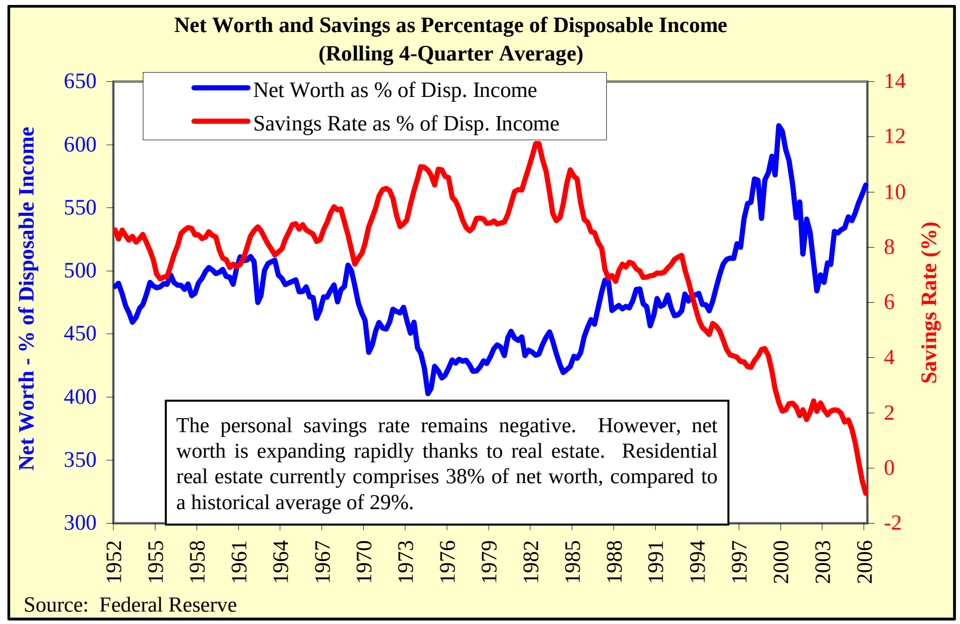
Source: Bureau of Economic Analysis

Signs of a Slowdown in Consumer Spending (cont.)





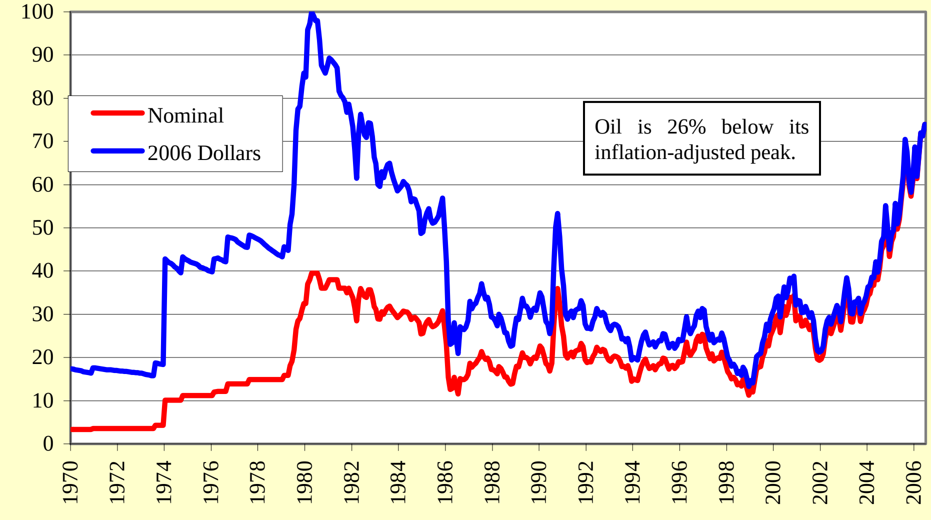




How Much Higher Will Oil Go?

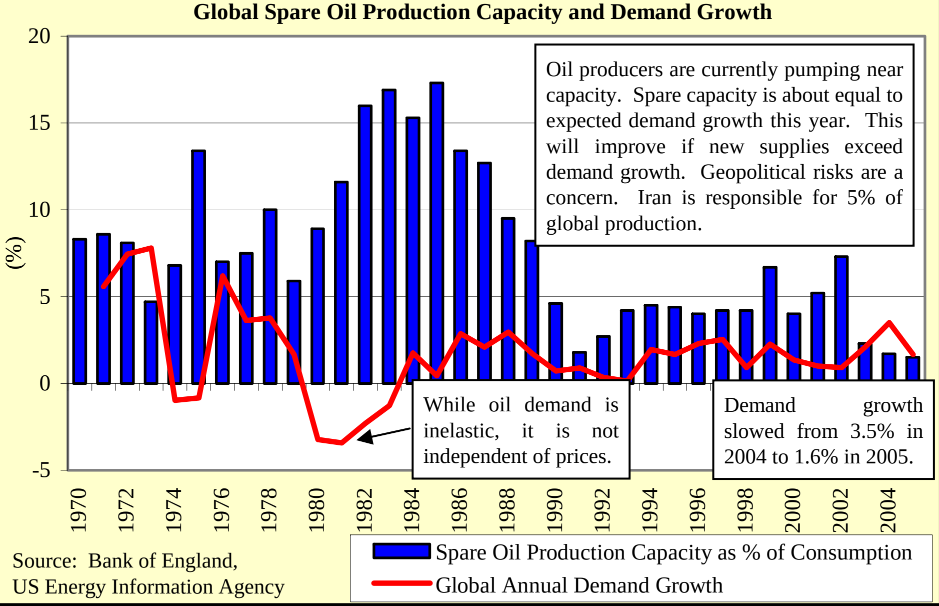
- Oil prices continued their upward march. Tensions with Iran, Nigerian supply disruptions, and (perhaps) a dose of financial speculation helped drive oil prices higher during the second quarter. Light crude oil finished the quarter at $74 per barrel.
- It's anybody's guess what will happen to prices over the next year or two. However, based on fundamentals, it seems prices should moderate or even decline as new capacity comes on-line and demand growth slows in reaction to higher prices.
  - ✓ Oil demand is highly inelastic over the short-term, meaning that demand is not very sensitive to price increases. Over the intermediate- to long-term, however, consumption becomes more sensitive to prices. Higher prices will lead to slower demand growth because of conservation and substitution with alternative fuels.
  - ✓ At present, oil supply is also inelastic even with high prices because the world is pumping near capacity. High prices are attracting significant new investments, but it takes at least five years for new capacity to come on-line. Cambridge Energy Research Associates estimates that oil production capacity will increase by 15 million barrels per day (18% of current capacity) by 2010 based on projects already in development or budgeted for development. The Energy Information Agency projects a demand increase of 8 million barrels per day by the end of 2010.
  - ✓ However, the "peak oil" crowd argues that production from existing fields (particularly in Saudi Arabia) will fall by more than these estimates build-in, creating a larger gap for new production to fill.
- Oil price volatility will likely continue because of the current tight supply and demand balance. Over the short-term, the risks seem tilted towards the upside. Natural disasters, rising tensions in the Middle East, and financial speculation all have the potential to drive prices even higher. Looking out a few years, our best guess is that prices will moderate.
- **Nevertheless, we recommend meaningful energy exposure in portfolios as a hedge.** A significant energy supply disruption is arguably the greatest risk faced by the global economy and, by extension, capital markets.

Oil Price
(Barrel of West Texas Intermediate Crude)



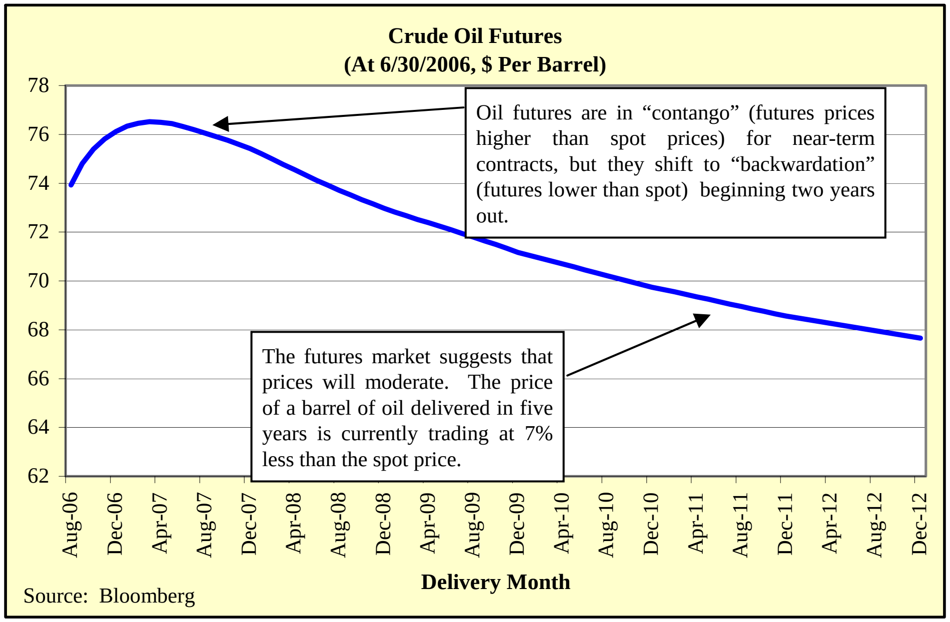
Source: Bloomberg, Bureau of Labor Statistics

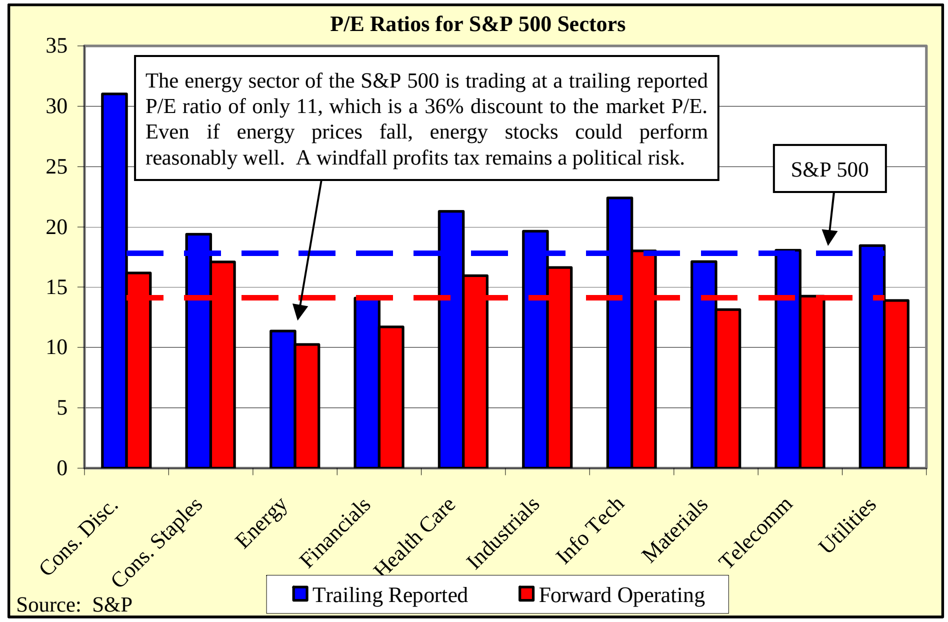
Global Spare Oil Production Capacity and Demand Growth

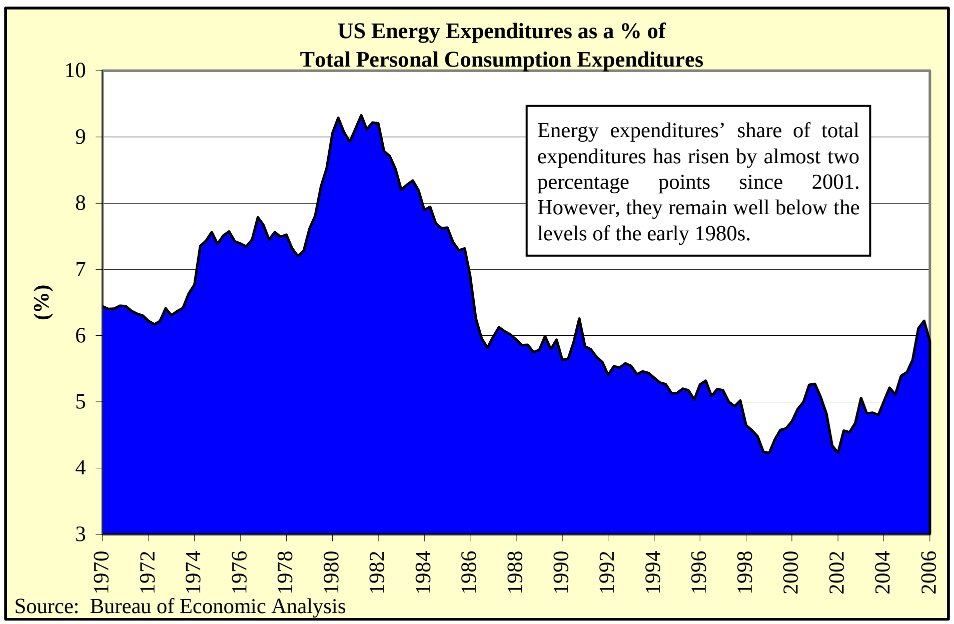


Source: Bank of England,
US Energy Information Agency

How Much Higher Will Oil Prices Go? (cont.)







Oil price at which energy source is economically viable	
$80	Biodiesel
$60	US corn-based ethanol (ex. tax credits)
$50	Shale oil
$40	Canadian tar sands, Brazilian cane-based ethanol, coal-to-liquids
$20	Conventional oil

Source: *The Economist*, Cambridge Energy Associates

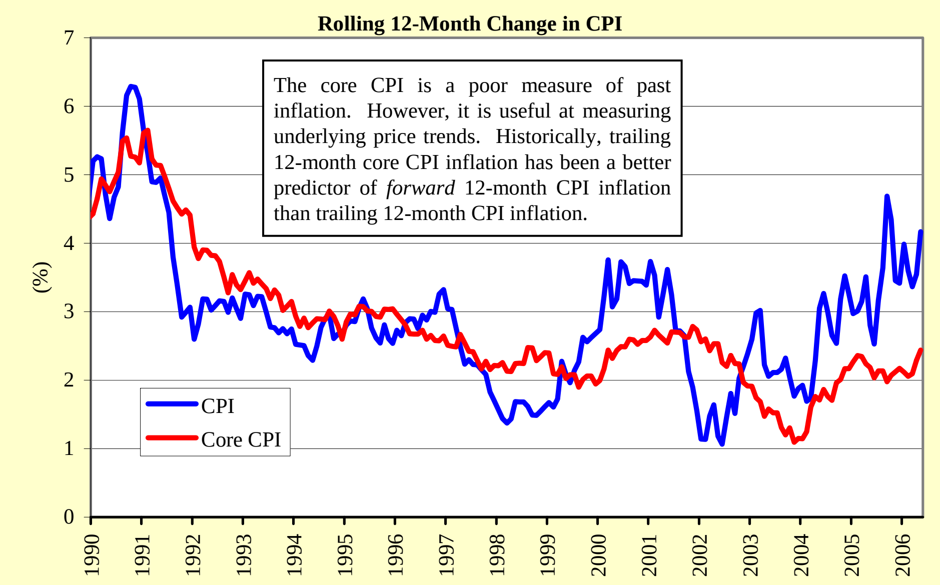
Alternative fuels are becoming more economical because of rising oil prices.

The US government imposes steep tariffs on Brazilian cane-based ethanol and gives substantial subsidies to domestically-produced corn-based ethanol.

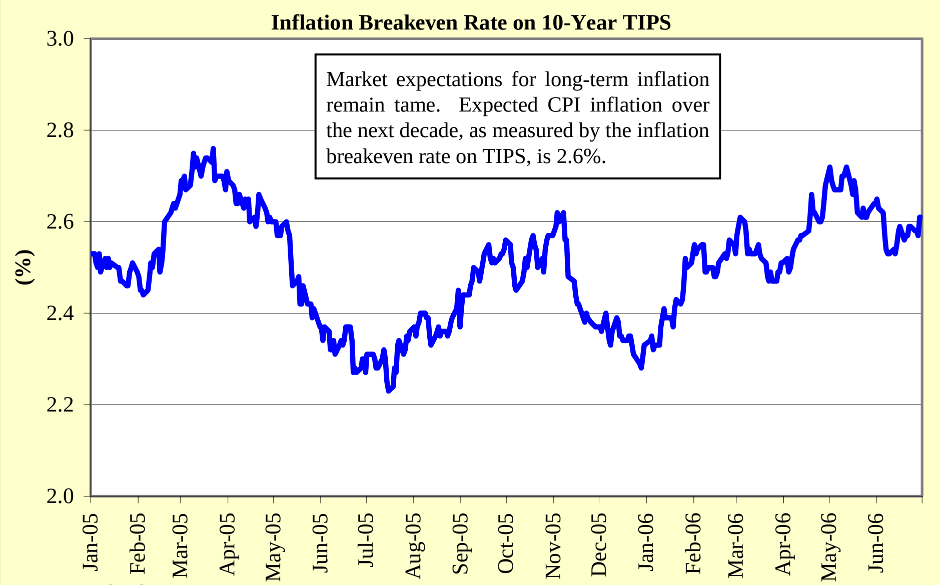
The Energy Information Agency projects “unconventional” oil supplies, such as Canadian oil sands, to reach 5 million barrels per day by 2010.

Stagflation on the Horizon?

- Energy prices are keeping inflation high. For the twelve months ended May, the Consumer Price Index increased 4.2%. With the economy at risk of slowing, there are rising concerns that we may experience a stagflationary period, similar to the 1970s when inflation was high and economic growth was weak.
- Since CPI inflation has been driven primarily by energy costs, there is cause for optimism that it will ease. The energy component of the CPI increased 24% over the twelve months ended May. While there is certainly a chance that prices will continue to surge at a similar pace, it is more likely that energy inflation moderates.
- Another concern is that core inflation is also trending upwards. The core CPI has risen by 2.4% over the last twelve months.
  - ✓ Most of the increase in the core inflation rate has come from an increase in owners equivalent rent, which makes up about 40% of the core CPI index. Owners equivalent rent is an estimate of the price at which homeowners could rent their houses. This component has been increasing as actual rents have been rising.
  - ✓ There does not seem to be significant pass through of energy costs to other components of the core CPI yet. This is because of a lack of wage inflation. Wages represent the bulk of costs for US businesses. Since the end of the recession, wage growth has trailed productivity growth by two percentage points per year. This has allowed companies to improve profit margins *and* to keep price increases moderate.
- In the 1970s, inflation fed on itself in part because workers had the bargaining power to negotiate cost of living adjustments into contracts. Today, US workers have much less bargaining power because of low-cost overseas labor. As a result, wages have struggled to maintain pace with inflation.
- Absent a significant energy supply shock, 70s-styled stagflation does not seem likely over the short- to intermediate-term in this era of globalization. **Despite this, inflation-protected bonds seem a better value than nominal fixed income securities, because inflation-protected bonds offer cheap insurance**.

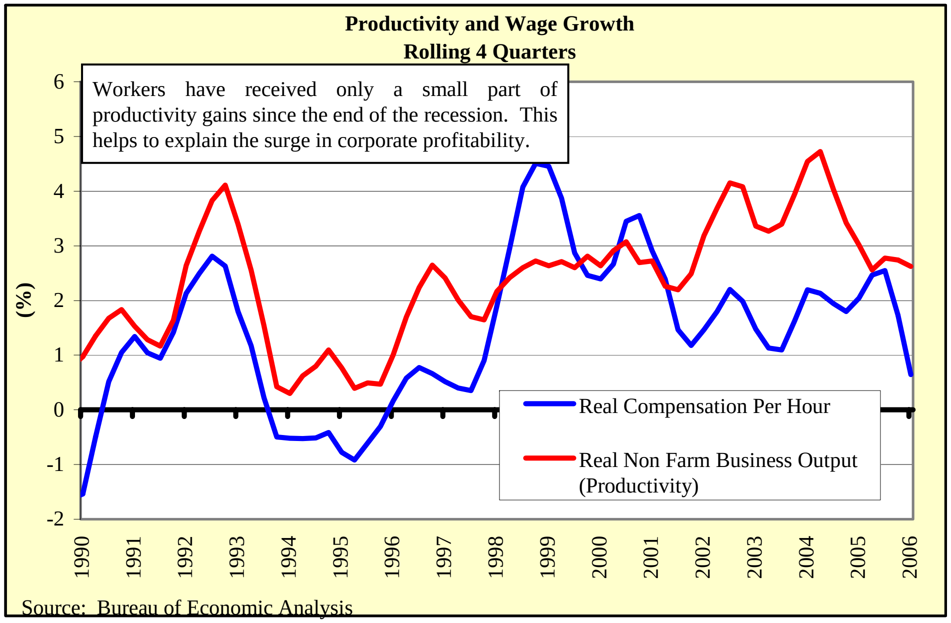


Source: Bureau of Labor Statistics

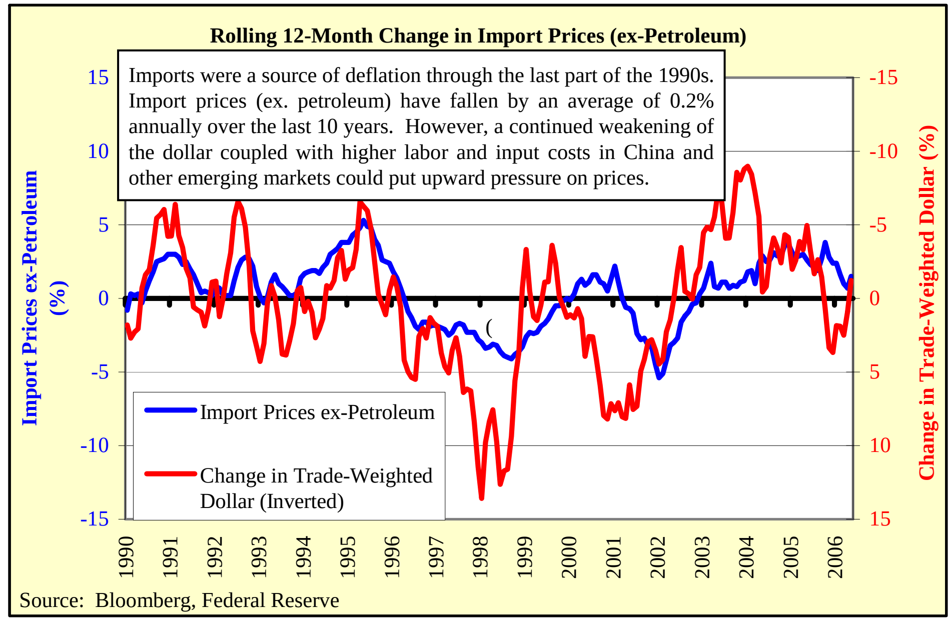


Source: Federal Reserve

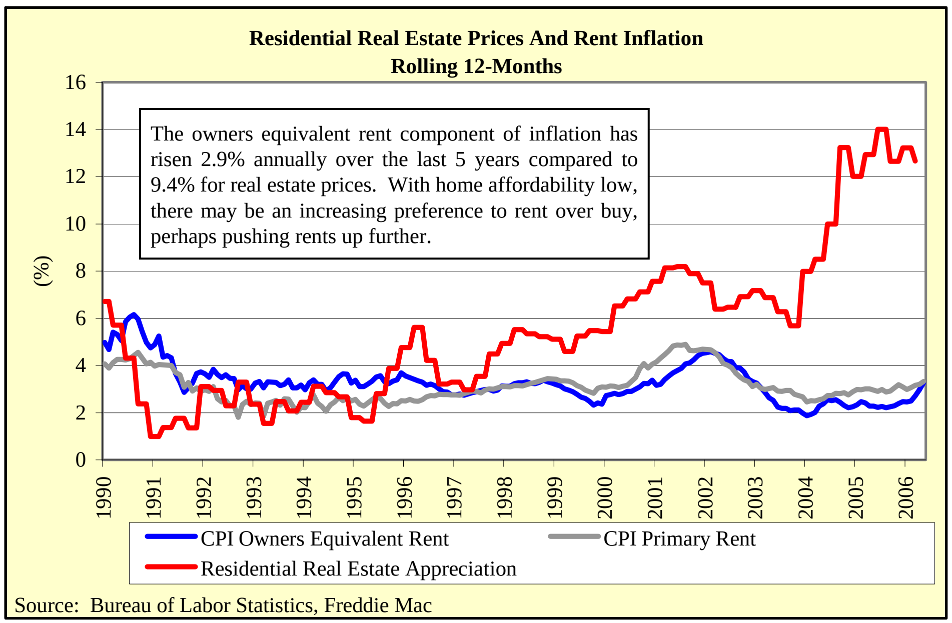
Stagflation on the Horizon? (cont.)



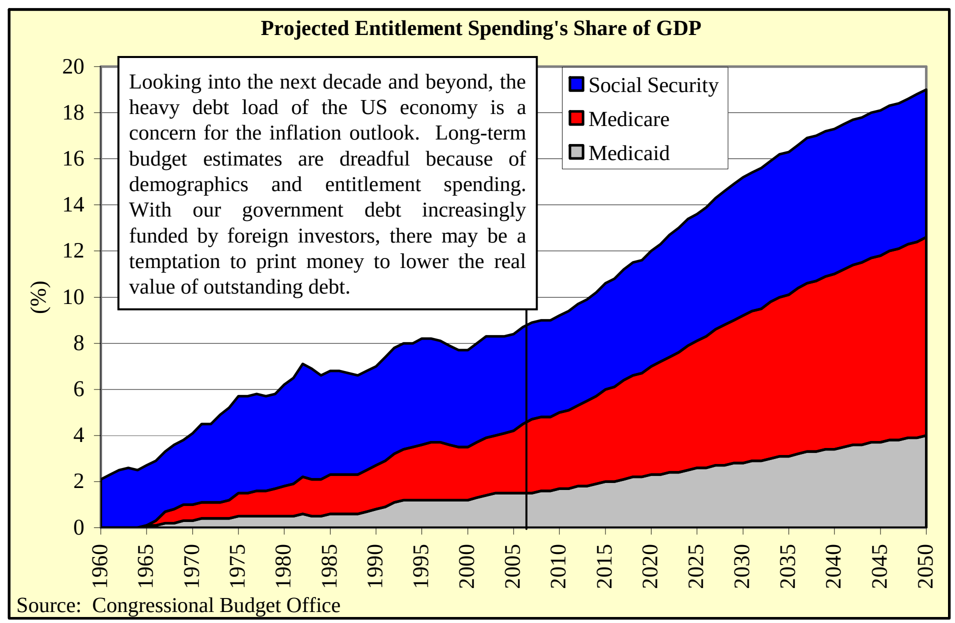
Source: Bureau of Economic Analysis



Source: Bloomberg, Federal Reserve



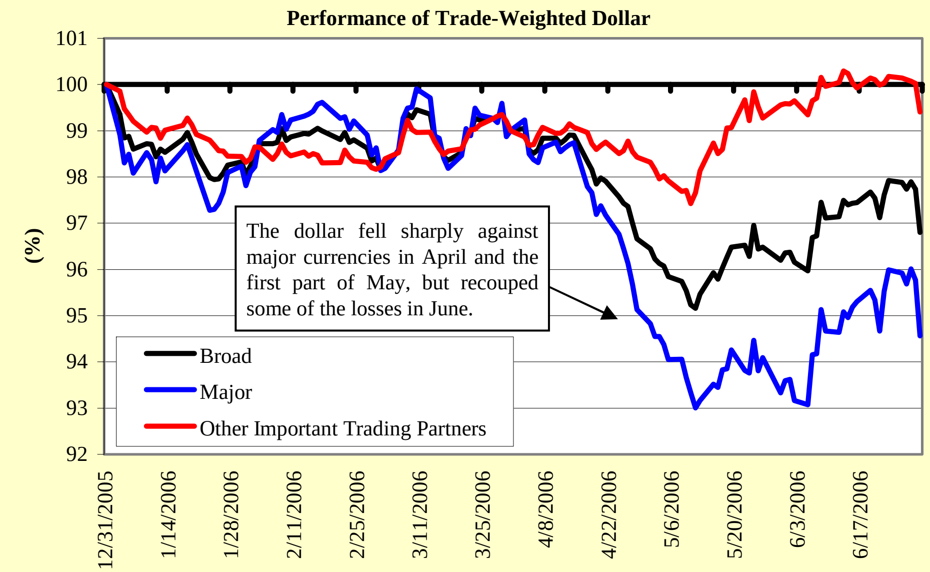
Source: Bureau of Labor Statistics, Freddie Mac



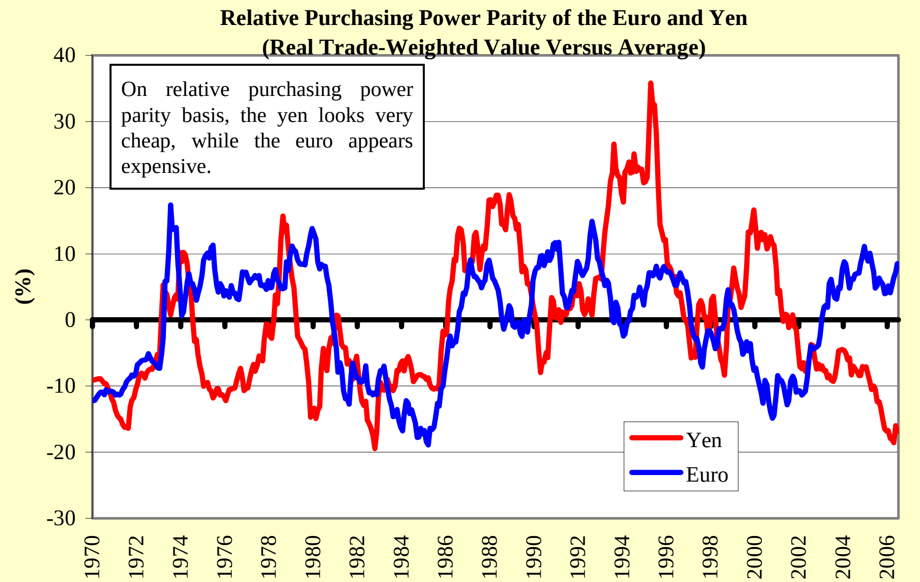
Source: Congressional Budget Office

The Dollar Weakened During the Quarter

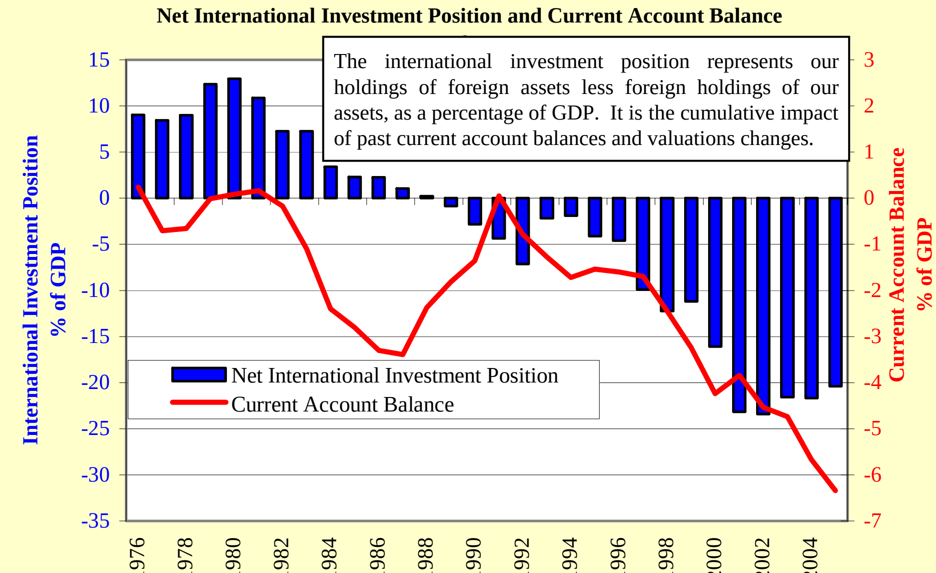
- The dollar weakened against most major currencies in the second quarter. It fell by 5.5% against euro and is now 7.4% weaker year-to-date. The dollar slipped 2.9% against the yen during the quarter.
- The Bureau of Economic analysis released the 2005 net international investment position data (US holdings of foreign investments less foreign holdings of US investments). Despite the 6.3% current account deficit for the year, the position improved from negative 21% of GDP to negative 20%. This is because foreign assets held by US investors substantially outperformed US assets held by foreign investors. However, this effect is likely to moderate as foreign assets post more modest returns relative to US assets, and the international investment position is likely to worsen annually by an amount close to the current account deficit.
- The dollar still looks vulnerable because of the huge current account deficit. The Japanese yen and other Asian countries' currencies need to appreciate the most against the dollar, but the burden may continue to fall on European currencies if Asian banks are reluctant to allow appreciation. **We continue to recommend substantial exposure to foreign currencies that will benefit from a secular depreciation of the dollar.**



Source: Bloomberg, Federal Reserve



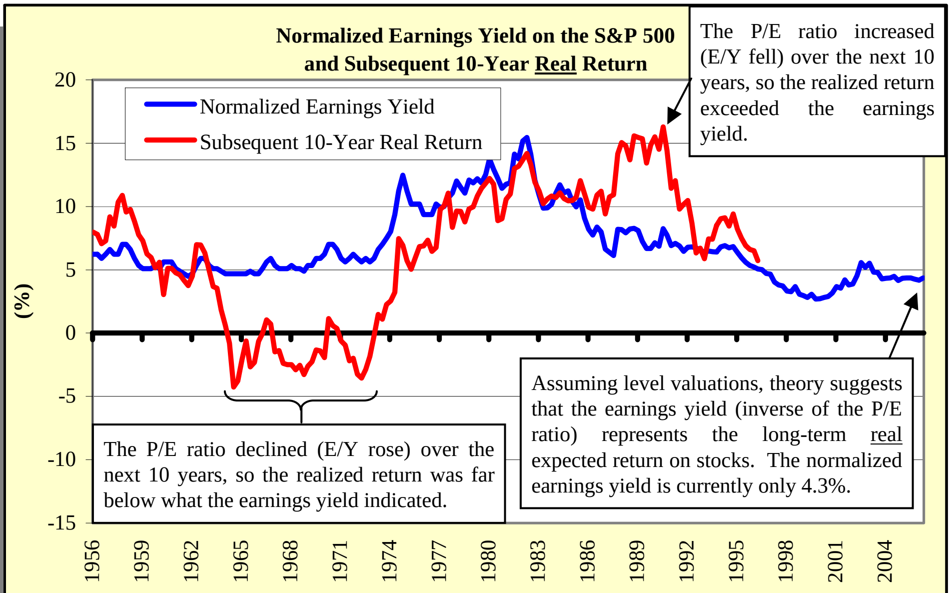
Source: JP Morgan, HA calculations



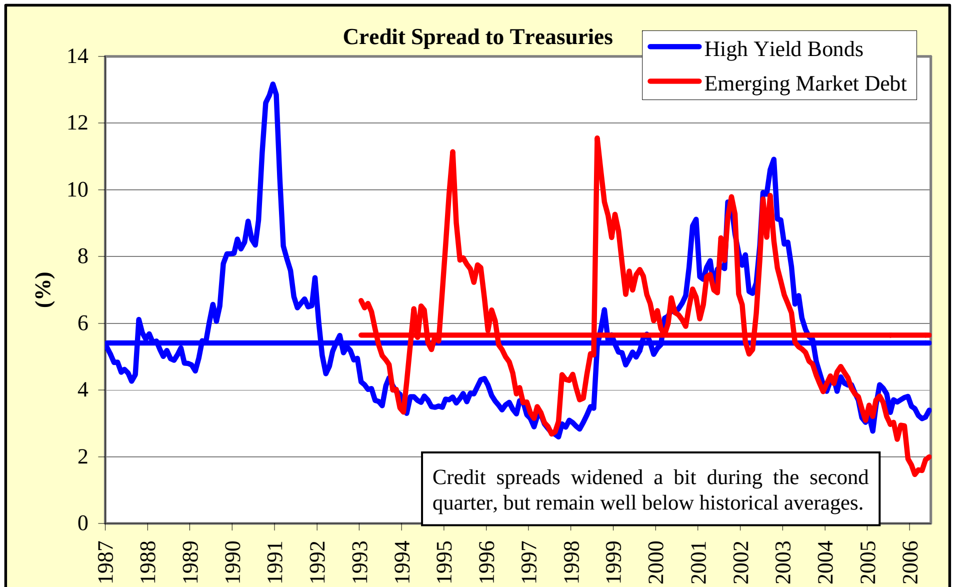
Source: Bureau of Economic Analysis

Risk Premiums Remain Thin

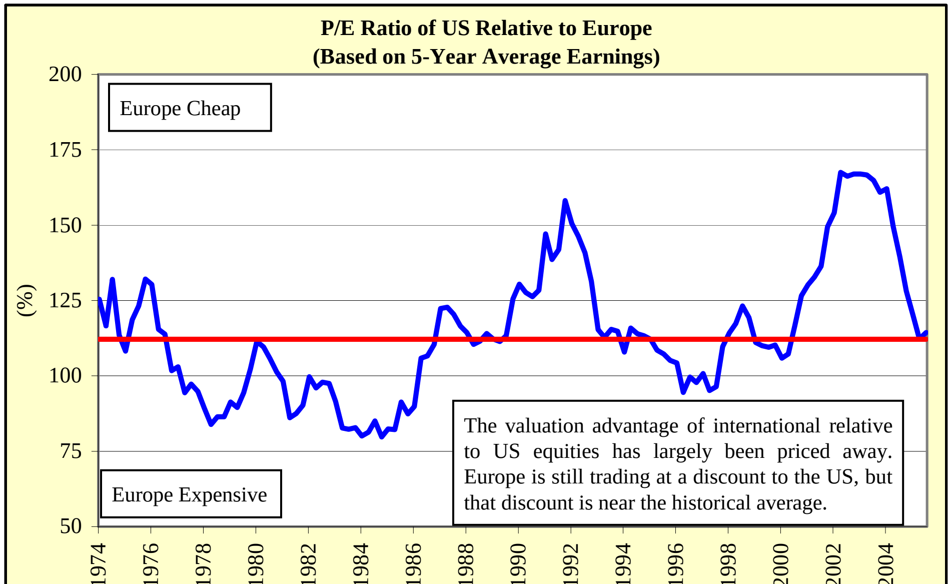
- In last quarter's report, we observed that risk premiums on global assets were at very narrow levels. Second quarter market returns marginally increased risk premiums in global equity asset classes, but they still remain very narrow by historical standards.
- Based on a normalized P/E ratio of 23, the S&P 500 is priced to provide only a 4.3% real return, assuming no change in valuations. This is only a 1.9 percentage point risk premium to long-term TIPS. International developed and emerging market stocks also appear richly priced.
- Credit spreads widened slightly during the quarter, but also remain well below normal levels. The high yield bond spread to Treasuries widened by 16 bps (from 3.24% to 3.40%), and the spread on emerging market debt widened by 44 bps (from 1.54% to 1.98%).
- **We continue to believe that equity and other risky asset classes face a challenging environment. Risk premiums appear too low.** The withdrawal of global liquidity and potentially weaker global economic growth will likely continue to roil markets. Now is not the time to overreach for returns.



Source: BARRA, Bureau of Labor Statistics, Hammond Associates



Source: Lehman Brothers

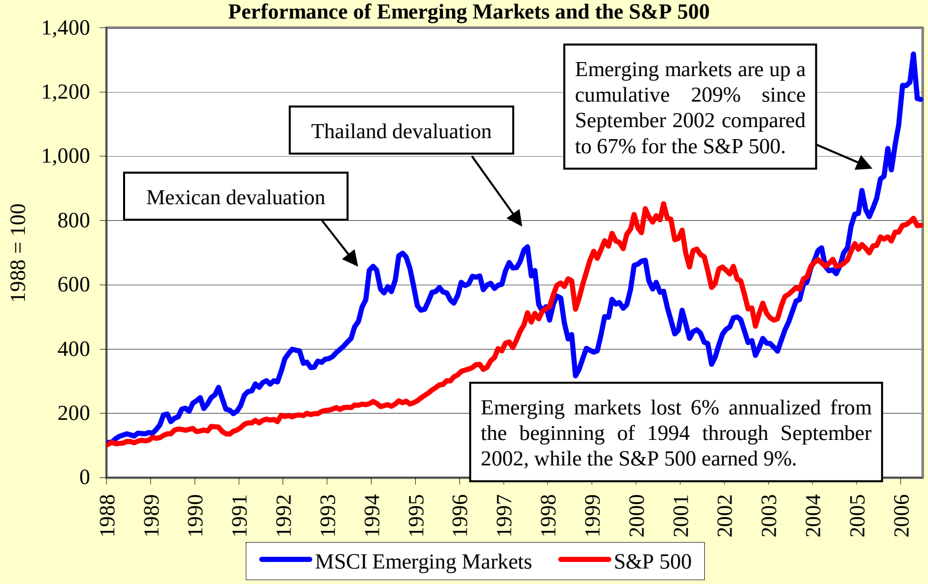


Source: Global Financial Data, Bloomberg

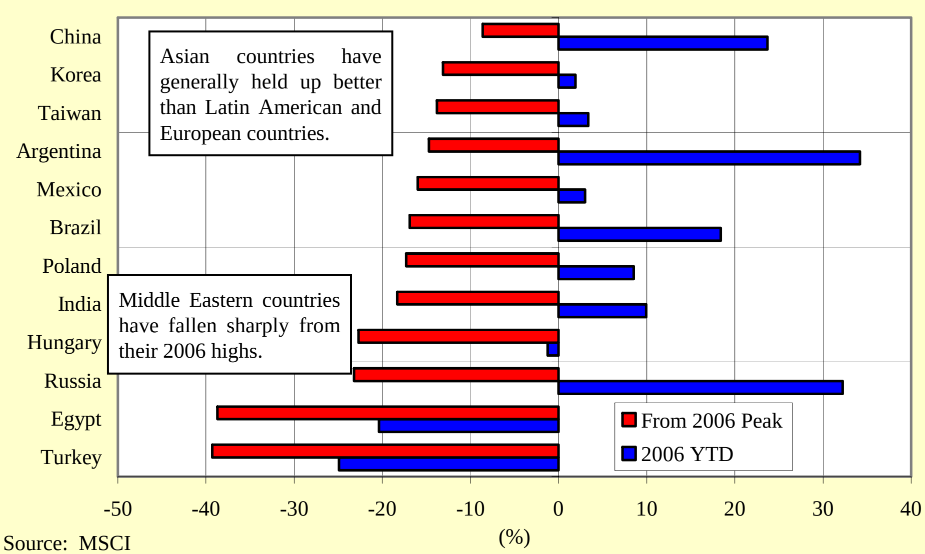
Emerging Markets: A Risk of Contagion?

- The wild swings in emerging market equities during the second quarter were reminiscent of the volatility during the 1997/98 currency crisis. In 1997, Thailand devalued its currency, which eventually led to a run on emerging currencies around the world. Over a thirteen month period, emerging market equities fell 56%, and many emerging market economies experienced severe recessions.
- Emerging economies as a whole are in much stronger financial shape than in 1997. In 1997, many were running large current account deficits. Now, most are running surpluses. Foreign currency reserves are much higher today. Reserves provide insurance against currency runs. In 1997, emerging market countries had reserves of $700 billion. Reserves have increased over four-fold since then to $3.1 trillion. The risk of contagion seems lower today than in 1997.
- While the risk of contagion is lower, investments in these countries are still at risk of substantial declines. Aside from ever present political risks, our largest concerns today are that emerging countries' economic growth is overly dependent on US consumption and that their equities are trading at valuations that leave little margin for error.
  - ✓ Led by China, the economies of emerging markets have been booming. China is exporting goods to the US, while other emerging market countries are exporting their natural resources to China. The ultimate reliance on US consumers is a concern for reasons outlined earlier in this report. If there is a hiccup in US consumption, emerging market equities are likely to feel the pain far worse than domestic equities.
  - ✓ Based on trailing earnings, emerging markets are trading at a P/E of 14, which is reasonable. However, that P/E ratio is based on near record high profitability. This high profitability, in turn, is being driven in large part by commodity producing companies. If a global growth slowdown occurs and commodity prices weaken, emerging market stocks could be hit with a double-whammy.
- **We believe emerging market equities still offer attractive long-term return opportunities, but investors should be prepared for a bumpy ride along the way.**

Performance of Emerging Markets and the S&P 500

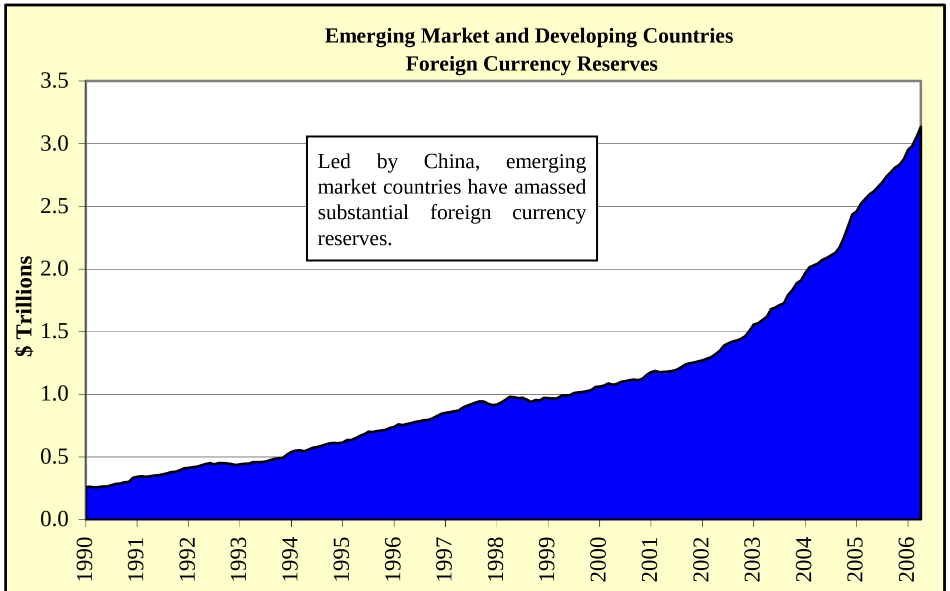


Performance of Select Emerging Market Countries

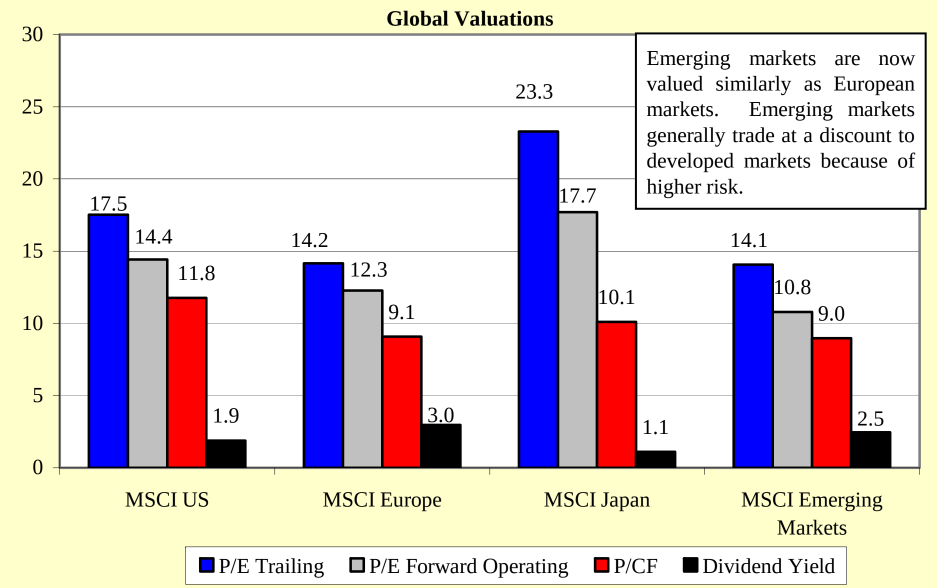


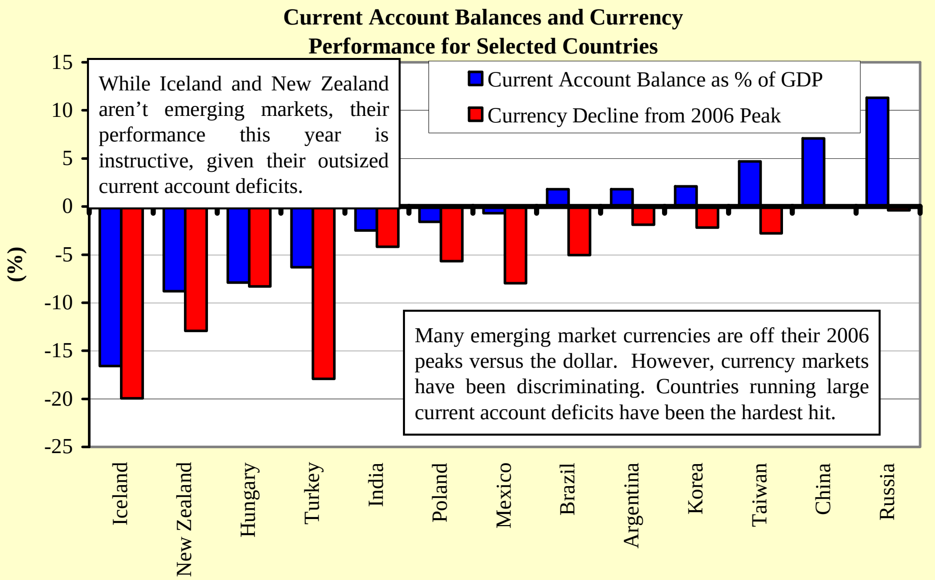
Source: MSCI

Emerging Markets: A Risk of Contagion? (cont.)

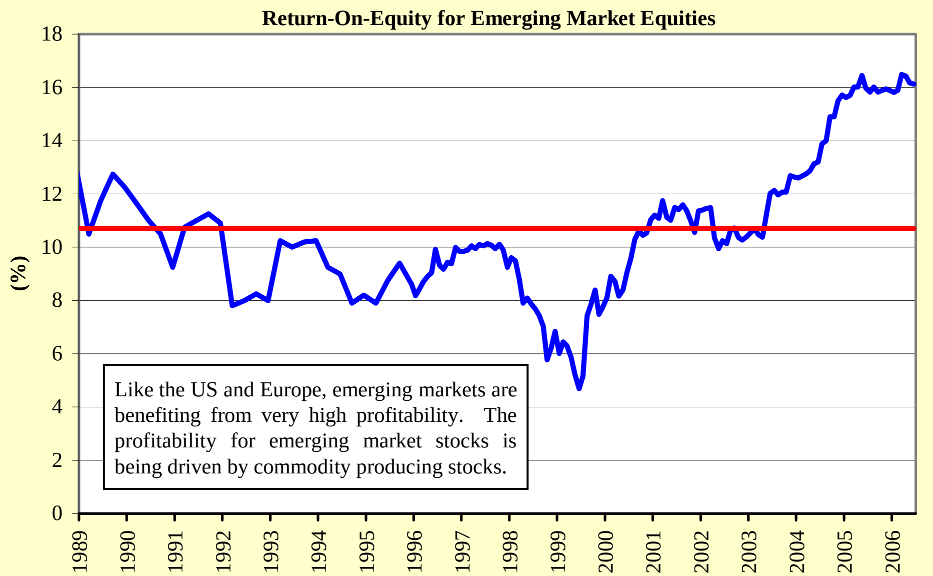


Source: IMF





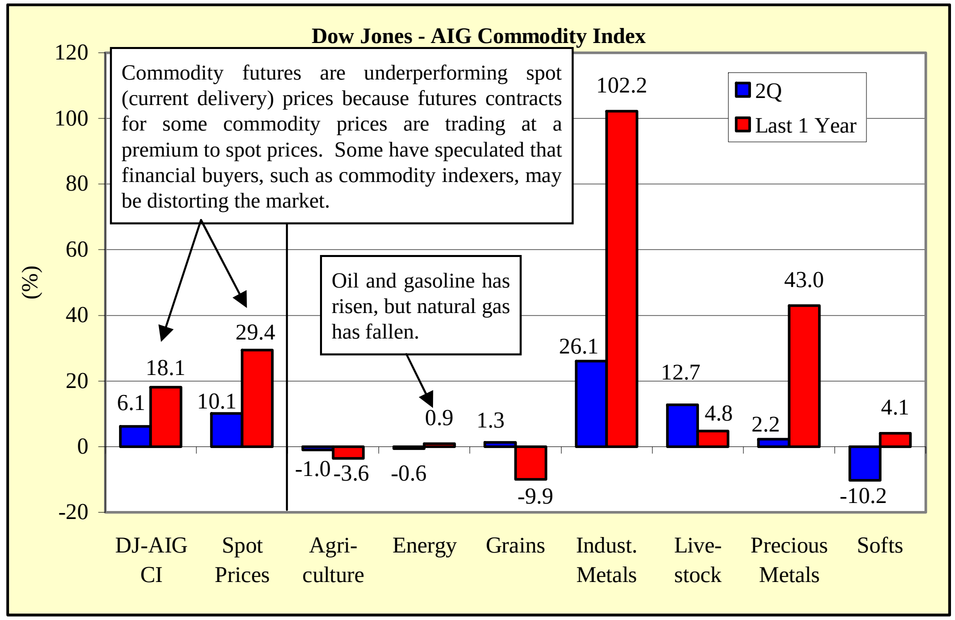
Source: IMF, Bloomberg

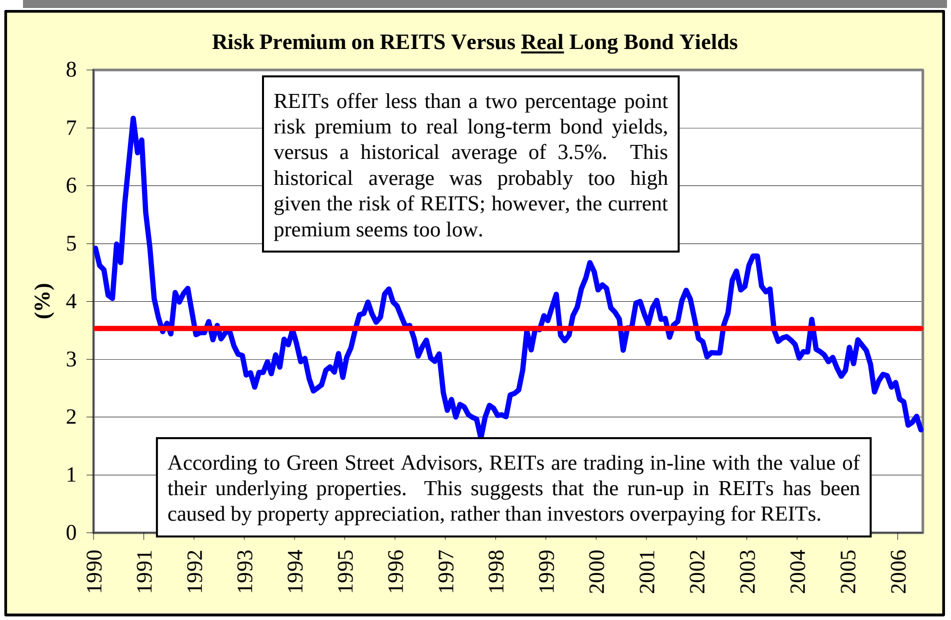


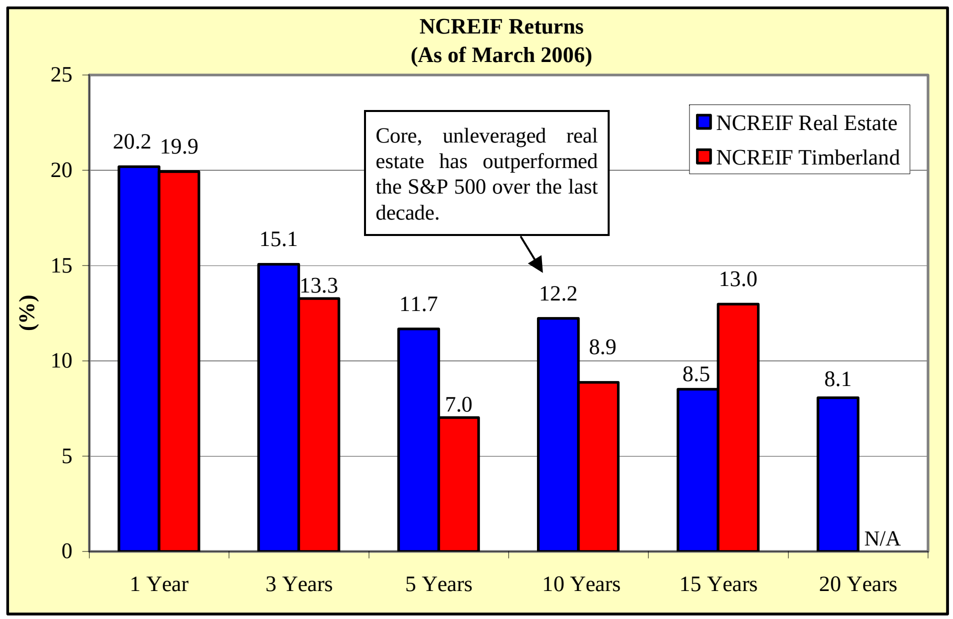
Source: MSCI

Real Assets: Industrial Metals Looking Frothy

- Commodities performed very well during the second quarter on surging industrial metals prices. The DJ-AIG Commodity index earned 6.1% for the quarter. The returns of the index versus spot prices are still suffering from negative roll yields. (See our 1Q 2006 report.) In general, commodity futures are trading at a premium to spot prices. Year-to-date, the DJ-AIG Commodity index has trailed commodity spot prices by 6%.
- The prices of industrial metals appear increasingly divorced from underlying fundamental demand. Many metals are trading far above their marginal cost. While the peak oil crowd makes legitimate arguments why oil should continue to trade at a substantially higher price than the cost to produce it, we've yet to hear anyone argue that we're reaching peak copper or nickel supplies. There's no shortage of either. It's just a matter of making the necessary investments to extract it.
- While residential real estate is showing signs of slowing, commercial real estate continues to perform well. The NCREIF Real Estate index appreciated 20% for the twelve months ended March. REITS stumbled in the second quarter, but held up better than most equity asset classes.

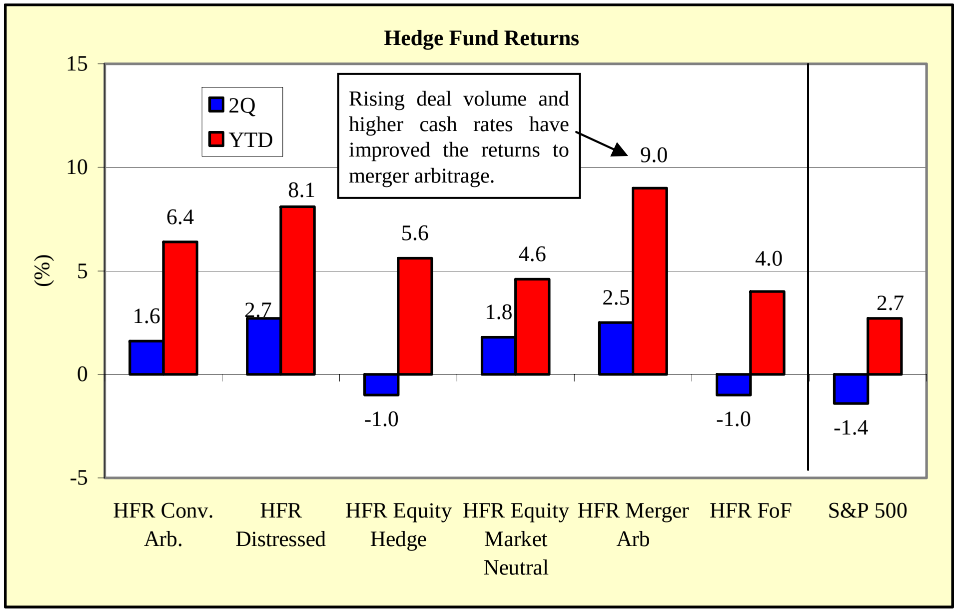


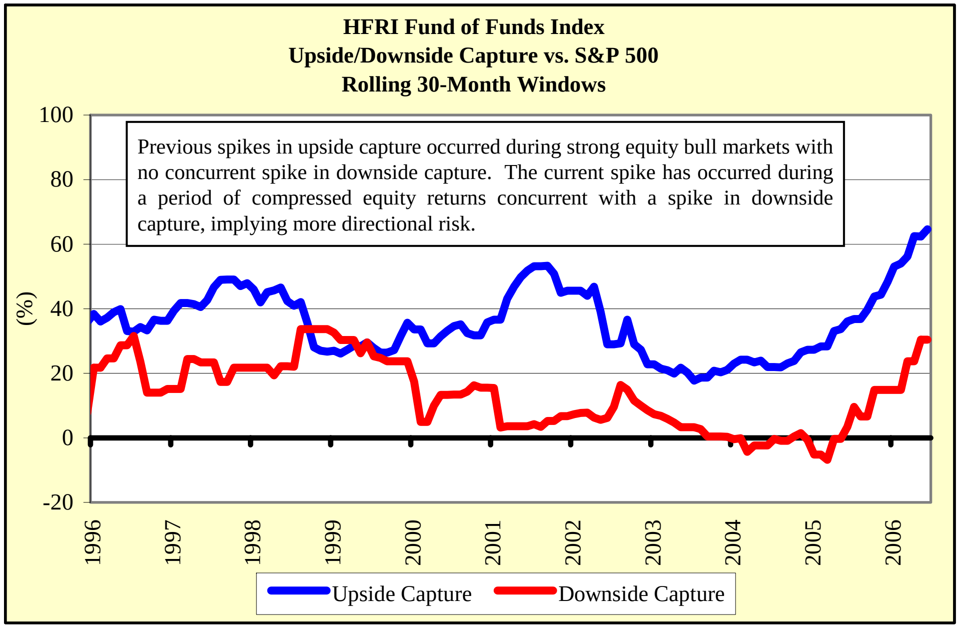




Hedge Funds: A Sneak Preview?

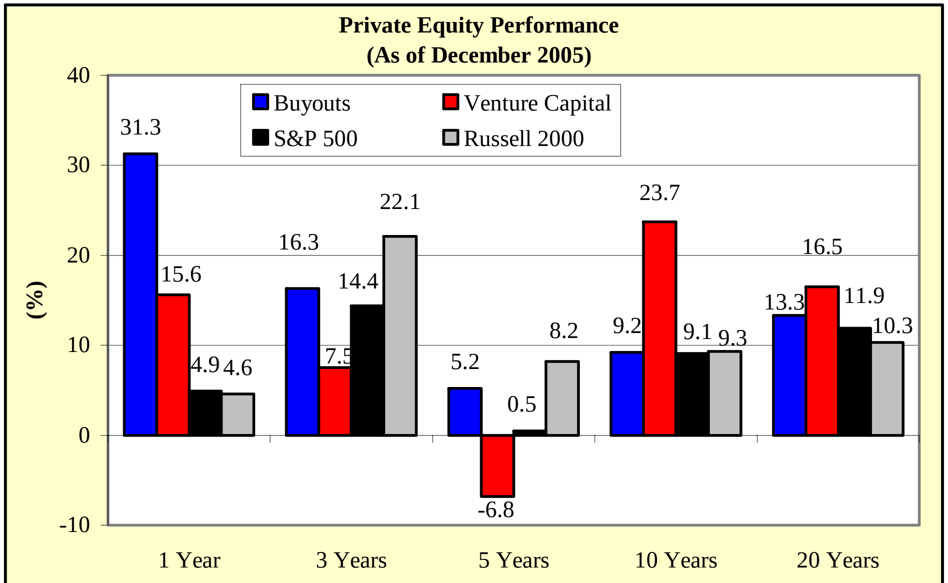
- During the second quarter, the HFRI Fund of Funds index declined 1.0%, leaving the index up 4% year-to-date. Directional exposures were the primary driver of the relatively weak quarterly results as most individual strategies performed well.
- The hedge fund strategies shown to the right represent the majority of exposures across funds of hedge funds. Given the solid returns of most strategies during the quarter (long/short equity was the only negative performer), it is interesting that the average fund of hedge funds declined 1%.
- We believe that many funds of hedge funds are taking greater directional exposure in an effort to generate returns (net of double fees) in a compressed return environment.
- The HFRI Fund of Funds Index has shown greater upside and downside capture over recent periods. Previous spikes in downside capture occurred as the result of a liquidity event in the markets. The current spike in downside exposure is occurring in the absence of such an event.
- As central banks around the world look to reduce liquidity, the risk of a liquidity shock becomes elevated. Investors should look to reduce their exposure to such an event during times like these; however, funds of hedge funds appear to be doing just the opposite. The second quarter of 2006 may prove to be a sneak preview of what's to come should the equity markets roll over.
- All hedge fund index data must be interpreted with extreme caution given the myriad of acknowledged biases. As we have noted previously, hedge funds are not an asset class. Actual investment results will depend on the managers selected and the portfolio construction methodologies employed in assembling those managers.



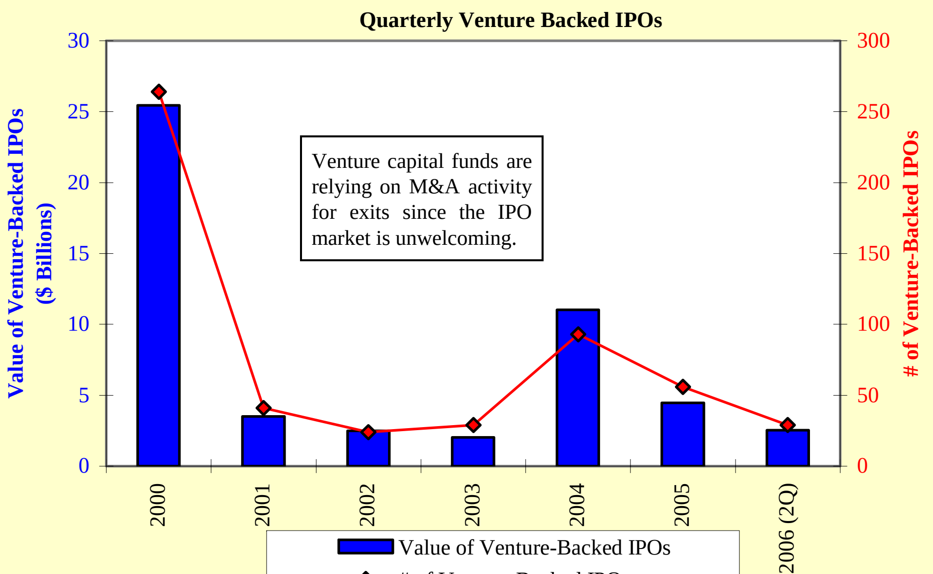


Buyout Fundraising on Record Pace in 2006

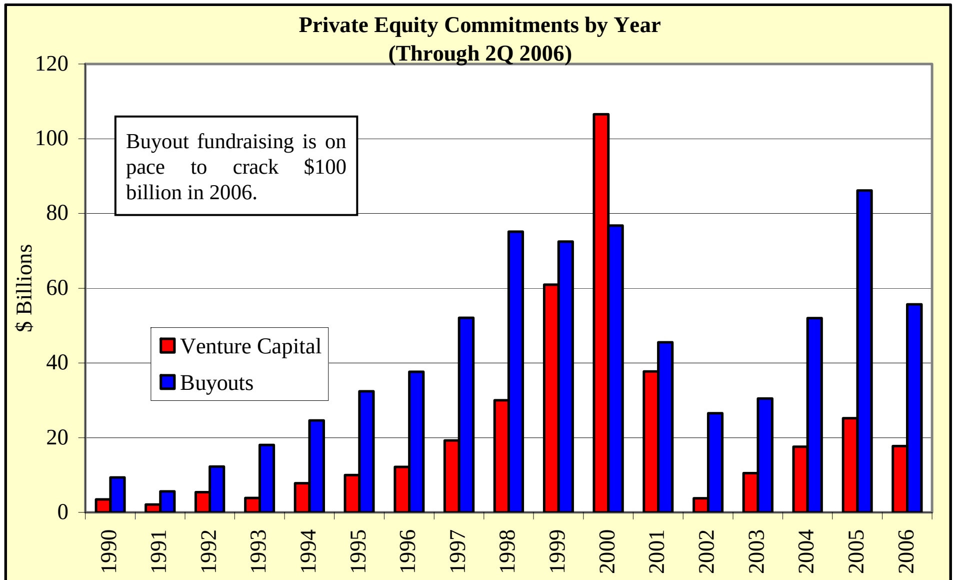
- According to Venture Economics, buyout fundraising has gotten off to a fast start in 2006. In the first half of the year, $56 billion of capital was raised, which puts fundraising on the pace to top last year's record level of $86 billion. Mega-sized funds continue to attract the bulk of capital.
- Buyout funds have been enjoying strong performance of late. Investments made from 2001 to 2003 when multiples were low on depressed cash flow are paying off handsomely. It's questionable whether buyouts can continue to post attractive returns given the high levels of fundraising over the last two years.
- Venture capital funds raised a much more modest $18 billion in the first half of 2006. The IPO market continues to be a challenge for VC funds. Through the first half of 2006, there have only been 29 IPOS raising total capital of $2.5 billion. Since the current IPO market is not a reliable exit route, companies have to be built to appeal to strategic buyers who are less likely to pay outrageous sums for acquisitions.



Source: Venture Economics



Source: Venture Economics



Source: Venture Economics

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