



HammondAssociates
INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

Third Quarter 2006

In this report . . .

- ✓ Shall We Tango?
- ✓ The Message from the Bond Market
- ✓ Can the Economy Withstand the Housing Slump?
- ✓ There's Value in Large-Cap Growth



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

Third Quarter Research Report Overview

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Executive Summary

- The renewed risk aversion exhibited by investors during the second quarter was short-lived. Global equity markets performed well in the third quarter. The S&P 500 gained 5.7%, lifting its year-to-date return to 8.5%. The MSCI EAFE index earned 3.9% (in US\$), underperforming the S&P 500 for the quarter. EAFE still has a sizeable lead so far in 2006, with a 14.5% return. Emerging market stocks climbed 4.9%, completely recovering the second quarter loss.
- Energy prices declined during the quarter. The price for a barrel of oil slid 15%. Prices will likely continue to be very volatile because of the tight supply and demand balance. We continue to recommend meaningful energy exposure in portfolios as a hedge against a supply shock.
- The Fed stood pat in the third quarter. The futures market predicts the Fed is finished and that it may begin a new easing cycle in the first half of 2007. The yield on the 10-year Treasury declined from 5.15% to 4.64% during the quarter, which suggests the bond market believes the economy is slowing.
- The housing market correction is turning out to be deeper than most economists expected. Housing starts have plummeted 20% over the last twelve months, and existing home sales have slid 13%. It's not clear whether prices are falling at a national level. Despite the housing slump, the consensus among economists is that the economy will experience a soft landing. However, the risks to this forecast appear weighted to the downside.
- The profit margin for the S&P 500 continues to improve. Profit margins tend to decline in periods of slower growth and particularly during recessions. If there is a recession, margins will contract, but they should hold up better than they did following the 2001 recession. Recession or not, profit margins are unlikely to stay at these elevated levels. We expect them to begin declining. This could be a significant headwind for equities in the coming years.
- After seven years of underperformance, valuations on large-cap growth stocks are becoming increasingly compelling. While they are by no means cheap on an absolute basis, they appear to offer the best relative value among domestic styles. We recommend that institutions overweight large-cap growth stocks within domestic equity portfolios at the expense of large-cap value and small-cap stocks.
- The valuations of REITs are looking very stretched. The dividend yield premium to real bond yields has contracted to just 1.8%, which is about half the historical average of 3.5%. Still, in a world of low returns, the expected return premium for REITs does not appear particularly out of line with other assets. Nevertheless, we prefer to get exposure to real estate through private partnerships implementing value-added strategies.



**Market Commentary:
Shall We Tango?**

October 2006

Many institutions have made significant allocations to natural resource investments over the last few years. These assets are attractive because they provide inflation protection, which is particularly beneficial to institutions whose expenses are sensitive to inflation. From a tactical perspective, natural resource investments have been particularly attractive because of China's insatiable demand for commodities and a feared secular decline in the dollar. Many natural resource investments have taken the form of private partnerships that invest in oil & gas properties and timberland. Institutions have also been gaining exposure to natural resources through commodity futures indexes. Commodity futures are attractive for this purpose because they offer liquid exposure to natural resources. In 2003, we began recommending that clients adopt a 3% to 5% allocation to a commodity futures index.

Many other investors have also made allocations to commodity futures indexes. As a result, assets passively tracking these indexes have ballooned over the last few years. In 2000, there was roughly \$5 billion tracking commodity indexes. Today, some estimates put the figure over \$100 billion, a 20-fold increase. Interestingly, a recent study by Ibbotson Associates suggested that up to a 30% allocation to commodities might improve the risk to reward profile of a portfolio.¹ In addition to commodity indexes, hedge funds are heavily involved in the commodity futures market. Important considerations now are the impact of these dollars on commodity futures pricing and the implications for future returns.

Investors with allocations to commodity futures indexes have been handsomely rewarded over the past few years (although the indexes have struggled this year). The DJ-AIG Commodity Index, which is the index we typically recommend, has returned 13.5%, annualized, over the last five years. The Goldman Sachs Commodity index has earned 13.1%. However, there have been growing problems below the surface. The prices for futures

¹Stephen Roach of Morgan Stanley observed that if all institutions actually did this, then the total invested in commodities would be over seven times the annual value of commodity production.

on most commodities are higher today than current delivery, or spot, prices. In addition, we question whether today's commodity prices are sustainable, as a reflection of fundamental factors, or are primarily fueled by speculation. At the root, our question today is whether investing in a commodity futures index is still prudent.

Commodity Futures Indexes

The two most commonly used commodity futures indexes are the Dow Jones – AIG Commodity Index (DJ-AIGCI) and the Goldman Sachs Commodity Index (GSCI). Both represent a basket of commodity futures. They assume a fully collateralized long position in a number of commodity futures contracts.² As each contract within the index reaches its expiration month, the index rolls to the next contract. For example, for a commodity with monthly contracts, this means that at the beginning of October the index rolls from the November futures contract to the December contract.

There are three sources of returns associated with investing in commodity futures: (1) the cash return, (2) the spot return, and (3) the roll yield. The cash return is simply the return earned on the collateral for the futures contracts. The spot return represents the change in the price of the commodity for current delivery. The roll yield is the return from rolling futures contracts. Futures on commodities trade at prices different than spot. If futures are trading at a discount to current prices, which is known as backwardation, the roll yield will be positive. If futures are trading at a premium to current prices, which is called contango, the roll yield will be negative. If there is a negative roll yield in any year that is greater than the cash return, the total return will trail the spot return.

Exhibit 1

GS Commodity Index				
Time Frame	Cash Return	Spot Return	Roll Yield	Total Return
1970-1979	6.3	9.0	4.6	21.2
1980-1989	9.2	(1.4)	2.7	10.7
1990-1999	5.1	(0.6)	(0.5)	3.9
2000-2006	3.0	12.4	(3.4)	11.8
Last 5 Years	2.2	18.7	(6.8)	13.1
Last 10 Years	3.7	7.6	(4.9)	6.1
Last 20 Years	4.7	5.1	0.2	10.3
Since Inception	6.1	4.0	1.2	11.7

Note: the component returns do not sum to the total return because of compounding.

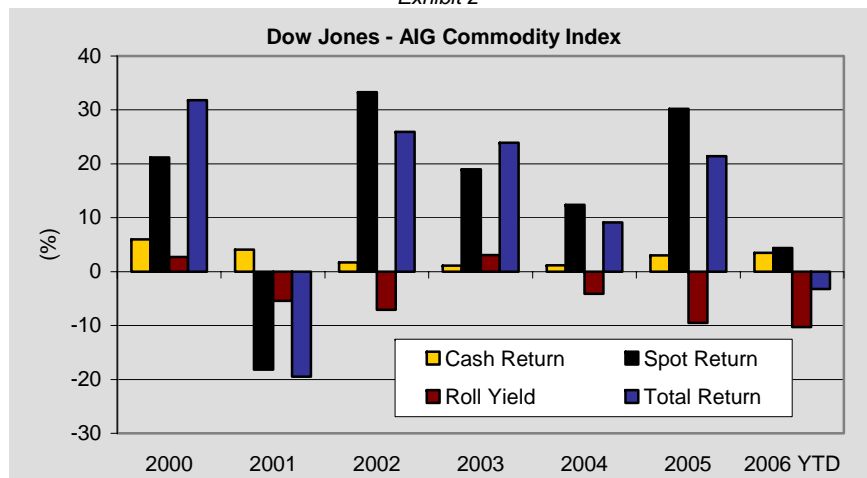
²Entering into futures contracts involves no cash outlay. To eliminate the leverage inherent in a futures contract, an investor should hold the notional value of the contract in T-bills, in which case the contracts are considered fully collateralized.

The spot return for commodities has been spotty over time, as shown in Exhibit 1. (We show the GSCI because it has a much longer history than the DJ-AIGCI.) In the 1970s, spot prices performed very well, but in the 1980s and 1990s they depreciated. For example, from January 1980 to December 2001, spot prices for the Goldman Sachs Commodity Index *declined 0.2%* on an annualized basis. Over the very long-term (since the mid-19th Century), prices for most commodities have declined in both nominal and real terms. This is because of productivity growth. It is much cheaper to grow a bushel of soybeans or extract a ton of copper out of a mine than it was 150 years ago.

In many periods, a significant part of the historical return for commodities has come from the roll yield. For example, from its inception in January 1970 through December 2001, the GS Commodity Index earned an excess return above cash of 4.3%, annualized. Spot prices rose just 1.7% during this time period and the roll return was 2.3%. However, the roll yield has also been negative during extended periods of time, like in the 1990's, when commodities lagged cash.

Going back to the DJ-AIGCI, there has been a definite downward trend in the roll yield over the last few years, as shown in the chart below. In 2003 the roll yield was positive 3.1%. It fell to -4.1% in 2004 and to -9.5% in 2005. Through the first nine months of 2006, it is -10.3% (-13% annualized). The cash return of 3.5% so far in 2006 offsets part of the negative roll yield. On a total return basis, the DJ-AIGCI has declined 3.2%, which is 7.6 percentage points below the spot return of 4.4%.

Exhibit 2



This highlights the difficulty for investors in commodity futures going forward. For commodity futures indexes to post positive returns, spot prices might have to post double-digit increases. This happened in 2002 through 2005. If spot prices were to stay flat or increase at mid single-digit rates, as has happened so far in 2006, then returns for investing in commodity futures would likely lag cash and could even turn negative.

Is Contango Rational?

Two important questions related to the future of investing in commodity futures are whether it is logical for futures to trade in contango and whether investors can continue to rely on significant increases in commodity spot prices.³ The argument for why future prices for oil and other commodities have historically been below spot prices is that producers are hedgers who want to short futures to lock in a future price. Hedgers were willing to accept futures prices that are below current spot prices to eliminate the risk that spot prices might fall sharply. In other words, hedgers have been willing to pay a risk premium to induce speculators to take the other side of the contract. There is a major debate within the marketplace today as to whether futures prices *should* be higher than spot prices and whether current spot prices are justified.

One side argues that this pricing relationship is justified at least for oil because of increasing demand in the developing world and the possibility of the world hitting peak oil in the future. They argue spot prices will continue to increase and contango is justified because oil supplies will continue to be tight and demand growth strong. For example, they point out that spare oil capacity is at record low levels and that the development of new oil fields or alternative sources of oil are years away. Natural gas should trade in contango at times because of seasonal demand variation.

The rapid rise in assets tracking commodity indexes and increased financial speculation makes us worry that the pricing is not based only on fundamentals. The Commodity Futures Trading Commission reports that the amount of noncommercial (speculative) positions in the futures market has jumped from 9% in 1995 to 16% in 2005. According to Douglas Hepworth of Gresham Investment Management, commodity index tracking requires more than \$50 billion of trading a month. While this might not sound like much in markets where \$1 trillion is traded monthly, marginal investors can have a

³Many commodities should trade in contango by the amount of the cash return since the collateral can be invested to earn the cash return risk-free. In this case, the futures are priced to match the spot returns. This is usually case for commodities where production is a small part of available supply, like with precious metals. Gold, for instance, almost always trades in contango by the expected cash return. Financial futures, such as those on the S&P 500, also trade in contango.

disproportionate effect on prices (especially when those investors are passive and are not price sensitive). Hedge funds may also be affecting the market. Lehman Brothers estimates that 80% of the recent decline in energy prices is the result of funds selling positions and 20% of the decline is the result of changes in fundamental factors. Thus, it is likely that speculators also played role in driving energy prices upward. For example, the volatility of natural gas spreads and size of the spreads both indicate that speculation might be playing a significant role in futures pricing. JP Morgan estimates that hedge funds and investment banks have poured \$50 billion into the commodity market in recent years. Anecdotal evidence from many energy floor brokers indicates that the size, volume, and volatility of trading have increased substantially, likely the result of hedge funds and other speculators. Of course, since energy prices fell sharply during the quarter, and we have witnessed the demise of a major hedge fund, one could argue that speculators have pared back their bets and prices are now at appropriate levels.

We have focused on energy contango. It is worth noting that agricultural futures are also trading in contango. Industrial metals, by contrast, are still trading in backwardation.

Industrial Metals

While energy prices get most of the press, industrial metal prices have risen even more sharply. Similar to energy, industrial metal prices have shot up because of strong demand and tight supply. Industrial metals have benefited from the rapid rate of development in China. The IMF estimates that China has accounted for at least 50% of global growth in demand over the past three years for industrial materials such as aluminum, copper, lead, steel, tin, zinc, and nickel. Any slowdown in China or the United States (China and other emerging markets are dependent on the US consumer to purchase their exports) would result in slowing demand and sharply falling prices. While high demand and tight supplies might explain a portion of the recent increase in industrial metal prices, the magnitude of the increase indicates that speculation likely played a role. Additionally, there is no shortage of industrial metals. Producers just need to make the necessary investments and then wait for additional production to come online. Not surprisingly, most industrial metals are in steep backwardation (one-year futures are priced 15-20% below spot prices). This is likely rational because of the additional supply that will come on-line as the result of high spot prices. While investors in industrial metal futures would benefit from a positive roll yield, they should not rely on major spot price increases to drive returns.

Should Institutions Continue to Invest in Commodity Indexes?

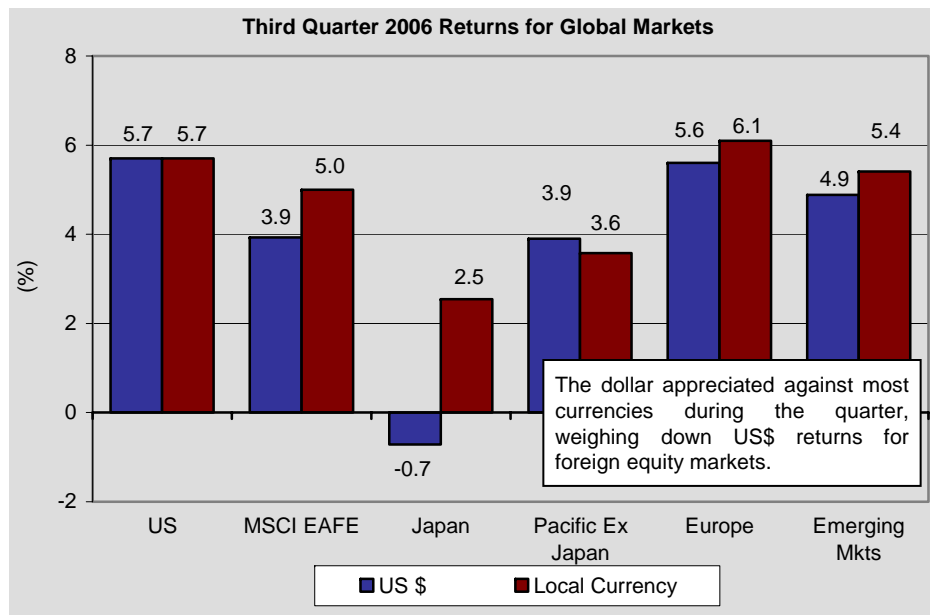
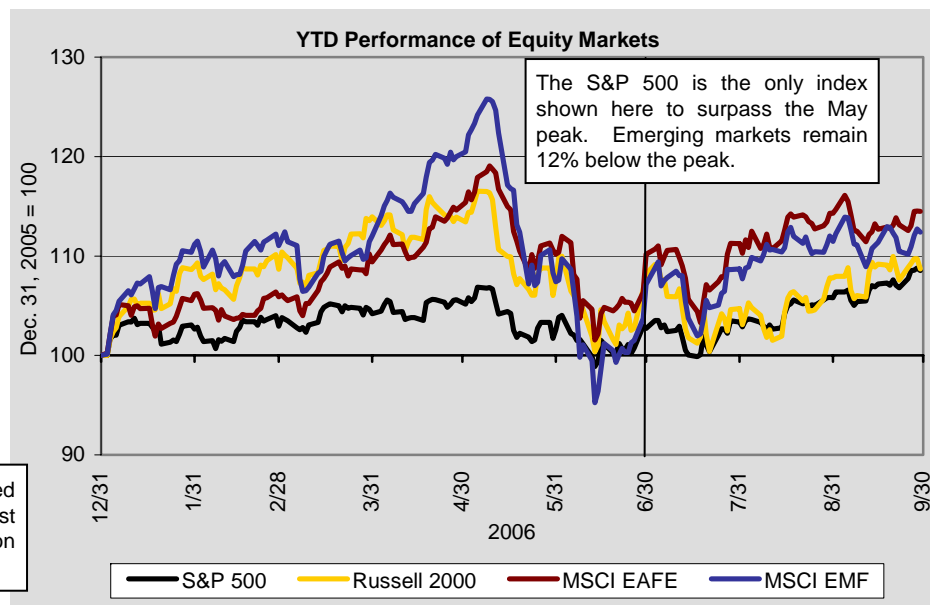
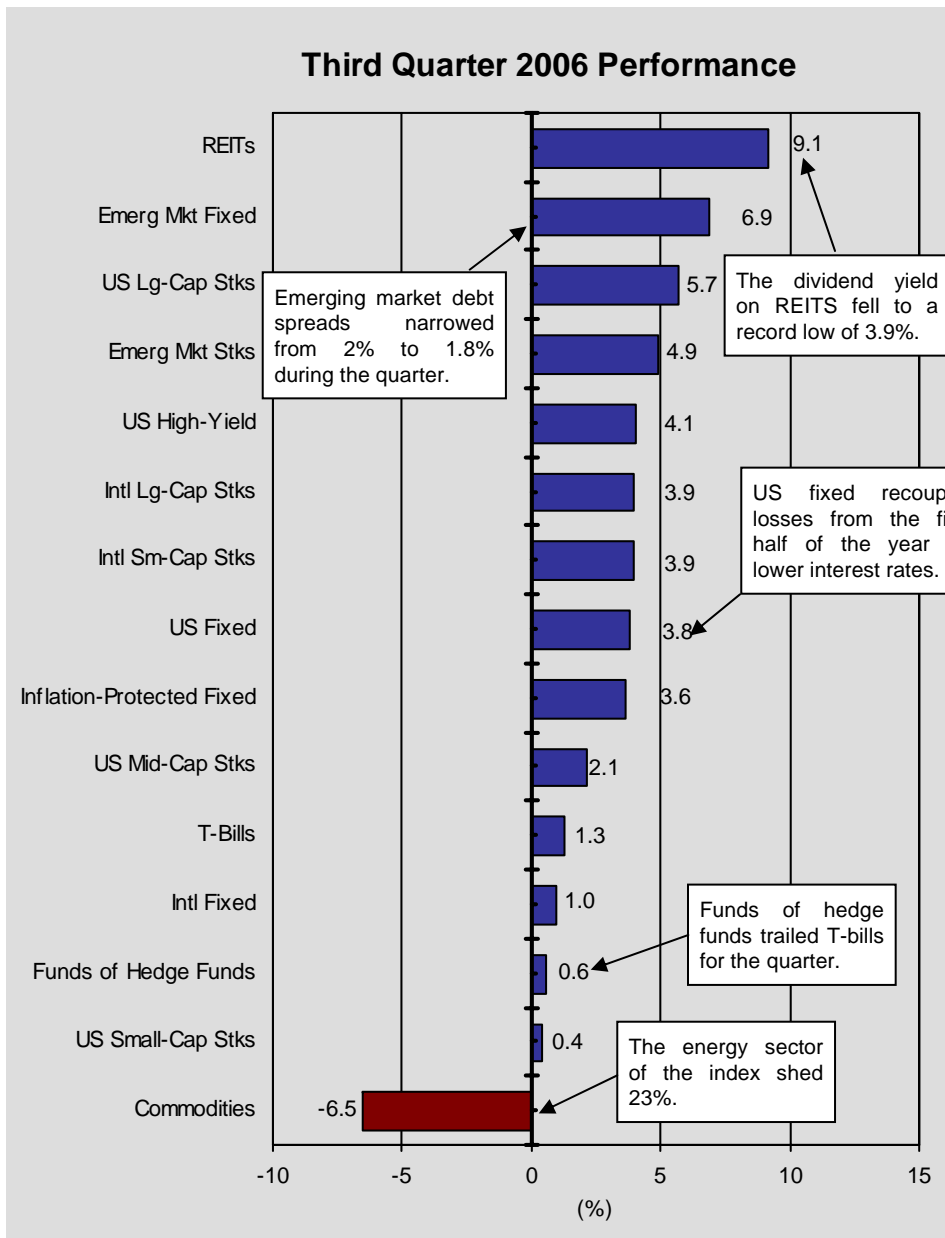
Commodity futures are not as attractive as they were a few years ago. The huge run-up in prices has increased the downside risk. If the US enters a recession, we would not be surprised to see a sharp pullback in commodity prices, particularly industrial metals. Furthermore, the large negative roll yield imbedded in commodity indexes as the result of contango will be a significant drag on future returns. It is difficult to determine if financial investors and speculators are driving the contango, or if it's a rational response to fundamental factors. If it's primarily caused by fundamental factors, then commodities can be reasonably expected to earn two to four percentage points above cash, with nice diversification benefits. If financial investors and speculators are driving it, it's likely that commodities will underperform cash. Our hunch is that it's a combination of the two. Regardless of the reason, spot prices must post double-digit returns just for commodity futures indexes to beat cash. This could certainly happen, as it did in 2002 through 2005, but we're not willing to bet on it. Overall, it is hard for us to justify a passive commodity allocation given today's conditions. There is a reasonable chance that the returns on commodity future indexes will lag cash.

The best case for commodity futures today is that they provide protection against an energy supply shock. A significant energy supply disruption is arguably the greatest risk faced by the global economy and capital markets. However, there are other ways to hedge this risk, while benefiting from energy contango. For institutions with the means, allocations to private partnerships in the energy exploration and production business are ideal. The problem with this approach is that it could take years to reach the desired exposure. An alternative is to simply invest in publicly traded energy stocks, but these stocks tend to move in sympathy with equity markets, dampening their short-term diversification benefits. Nevertheless, they should thrive in the event of a secular increase in energy prices, as they have over the past few years. In addition, they can take advantage of contango by selling futures on production at a premium to spot. While energy prices must rise just for commodity indexers to breakeven, energy stocks appear priced for falling energy prices. They trade at a P/E ratio of 10 on trailing reported earnings, which is a 42% discount to the market P/E. While energy stocks have risks of their own, they appear a better way to play energy than commodity indexes.

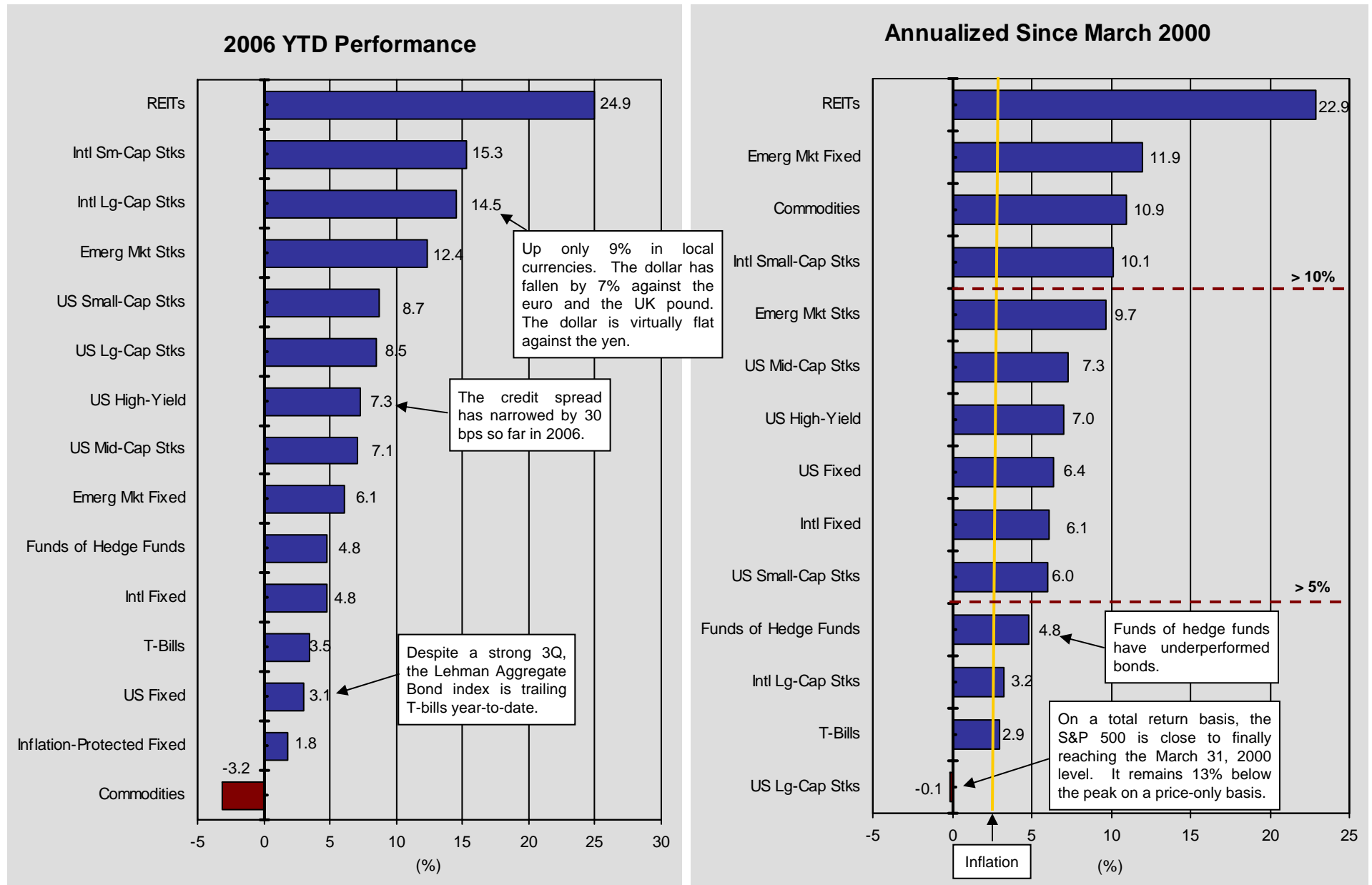
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Global Equity Markets Rebounded

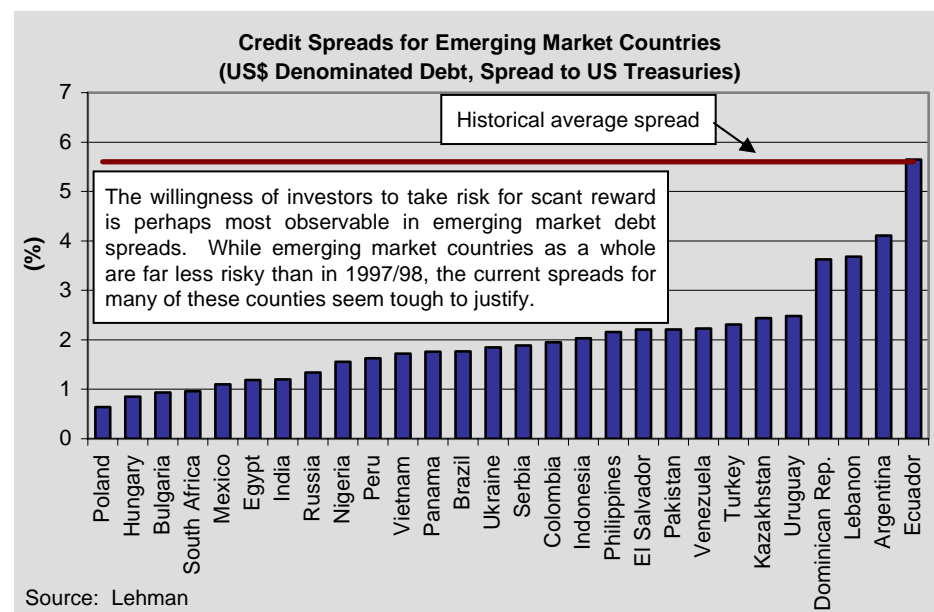
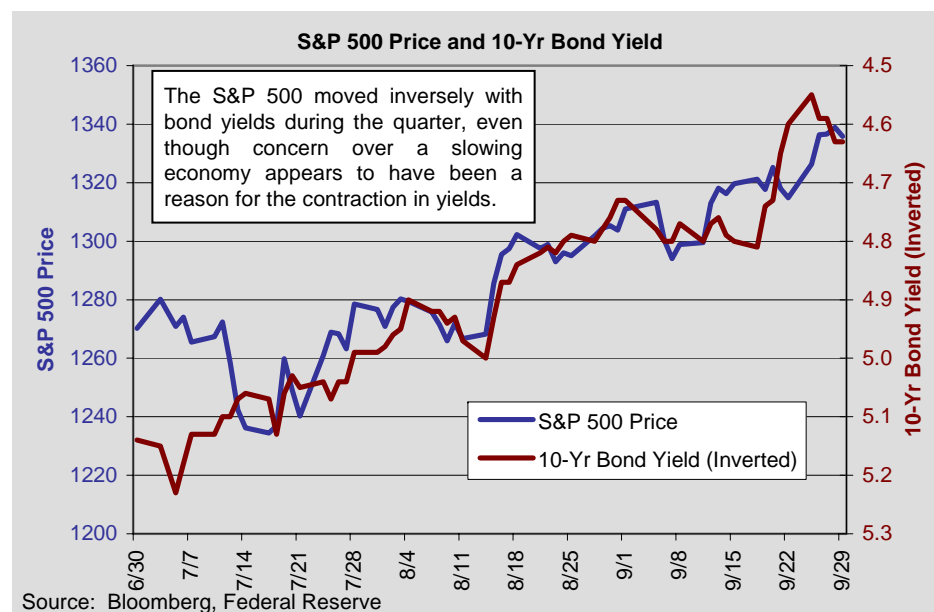
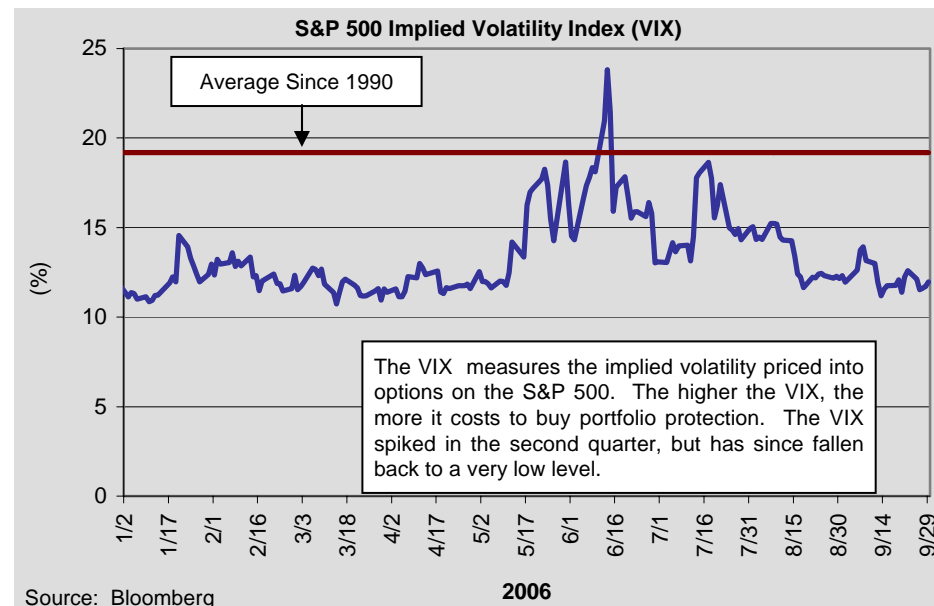


2006 Shaping Up to be a Good Year



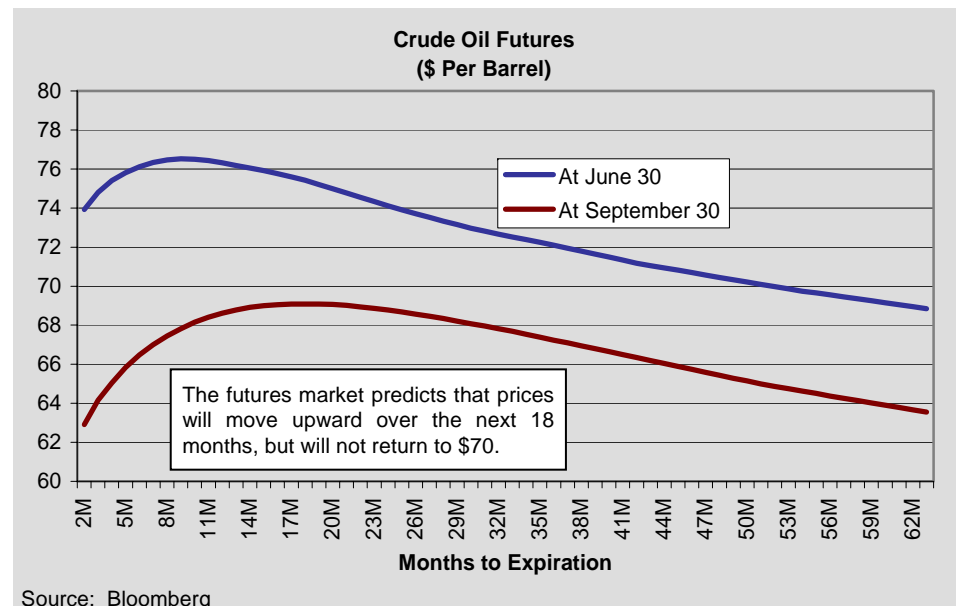
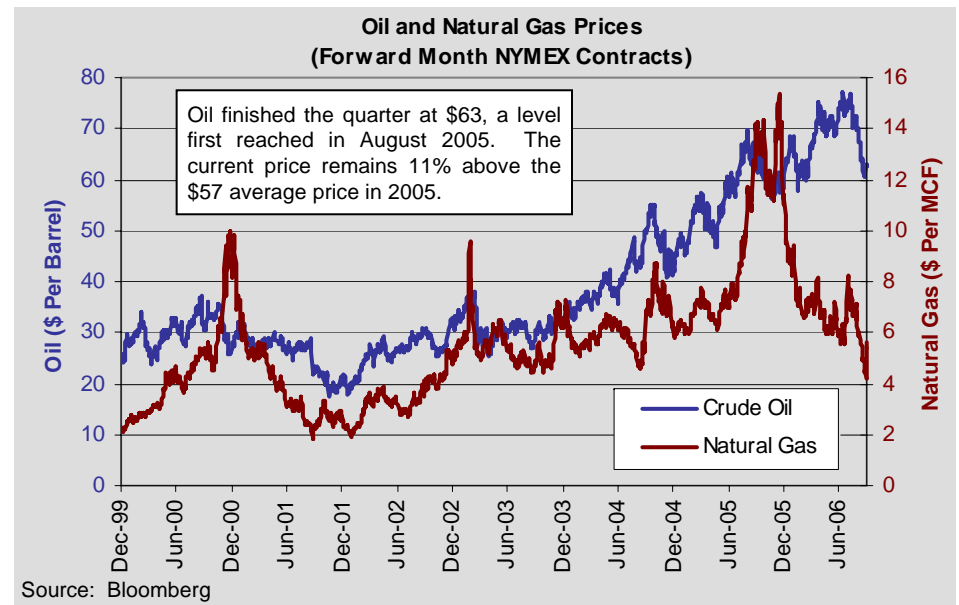
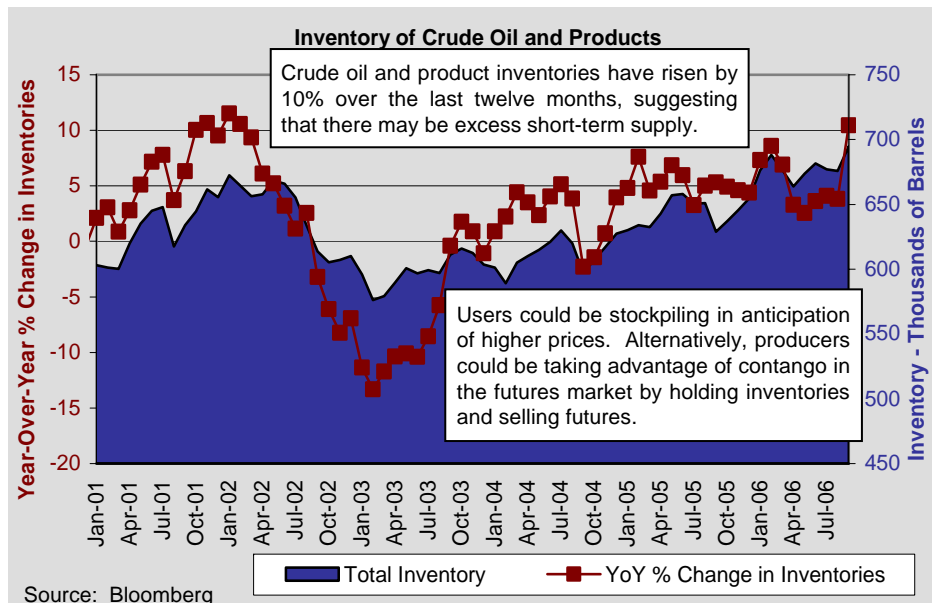
Risk Aversion Was Short-Lived

- The renewed risk aversion exhibited by investors during the second quarter appears to have been short-lived. Despite worse-than-expected housing news and a slowing economy, the S&P 500 and other equity asset classes enjoyed a strong quarter.
- Investors seem to be overly focused on the silver lining of the slowing economy—the Fed may soon begin to cut short-term interest rates. As economic data was released pointing to slower growth, bond yields fell and equity markets rose. Markets seem to be banking on a soft landing for the housing market and the economy.
- It's troubling that investors seem to be relying on the Fed and other central banks to inject liquidity to keep assets afloat (and it remains to be seen whether central banks will be accommodating). A short-term injection of liquidity can make overpriced assets even more overpriced, but it comes at the expense of future returns.



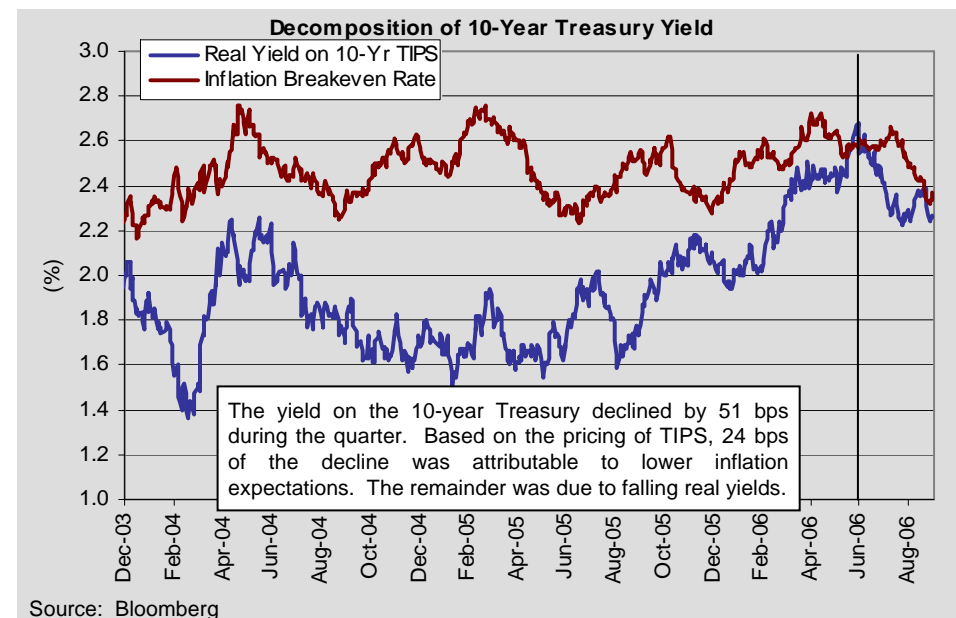
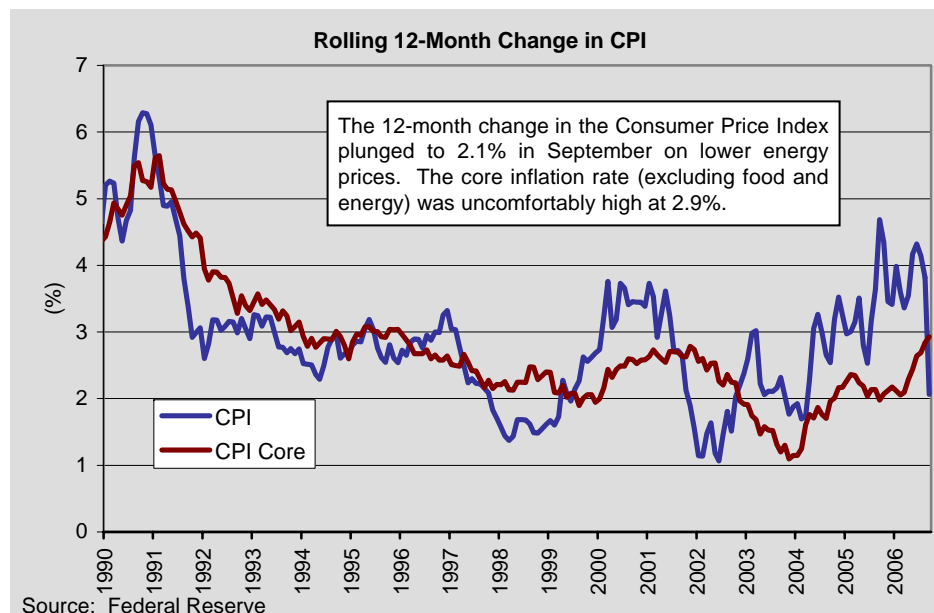
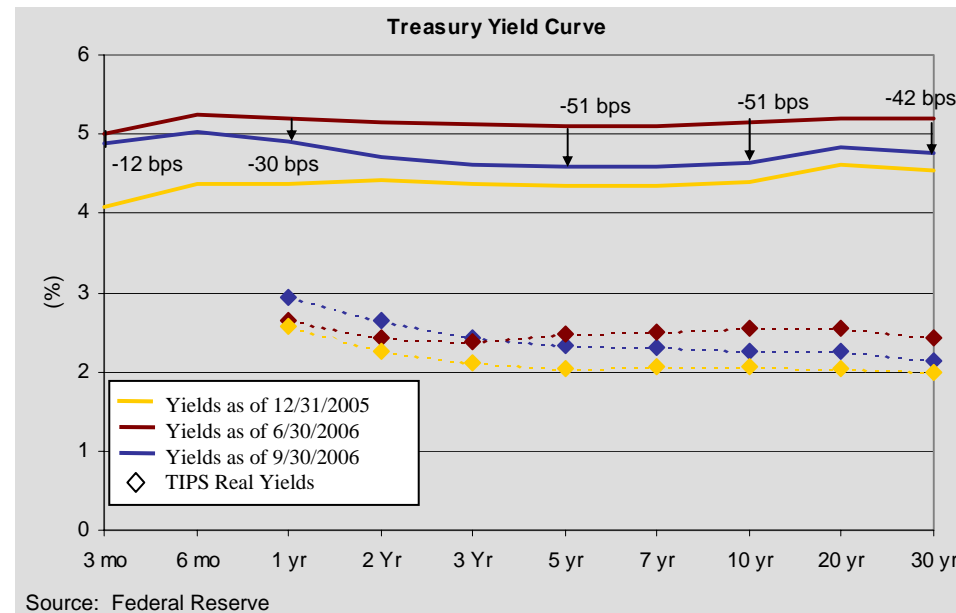
Energy Prices Tumbled During the Quarter

- Energy prices declined during the quarter. The price for a barrel of oil slid 15%, from \$74 to \$63 (and it has fallen below \$60 in October). Front month natural gas futures declined from \$6.10 per mcf to \$5.62. Gasoline prices fell even more on weaker refiner margins. Wholesale gasoline prices tumbled 30%.
- There are a number of factors which may have contributed to the decline: (1) easing tensions in the Middle East; (2) anticipation of slower demand growth in light of the slowing US economy; (3) short-term excess supply, as evidenced by the rapid rise in inventories; (4) a benign Gulf hurricane season; and (5) reduced financial speculation.
- Where oil goes from here is anybody's guess. OPEC has indicated a reluctance to allow the price to fall below \$60 a barrel, but it remains to be seen whether member countries have the discipline to lower production at a price that remains substantially above marginal cost.
- Prices will likely continue to be very volatile because of the tight supply and demand balance. **We continue to recommend meaningful energy exposure in portfolios as a hedge.**



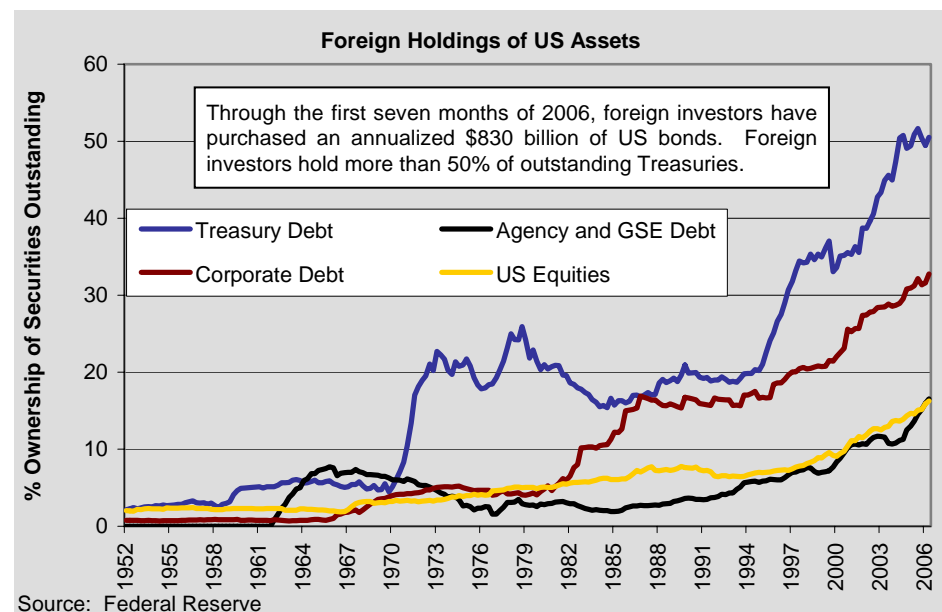
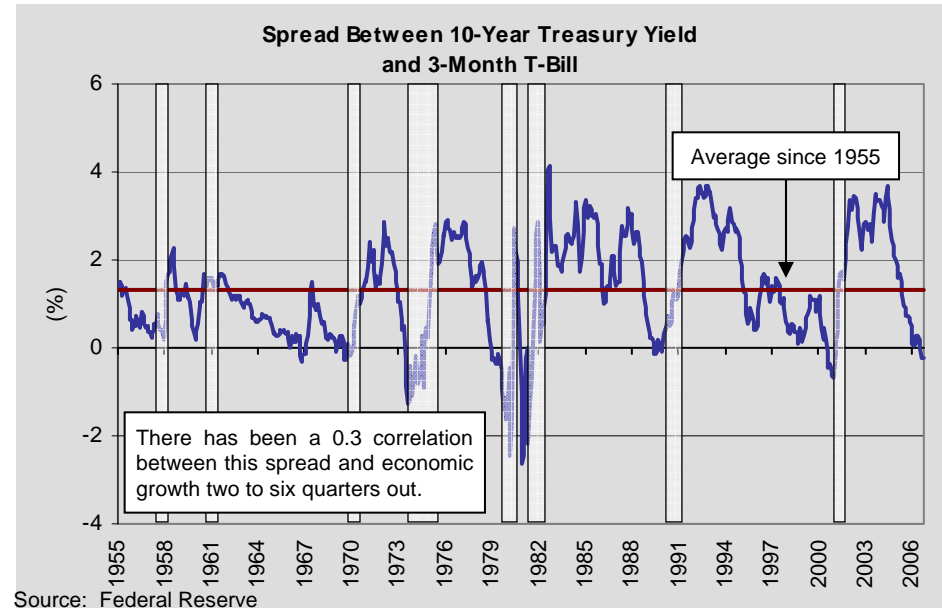
The Fed Pauses

- The Fed stood pat in the third quarter, perhaps marking the end of this tightening cycle, which included 17 quarter-point hikes. If the Fed holds at 5.25%, it will be the lowest Fed Funds rate at the end of a tightening cycle since 1959. The futures market predicts the Fed is finished and that it may begin a new easing cycle in the first half of 2007.
- Bond yields fell sharply during the quarter. The yield on the 10-year Treasury declined from 5.15% to 4.64%. The inflation breakeven rate priced into 10-year TIPS declined 24 bps, from 2.61% to 2.37%, suggesting about half of the decline in the 10 year yield was due to falling inflation expectations. The real yield on 10-year TIPS declined from 2.54% to 2.27%.
- With the decline in bond yields, the yield curve inverted between 3-months and 10-years. T-bills offer a 25 bps yield premium to 10-year bonds. Historically, an inverted yield curve has been a reliable predictor of a recession.



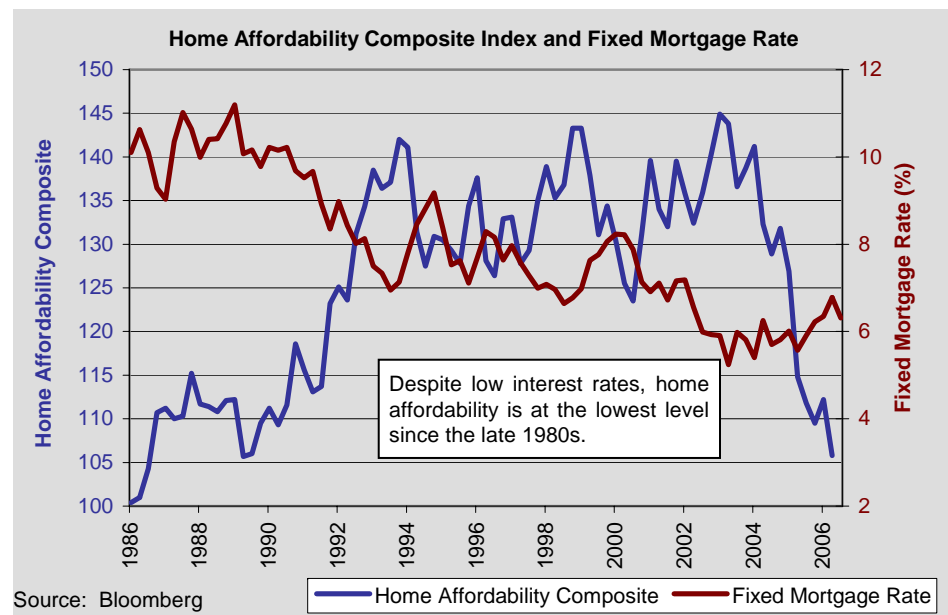
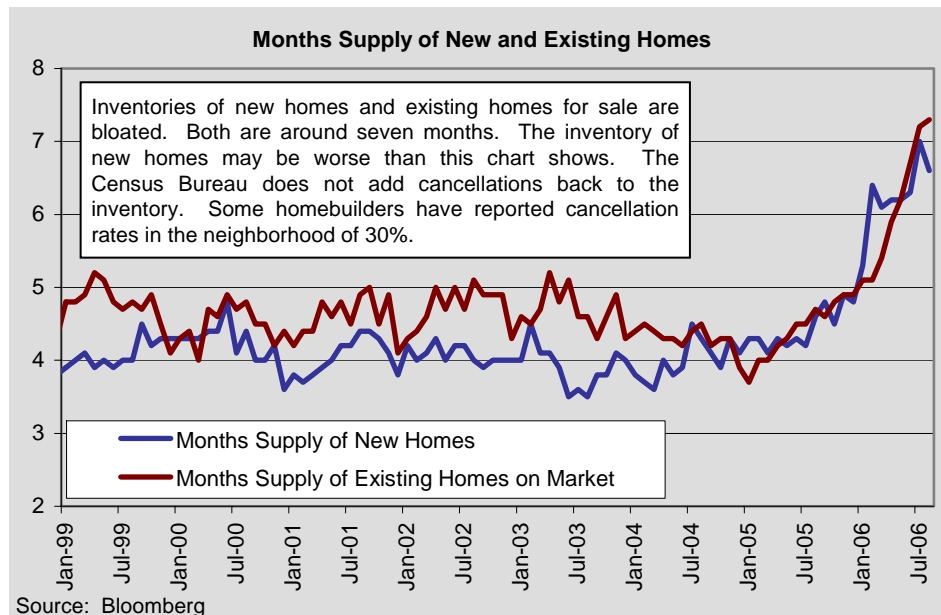
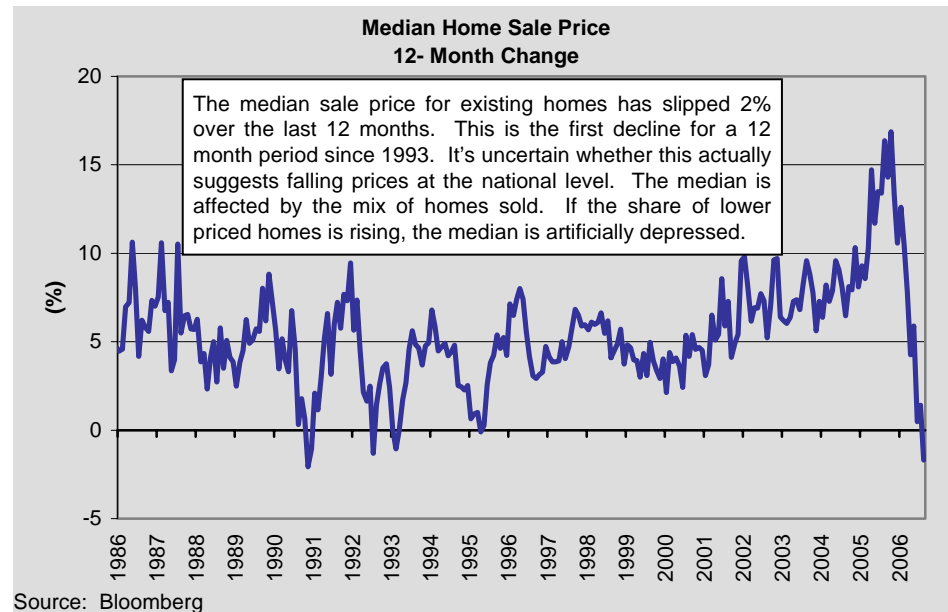
The Message from the Bond Market

- Since 1970, a recession followed all six instances when the spread between the 10-year Treasury and the 3-month T-bill turned negative. Inverted yield curves have been good predictors of recessions because they suggest the Fed will be cutting short-term rates significantly in response to a weak economy.
- There are factors that suggest the current modest inversion *does not* mean that the bond market expects a recession.
 - **Lower inflation risk premium** – Part of the maturity premium for bonds represents compensation for the risk that inflation is higher than expected. If the risk of unexpected inflation is lower than in the past, the yield curve could be permanently flatter, in which case expectations for Fed easing do not have to be as high to cause inversion. The market may be forecasting a typical easing cycle.
 - **Foreign bond purchases** – Foreign purchases of US bonds are likely artificially lowering intermediate and long-term yields, which makes the yield curve more prone to harmless inversion. Asian central banks, particularly China's, continue to invest much of their annual trade surpluses in Treasuries and other US obligations to keep their currencies from appreciating against the dollar. It also appears that oil exporters are recycling some of their revenue back into dollars (so-called "Petrodollars").
 - **Credit Spreads** – The yield premium for investing in high yield ("junk") bonds was virtually unchanged for the quarter and remains abnormally low. This is inconsistent with an expectation of a recession, since one would presumably result in a spike in defaults.
- We suspect these factors make the current inversion of the yield curve a less reliable indicator of an impending recession, especially since the magnitude of the inversion is low at only 25 bps.
- The bond market may not be predicting a recession, but its message should not be ignored by investors. The sharp decline in the 10-year bond suggests that the economy is slowing, and the odds of a recession, while perhaps not at 50%, are higher than they were a few months ago.



The Housing Slump Deepened

- The housing market correction is turning out to be deeper than most economists expected. Housing activity has slowed sharply. Housing starts have plummeted 20% over the last twelve months, and existing home sales have slid 13%. The months supply of existing homes on the market is at its highest level since 1993.
- While activity is falling, it's not clear whether prices are falling at the national level. Freddie Mac's repeat sales price index was 1.2% higher for second quarter 2006. Third quarter data will not be available for two months. Most economists still believe that prices will hold up at the national level, but warn that some local markets are vulnerable.
- The decline in interest rates should provide some relief to the housing market. Freddie Mac reports that 30-year fixed mortgage rates declined from 6.78% to 6.31% during the quarter. Still, the current rate is 10 bps above where rates started the year and 44 bps above the average level of 2005.

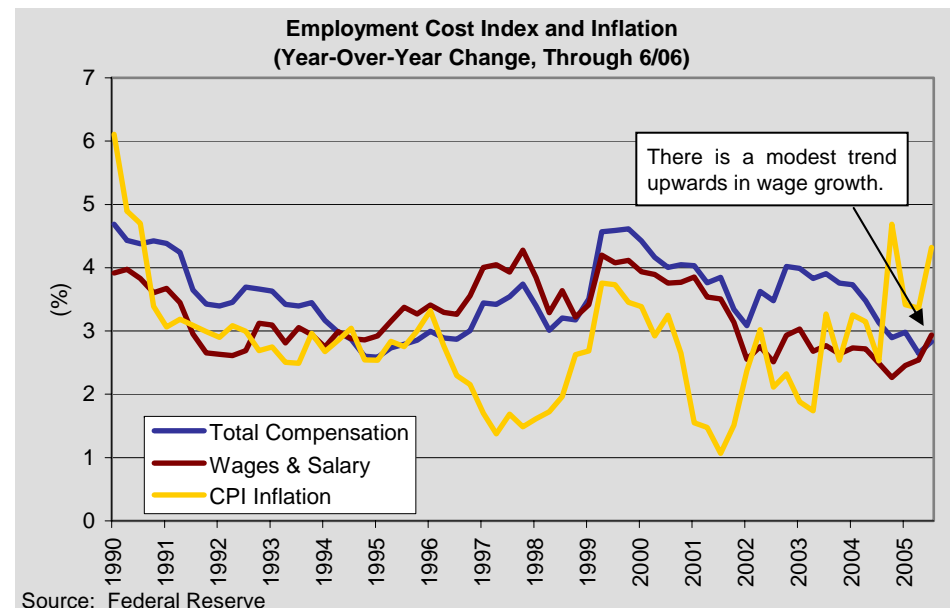
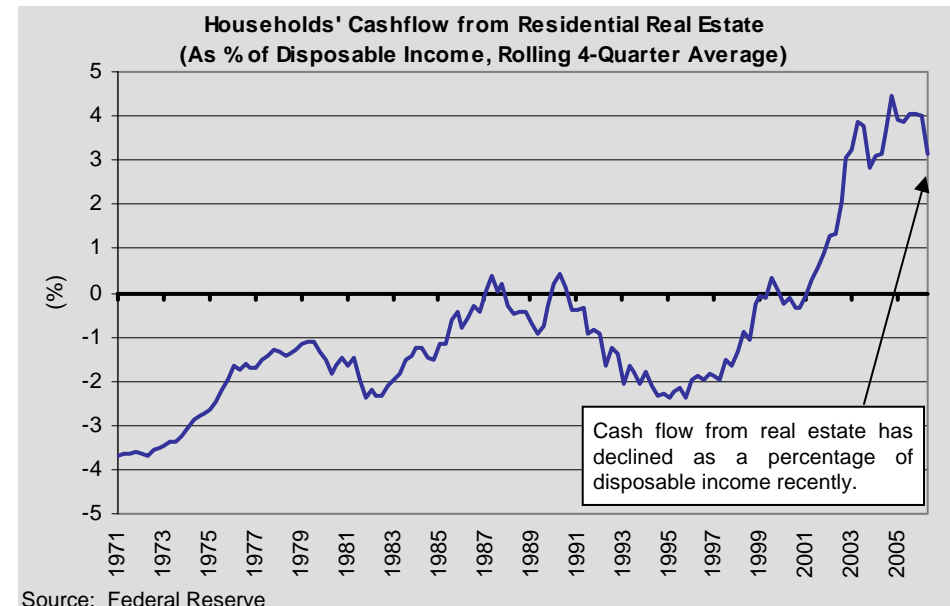


Can the Economy Withstand the Housing Slump?

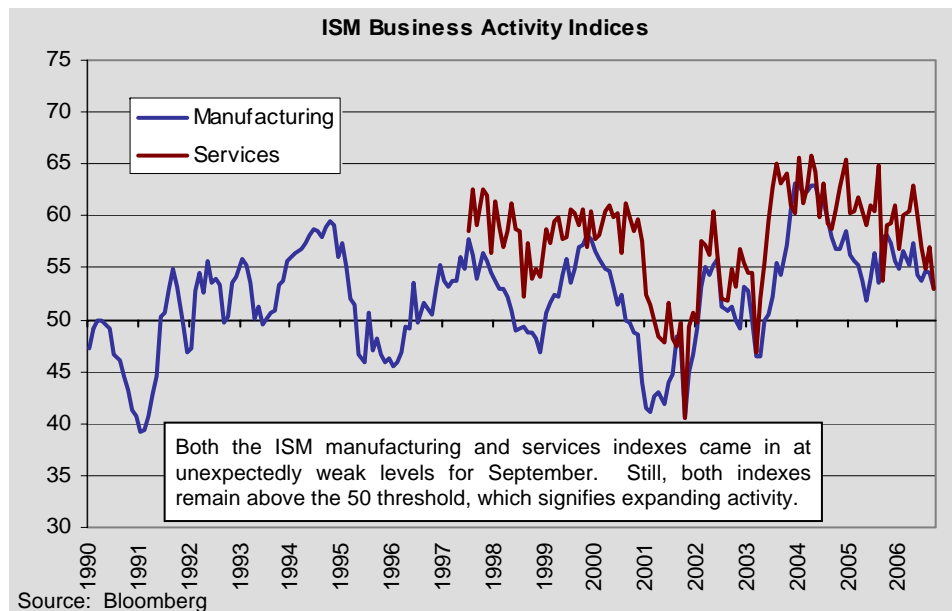
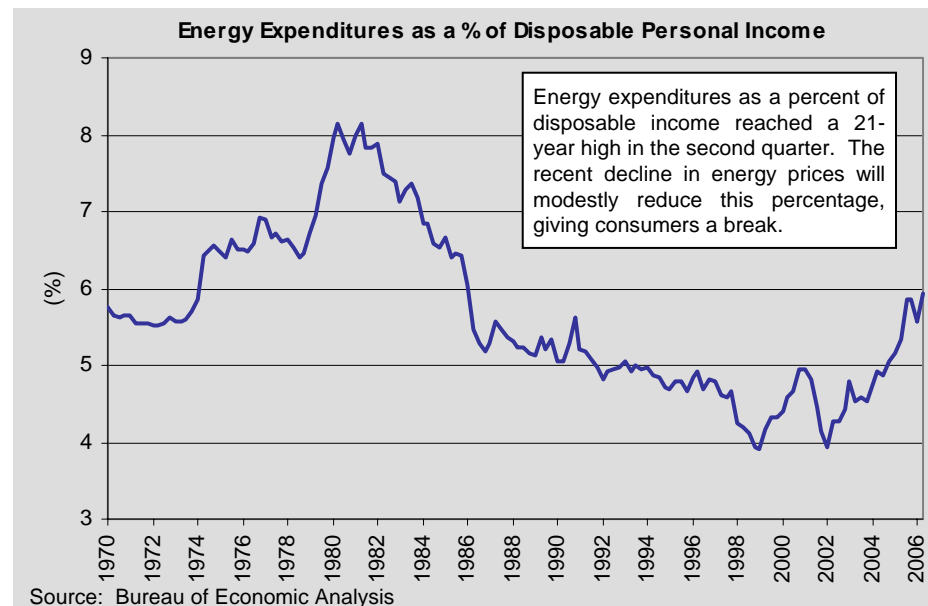
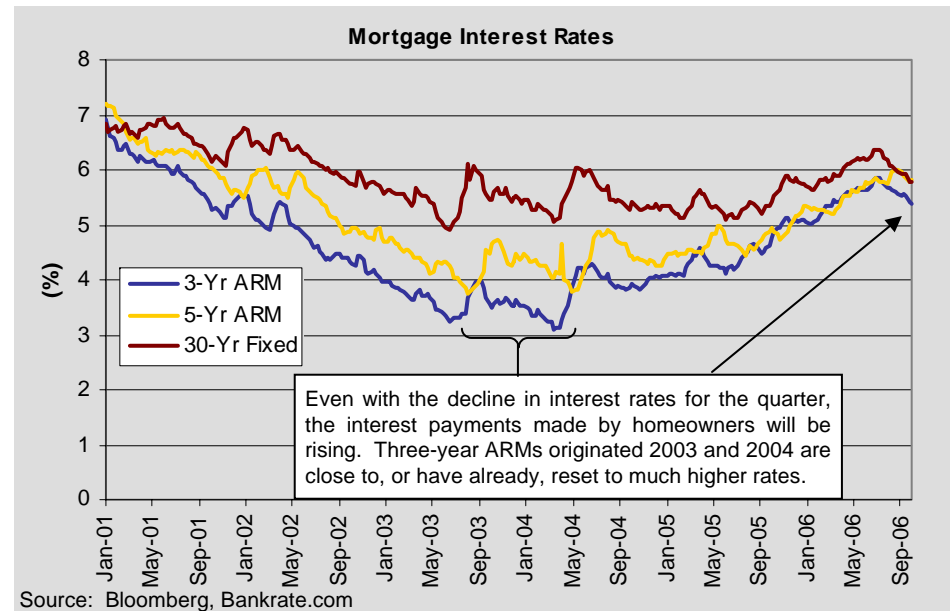
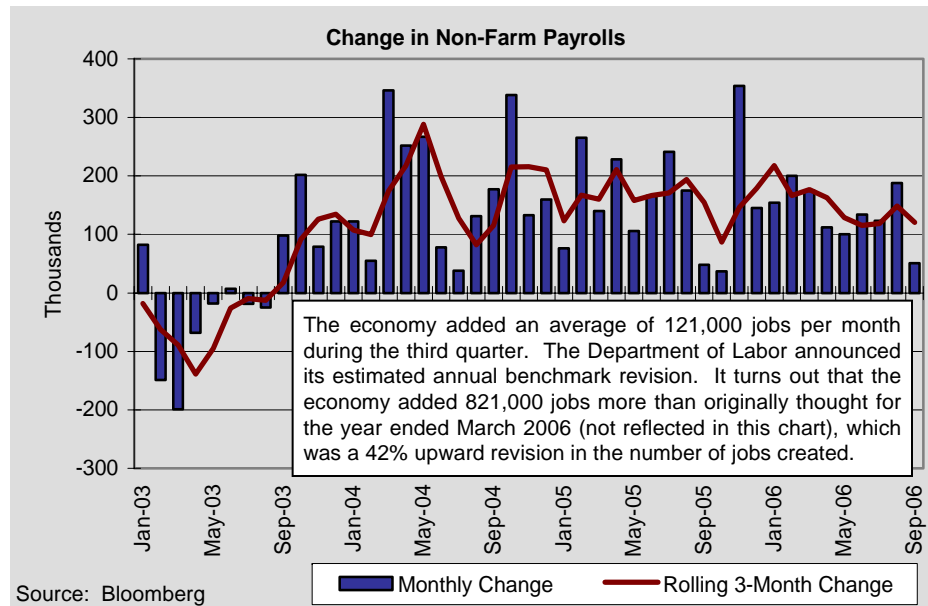
- The economy grew at a 2.6% annualized rate during the second quarter, which is slightly below the long-term trend rate of 3%. Economists polled by Bloomberg think the economy expanded only 2.5% during the third quarter.
- The direct effects of the housing slowdown are showing up in the residential fixed investment component of GDP. During the second quarter, residential investment declined at an 11% annualized rate, trimming 0.7% from GDP growth for the quarter. The rate of decline was likely even worse in the third quarter. A decline in housing-related jobs could dampen overall employment growth. Economy.com reports that housing-related employment has already fallen by 50,000. Many more jobs are likely to be lost in coming months.
- The indirect effects of the housing slowdown are uncertain and, perhaps, more worrisome. Consumption growth in recent years has been supported with mortgage equity withdrawals and a reduction in the savings rate. With prices leveling off, and at risk of falling, households will probably be less likely to tap home equity to support spending.
- With a decline in the housing wealth effect, the labor market is left as the key driver of consumption growth. Healthy growth in real wages, which has been absent over the last few years, is needed to keep consumption expanding at a 3% clip.
- The consensus among economists is that the economy will experience a soft landing. However, the risks to this forecast appear weighted to the downside. A significant decline in real estate prices at the national level, while seemingly unlikely, is one factor that could lead to a hard landing.

	2Q Growth (%)	Contribution to 2Q Growth (%)
Personal Consumption Expenditures	2.6	1.8
Residential Fixed Investment	(11.1)	(0.7)
Non-Residential Fixed Investment	4.4	0.5
Government Consumption	0.8	0.2
Change in Inventories	-	0.4
Trade Balance	-	0.4
GDP Growth	2.6	

Source: Bureau of Economic Analysis

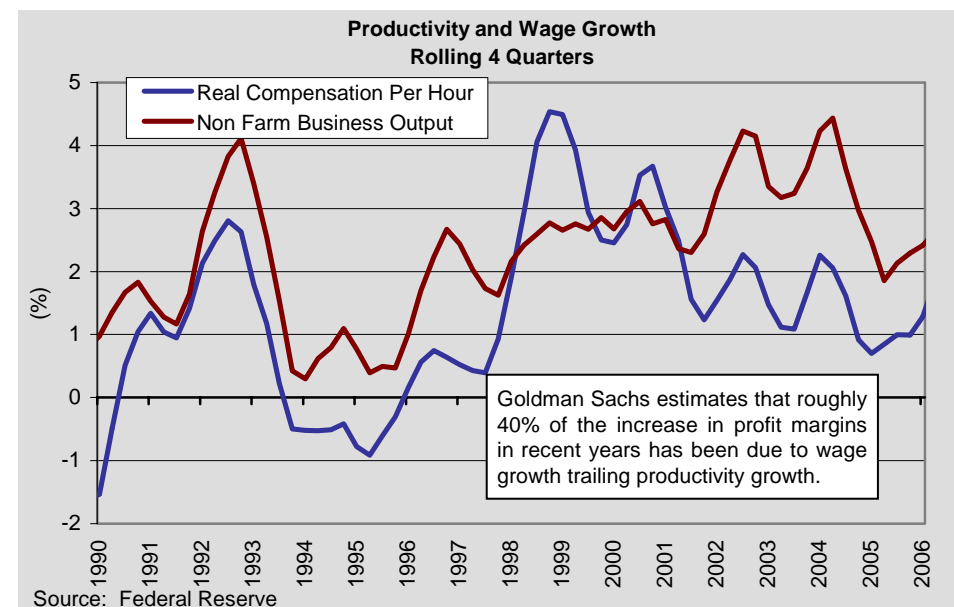
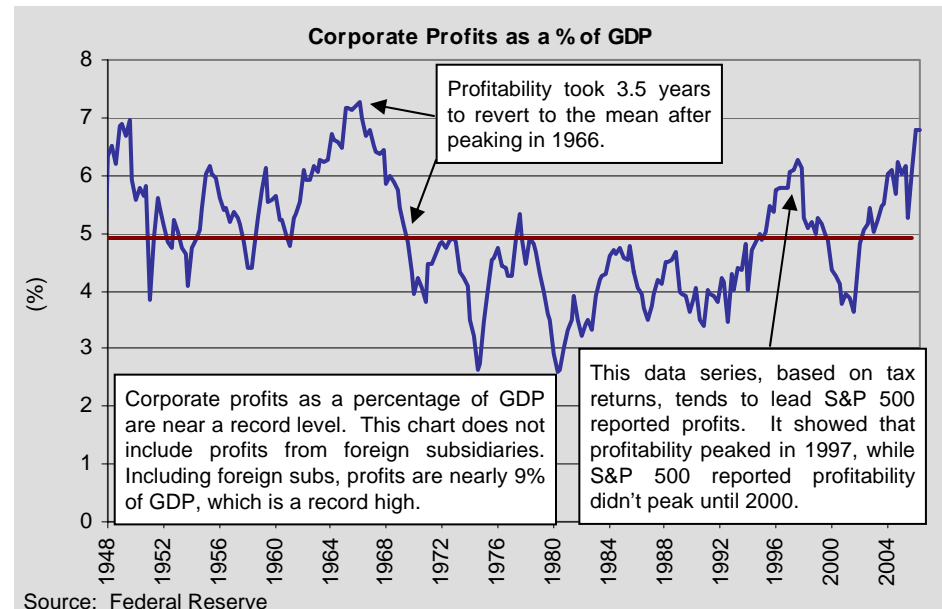


Can the Economy Withstand the Housing Slump? (cont.)

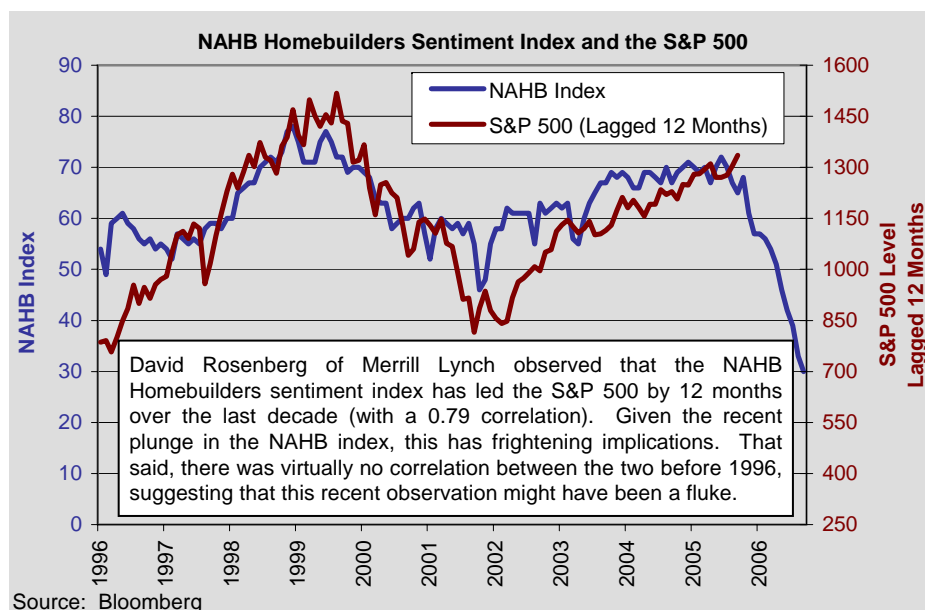
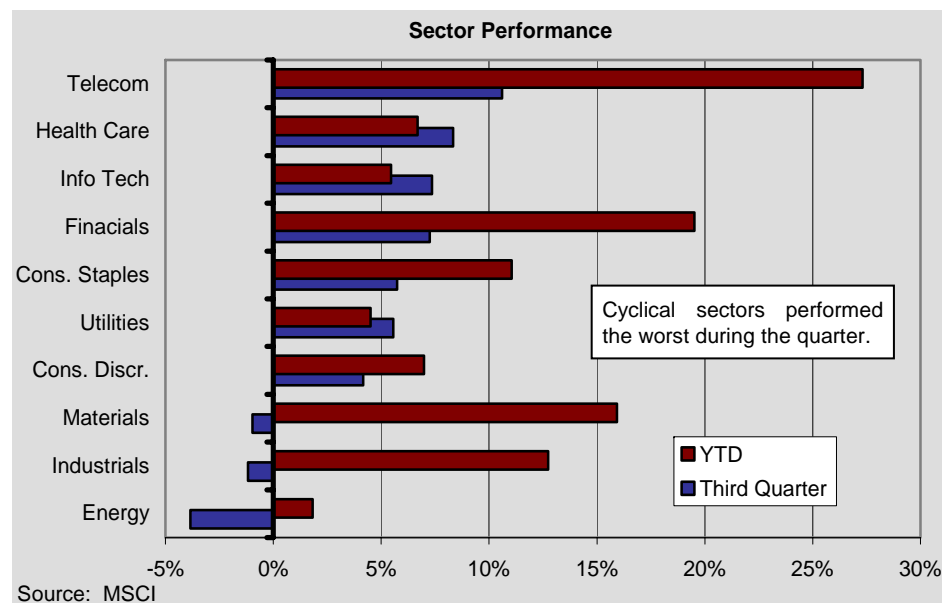
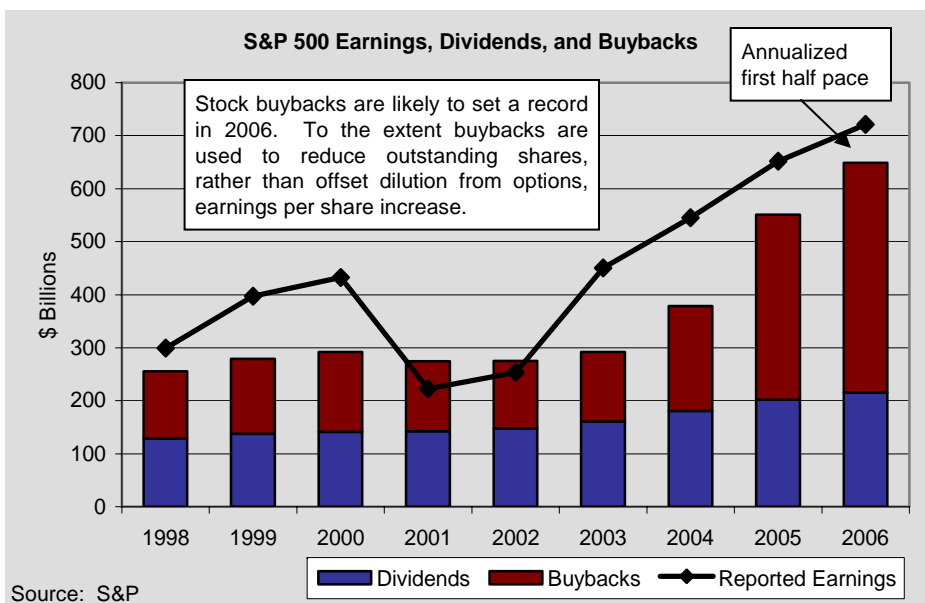


Will an Economic Slowdown Take a Bite Out of Profit Margins?

- Profits for the S&P 500 continue to grow at a rapid rate. Reported earnings for the index increased an estimated 25% for the twelve month period ended in September. The S&P's P/E ratio is down to 17, which isn't far from the historical average of 16.
- The recent rise in profits is being fueled primarily by an expansion in profit margins. The profit margin on S&P 500 sales is at a record level of 9.6%, compared to a historical average of 5.8%. A significant part of this expansion has come from businesses' ability to keep a lid on wage costs. Wage growth has significantly trailed productivity growth since the end of the recession.
- Profit margins are mean reverting. Based on our normalized earnings measures, which assumes profit margins revert to more normal levels, the P/E ratio on the S&P 500 is 24. This implies a long-term real return on the index of only 4.2% ($1 / 24$), assuming current valuations hold.
- Profit margins tend to decline in periods of slower growth and particularly in recessions. If there is a recession, margins will contract, but they should hold up better than they did following the 2001 recession. Businesses have been very conservative over the last few years. Business investment as a percentage of GDP has been modest since the tech bubble burst. Corporations are using record profits to return cash to shareholders through buybacks and dividends. In contrast, businesses over-invested in the mid to late 1990s, which contributed to the margin collapse in 2001.
- Recession or not, profit margins are very unlikely to stay at these elevated levels. We expect them to begin declining. (Admittedly, we've been saying that for two years.) Eventually workers will begin to capture a larger share of productivity growth, or the fat margins will attract competition, which will pass on productivity gains on to consumers through lower prices. This could be a significant headwind for equities in the coming years.



Will an Economic Slowdown Take a Bite Out of Profit Margins? (cont.)



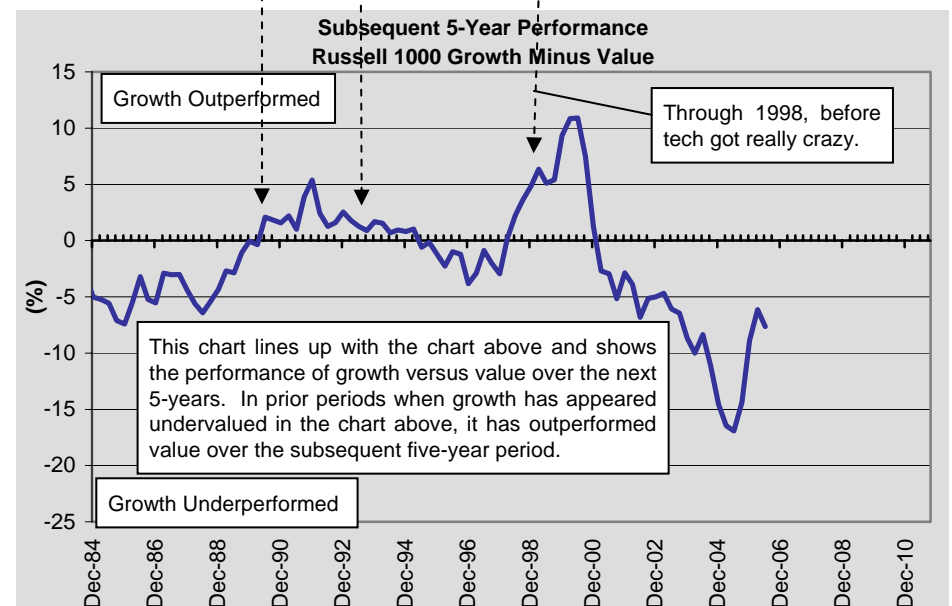
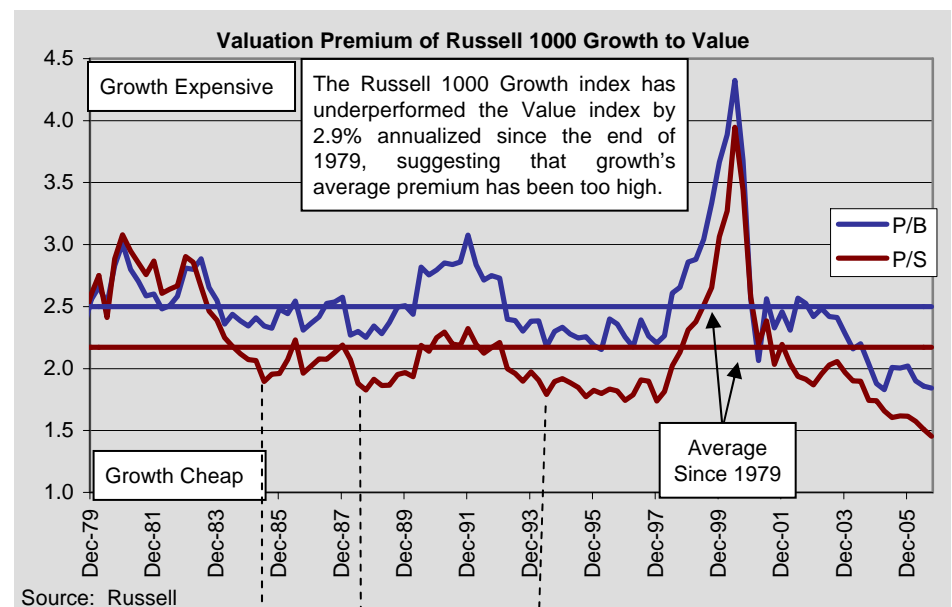
Performance of S&P 500 Around the End of Fed Tightening Cycles

Fed Funds Peak Date	3 Months Prior	Months 1 to 12	Months 13 to 24
October 1957	-13.5	30.0	15.7
November 1959	-1.4	-1.3	32.4
November 1966	5.4	20.7	19.0
August 1969	-6.9	-11.4	25.5
July 1974	-11.3	17.4	21.2
January 1981	2.7	-2.2	27.7
August 1984	12.1	18.6	38.9
February 1989	6.5	18.8	14.7
February 1995	8.1	34.7	26.3
May 2000	4.3	-10.6	-13.8
Average	0.6	11.5	20.7
Stdev	8.6	16.5	14.3

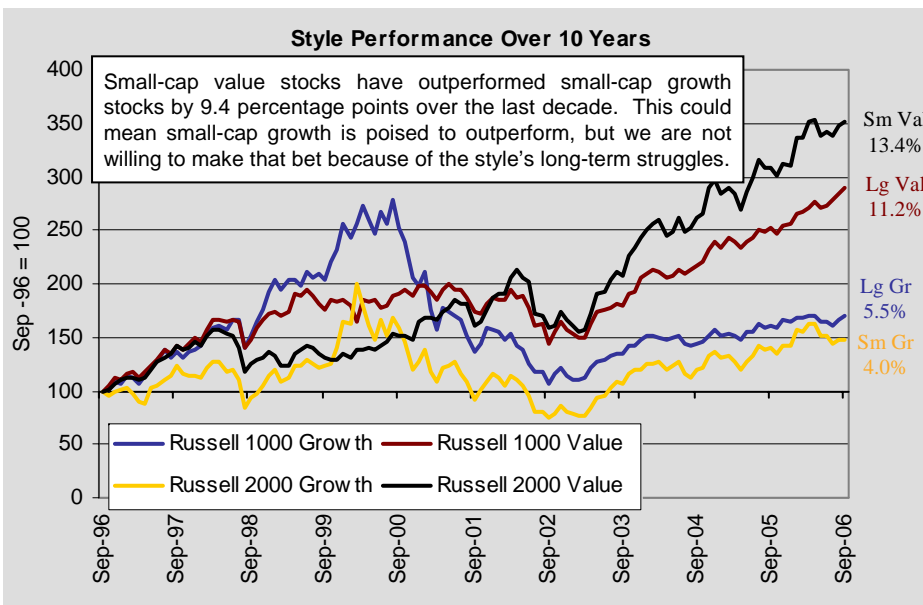
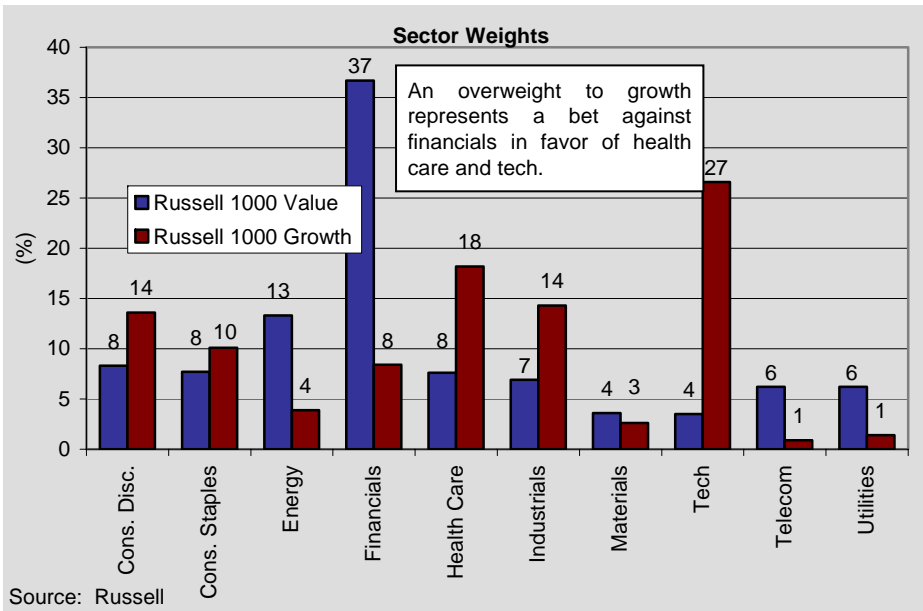
Equity markets have earned slightly below average returns in the 12 months following the end of Fed tightening cycles (11.5% versus an arithmetic average of 13.3% since 1950). The S&P has earned returns well above average in months 13 to 24, which is usually well into the next easing cycle.

There's Value in Large-Cap Growth

- After seven years of underperformance, valuations on large-cap growth stocks are becoming increasingly compelling. While they are by no means cheap on an absolute basis, they appear to offer the best relative value among domestic styles.
- Growth stocks have traded at a valuation premium to value stocks because they are expected to experience greater earnings growth. However, the average valuation premium for growth stocks has been too high, as evidenced by their long-term underperformance. Investors have usually paid too much for growth. For this reason, we have historically urged clients to overweight value stocks.
- However, after trailing the broad market for several years, investors currently are not willing to pay enough for growth. The premium for growth stocks is now well below average.
 - Since 1979, large-cap growth stocks have traded at an average 2.5x premium to value stocks based on price-to-book. They are currently trading at a 1.8x premium, 28% below average.
 - Growth's premium on price-to-sales has averaged 2.2x. It is currently only 1.4x, or 37% below average.
- Value stocks usually outperform growth stocks during recessions and bear markets. However, the next downturn could be different. We wouldn't be surprised to see large-cap growth outperform, because their profit margins should hold up better.
- We do not suggest overweighting small-cap growth stocks. Small-cap stocks look very expensive relative to large-cap stocks. Furthermore, we don't have conviction that small-cap growth stocks will outperform small-cap value stocks because of small-cap growth's dismal historical track record.
- We recommend that institutions overweight large-cap growth stocks within domestic equity portfolios at the expense of large-cap value and small-cap stocks.** Large-cap growth stocks are by no means as cheap as small-cap value in 2000, but they seem a very good bet for the next three to five years.



There's Value in Large-Cap Growth (cont.)



Cyclicality in Style Returns

Annualized Returns For Rolling Non-overlapping 3-Year Periods	Large	Large	Small	Small
	Growth	Value	Growth	Value
1964-1966	6.4	12.8	14.7	19.7
1967-1969	10.4	9.7	21.8	23.5
1970-1972	12.5	12.4	1.4	7.1
1973-1975	-9.8	2.7	-12.9	-2.2
1976-1978	2.3	11.8	27.0	31.6
1979-1981	15.3	14.9	27.7	24.9
1982-1984	11.4	19.3	7.0	22.1
1985-1987	17.3	16.6	6.7	9.3
1988-1990	14.7	12.3	6.1	4.4
1991-1993	15.1	18.7	22.7	31.4
1994-1996	20.1	18.2	12.5	14.5
1997-1999	34.1	18.8	17.8	6.7
2000-2002	-23.6	-5.1	-21.1	7.5
2003-2005	13.2	17.5	20.9	23.2
Annualized Return (1967 - 2005)	9.3	12.7	9.6	15.2
# of Times Best	5	1	1	7
# of Times Worst	5	2	5	2

The returns from 1979 to present represent Russell style indexes. Returns prior to 1979 are from the Fama and French research.

Small-cap value stocks have been the best performer in the last two periods. No style has been the winner for three consecutive periods.

Feast or famine - large-cap growth stocks have been either the best or worst performing style in the last seven consecutive periods.

Strategy Returns (1967 - 2005)

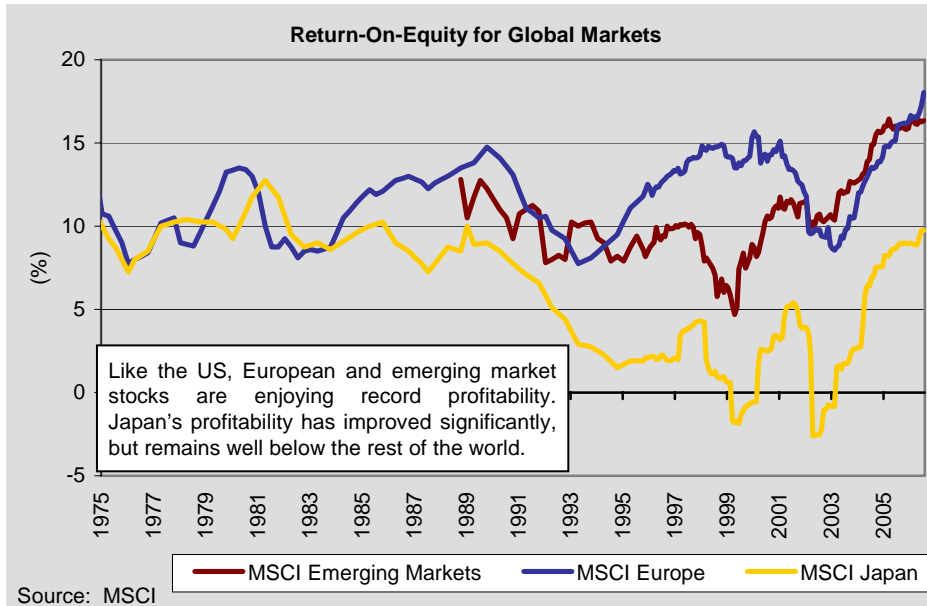
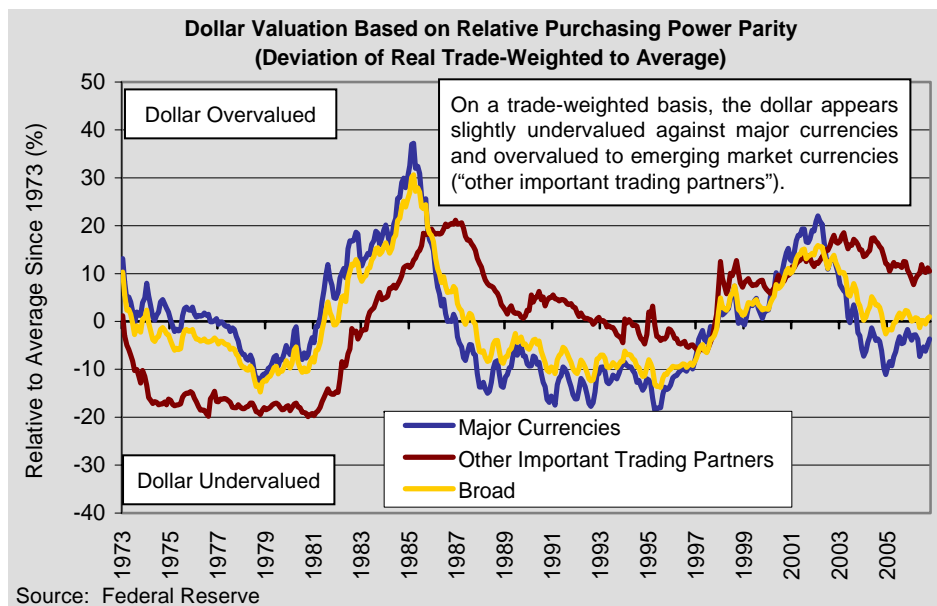
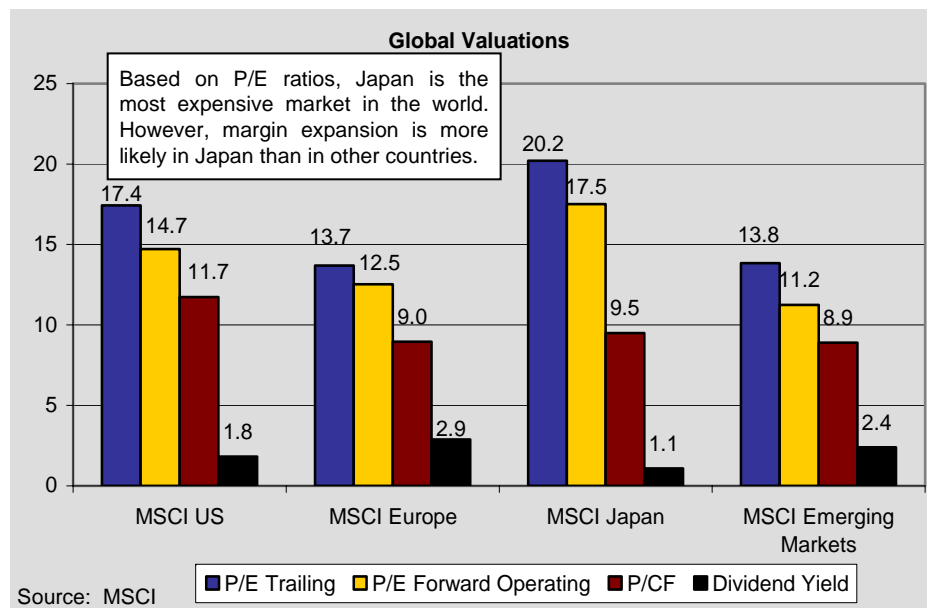
Purchase Best Performer at End of Each Period	10.6
Purchase Worst Performer at End of Each Period	12.9
Equal Weight	12.4

We simulated three strategies: (1) purchase the best performing style at the end of each period and hold for the next three years, (2) purchase the worst performing style and hold for the next three years, and (3) equal-weight all four styles, rebalancing at the end of every three years.

The strategy of purchasing the worst performing style performed the best earning 12.9%. Purchasing the best performing style yielded a return of only 10.6%. Equal-weighting all four strategies performed well, earning 12.4%.

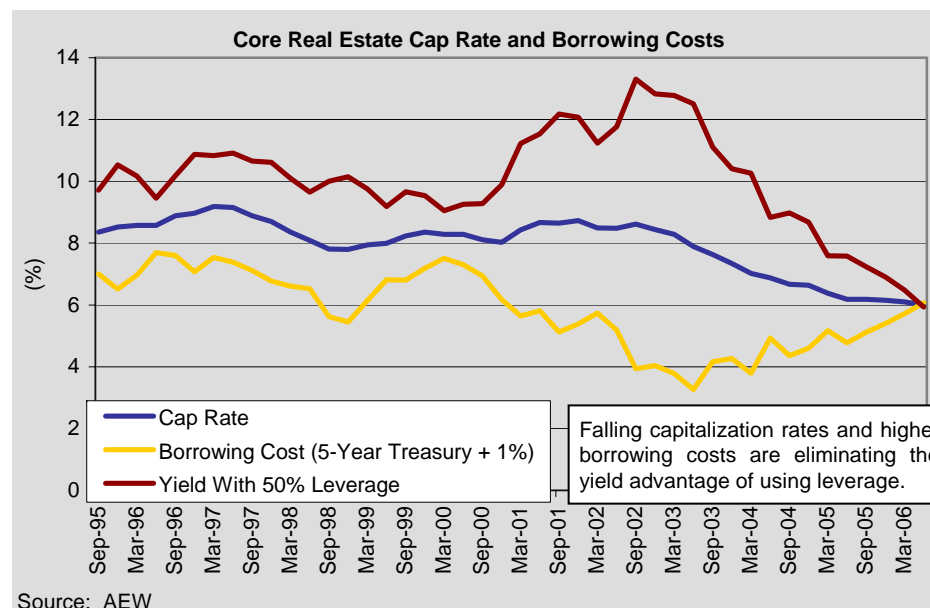
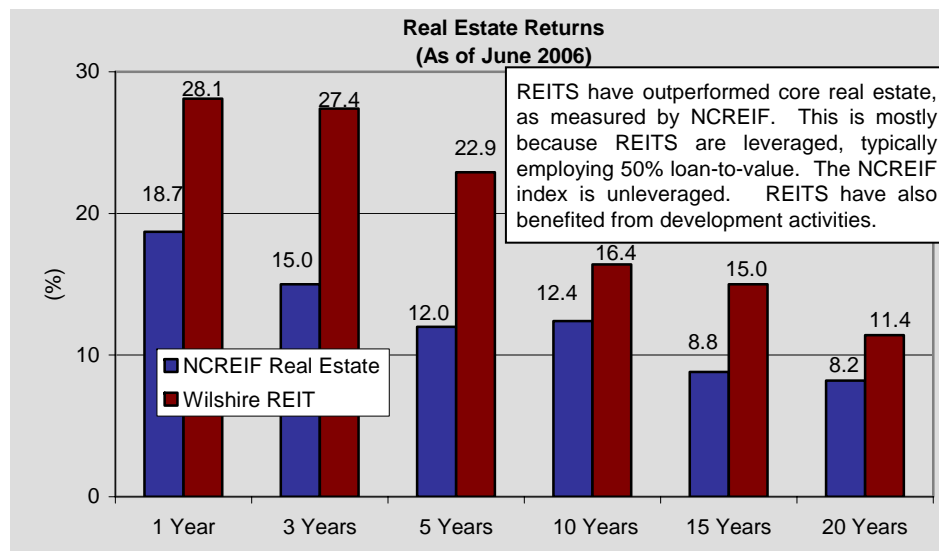
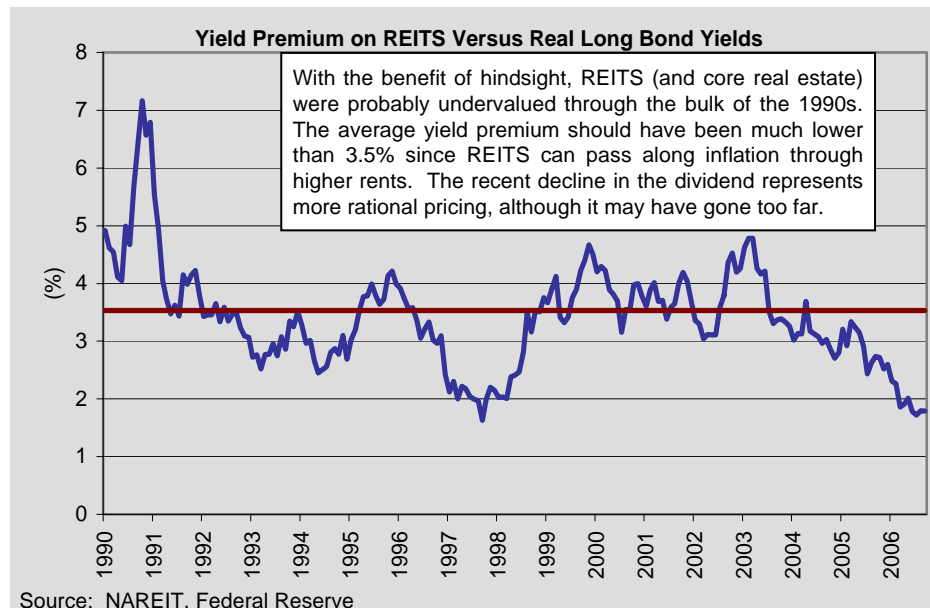
International Equities Are Modestly More Attractive than Domestics

- International equities modestly underperformed US equities during the third quarter. So far in 2006, international equities have a substantial advantage because of the fall in the dollar. The MSCI EAFE index is up 14.5% year-to-date against 8.7% for the S&P 500.
- Based on current profitability, European equities look the most attractively valued in the world, trading at a P/E of less than 14. However, as in the US, European companies' profitability is far above normal. The ROE for European countries is 18%, nearly 50% above the historical average. On a normalized basis, the P/E for Europe is 20. That's cheaper than the US normalized P/E of 24, but it is no bargain.
- The dollar still appears vulnerable, but international developed market indexes may not benefit much. They are dominated by European currencies, which also appear overvalued.
- Emerging market equities appear attractive on a current valuation basis. We are concerned about their reliance on US consumption for economic growth, but continue to recommend an overweight as a long-term growth play. Emerging market currencies also have more potential to appreciate against the dollar.



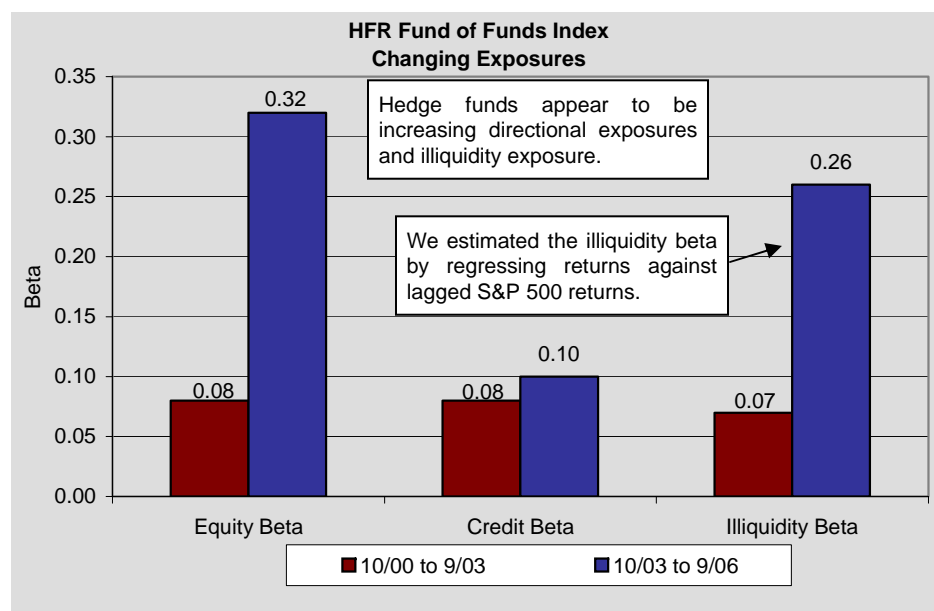
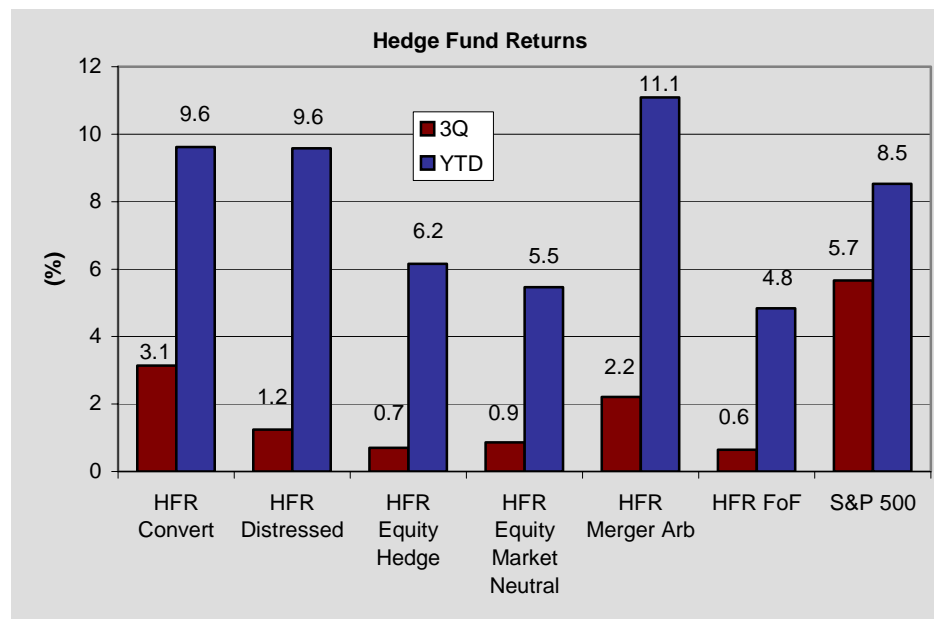
Is It Time to Exit REITs?

- The valuations of REITs are looking very stretched. The dividend yield premium to real bond yields has contracted to just 1.8%, which is half the historical average of 3.5%. The last time the premium was this low was in 1997. REITs proceeded to fall 17% in 1998.
- Unlike in 1997, however, REITs are trading near the value of their underlying properties. According to Green Street Advisors, REITs traded at a premium to net asset value of around 30% in 1997. Today, the premium to net asset value is only 3%. Therefore, the recent run-up in REITs seems a function of underlying real estate trends, rather than investors overpricing REITs. REITs are simply reflecting the run in commercial real estate.
- In a world of low returns, the expected return for REITs does not appear particularly out of line with other assets. If current valuations hold, REITs should provide a real return in the neighborhood of 4%, which is close to the return we expect for the S&P 500. Real estate should still be part of a diversified portfolio, and REITs provide convenient, liquid exposure.
- For institutions willing to sacrifice some liquidity, we prefer to get exposure to real estate through private partnerships implementing value-added strategies. Through their potential to make operational improvements, we believe they are more likely to provide a reasonable return for the risk taken.



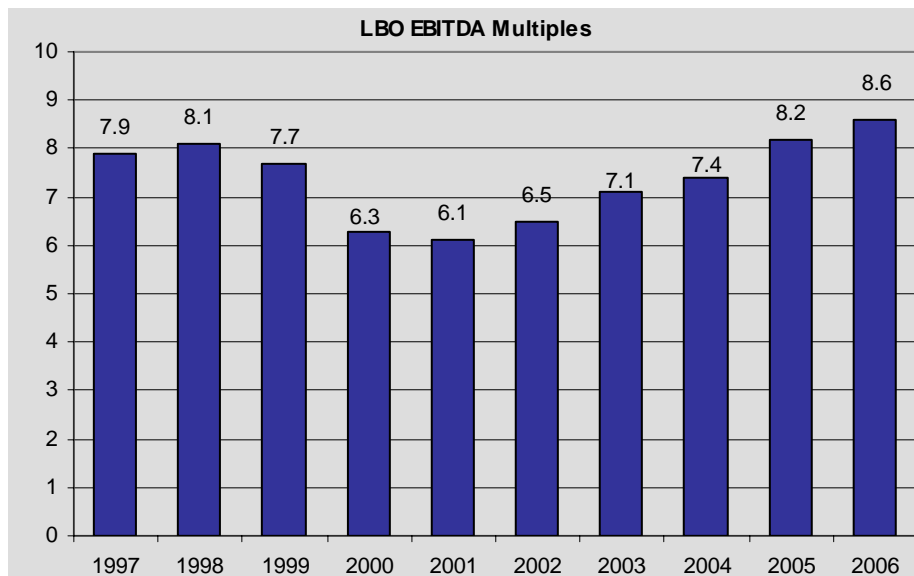
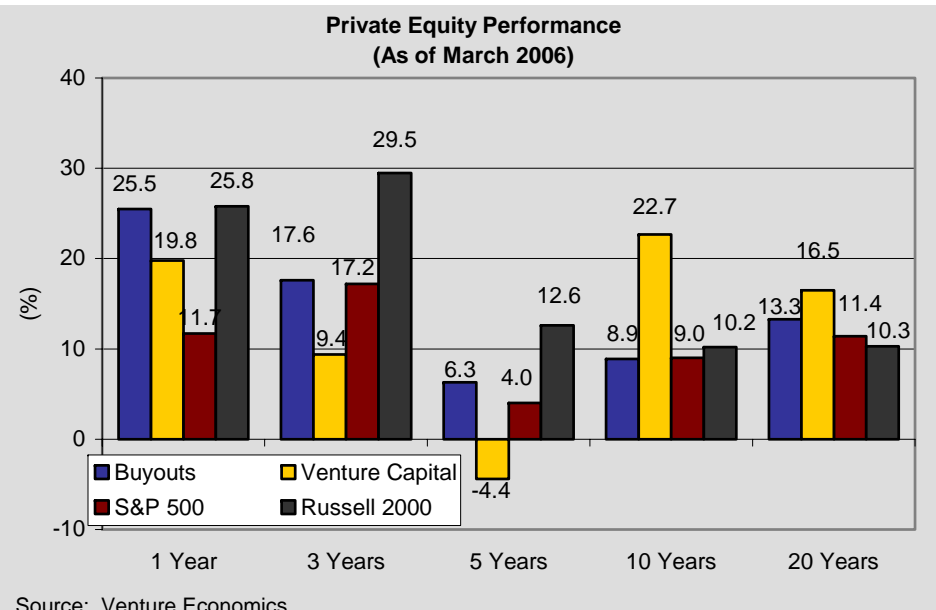
Hedge Funds: Unanticipated Risks?

- Broadly speaking, hedge funds generated rather benign results during Q3 2006 as the HFRI FoF Index was up 0.6% for the quarter. Classic arbitrage strategies performed well during the quarter; however, these strategies have become less influential pieces of the puzzle as the average hedge fund allocator/investor continues their move towards more directional exposure. The HFRI Equity Hedge Index was up 0.6% for the quarter. This is the same return one could have achieved through a passive exposure to long small-cap value / short large-cap growth, which is a bet many long/short funds appear to be making.
- We have discussed two trends in the hedge fund space in previous quarterly research reports: increased directional exposure to equities and the thirst for yield. These risks were evidenced in March/April 2005 (credit risk) and May 2006 (directional equity risk). A third significant trend is the move into less liquid, private equity-like investments. The evidence of this trend is anecdotal; however, the proliferation of the side pocket investment, which is often used to house illiquid investments, is significant.
- Given the benign, low volatility market environment of late, the increased risks associated with these exposures has remained hidden from investors; however, one should not mistake this for a lack of risk. Investors may be unwittingly increasing their allocation to these asset classes (directional equities, directional credit, and private equity) under the expectation that they are reducing risk.
- Most investors break out hedge funds as a distinct asset class within their asset allocation mix with the expectation that they will achieve a differentiated, uncorrelated return from the rest of their asset class exposures. However, what many are getting these days is a bucket that is increasing one's exposure to directional equities, directional credit, and private equity. We are focusing our efforts on creating hedge fund programs that are truly providing alternative risk exposures.

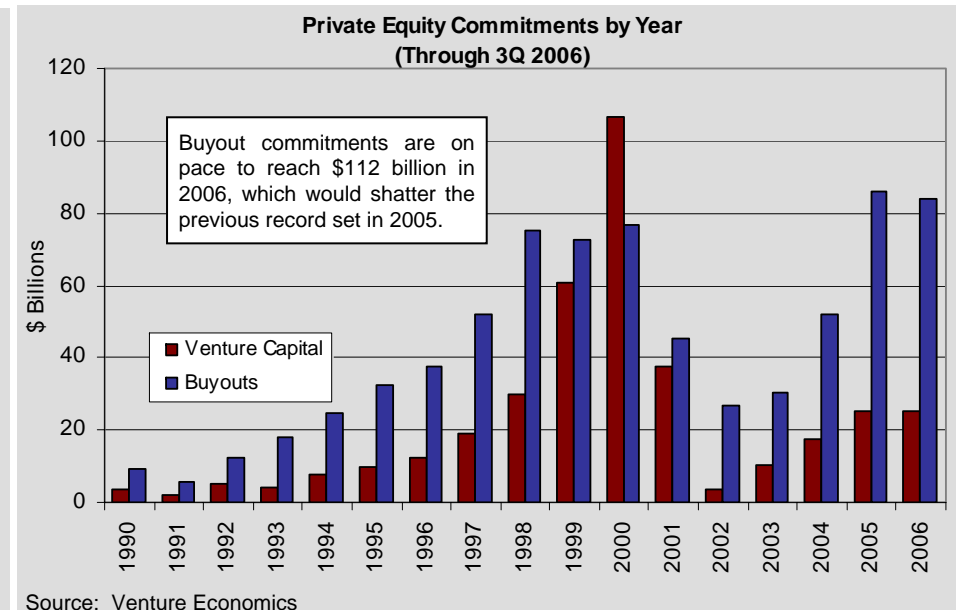


Buyout Commitments Approaching \$100 Billion for 2006

- Buyout funds continue to raise an eye-popping amount of capital. They remain on track to top the \$100 billion mark for the first time.
- The huge amount of capital chasing buyout deals, and banks' willingness to fund those deals, appears to be pushing up prices. Deals are being done at very high multiples. The average buyout deal has carried an 8.6x EBITDA valuation in 2006. This is even higher than in 1997/99 when public market multiples were far higher. Multiples are substantially higher than in the earlier part of the decade.
- The IPO market is still not accommodating. Venture-backed IPOs have raised only \$278 million so far in 2006. In comparison, new venture capital commitments are on pace to hit \$34 billion. Those that have gone public have performed well post-offering, surging more than 20% on average. These post-venture returns may begin to attract the interest of small-cap growth managers, but in the meantime VC firms must continue to appeal to strategic buyers.



Source: Morgan Stanley



Source: Venture Economics



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