



HammondAssociates
INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

Fourth Quarter 2006

In this report . . .

- ✓ Global Equity Investors Were Well Rewarded in 2006
- ✓ Risky Business
- ✓ How Likely is a Recession in 2007?
- ✓ Large-Cap Growth Poised to Outperform in 2007



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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

Fourth Quarter Research Report Overview

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Executive Summary

- 2006 was an excellent year for equities worldwide. Domestically, the S&P 500 rose 15.8% and the Russell 2000 gained 18.4%. Internationally, MSCI EAFE gained 26.3% and MSCI Emerging Markets surged 32.2%.
- The growth in global liquidity has encouraged risk taking by providing an abundant source of cheap funds to capital markets. We believe investors should use this opportunity to reduce risk since it's not priced to pay much in the future. We are unsure of the timing and catalysts for risk premiums to rise. However, today's low risk premiums make it more likely that any downturn will be painful. As Alan Greenspan warned in August 2005, "history has not dealt kindly with the aftermath of protracted periods of low risk premiums."
- Economic growth slowed in the second half of the year. GDP grew by 2.0% in the third quarter and an estimated 2.5% in the fourth quarter. The contraction in residential investment is the main constraint to growth. But, US consumers are apparently undaunted. The resilience of US consumers makes a recession unlikely this year; however, a significant drop in real estate prices, the bust in real estate investment spreading to other industries, and a reduction in the availability of cheap credit are risks to this view.
- The dollar fell by 11% against the euro and by 14% against the British pound in 2006. However, it rose slightly against the yen. The euro and the pound appear to be overvalued, while the yen appears undervalued. The dollar seems likely to fall further against Asian currencies. We continue to recommend that investors diversify into foreign currency-denominated assets
- Supported by double-digit earnings growth and rising M&A activity, US equities performed well in 2006. As for 2007, we wouldn't be surprised to see stocks have another strong year. Excess global liquidity and high profit margins are supportive of equity markets over the near term. However, the good times won't last indefinitely. We expect a real return on the S&P 500 of only 2% to 4% over the next decade. Within the US market, we recommend that investors overweight large-cap growth stocks, with a particular emphasis on high quality growth stocks, and underweight small-cap stocks and large-cap value stocks.
- International equities remain modestly more attractive than domestic equities. European stocks are trading at a slight discount to US stocks. While Japan is expensive on a valuation basis, it has the potential to improve profitability. Emerging market valuations are a concern as their discount to the rest of the world has nearly vanished.
- REITS surged again in 2006 and now appear to be overvalued. Buyout commitments reached \$160 billion in 2006. Rising valuations and excessive capital are a concern, particularly in the mega-sized space.



Market Commentary

January 2007

Booming corporate profits and excess global liquidity made 2006 highly rewarding for global equity holders. The MSCI All Country World Index returned 21% in dollar terms, in line with its remarkable 20% annualized return over the last four years. The US equity market, although performing well, has remained a global laggard. In US dollar terms, the S&P 500 was the second worst performing developed equity market in the world. Only Japan fared worse. The S&P 500 returned 15.8% in 2006, compared to 26.3% for the MSCI EAFE index of international developed market stocks and 32.2% for the MSCI Emerging Markets index. As we suggested in late 2005, the weak dollar was a significant contributor to international equity returns in 2006. In fact, in local currency terms, MSCI EAFE appreciated only slightly better than US equities at 16.5%. However, since the beginning of the global equity market recovery in 2003, the S&P 500 has trailed MSCI EAFE by 9.6 percentage points annualized and the MSCI Emerging Markets index by 21.7 percentage points.

Diversification Paid Off Again in 2006

The divergence in recent years between the performance of US and international equities illustrates the value of diversification. A sample 75% diversified equity indexes / 25% diversified bond indexes portfolio (with tilts in favor of international, small-cap, and value stocks)¹ that we began tracking in the late 1990s (when diversification was out-of-favor) has earned 8.9% annualized since the beginning of 2000 and 18.5% during the recovery over the past four years. In contrast, a 75% S&P 500 / 25% Lehman Aggregate Bond portfolio earned only 2.7% and 12% for those two time periods, respectively. However, the valuation disparities that led to the outperformance for diversified portfolios have largely been corrected. Risk

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

premiums across global assets are far lower today than they were at the height of the equity market bubble in 2000. There are few, if any, cheap asset classes in the world. Diversification away from domestic large-cap stocks won't be as beneficial in the future. **In fact, if there is a global equity market downturn, the S&P 500 is likely to hold up better than most other equity asset classes**, as it did during the pullback in May/June 2006. (See Exhibit 1, below.)

Exhibit 1

	Jan. 1 to May 10	May 11 to June 13	June 14 to Dec 31	2006
S&P 500	6.7	(7.3)	17.1	15.8
Russell 2000	15.6	(13.2)	17.9	18.4
MSCI Japan	14.3	(19.1)	14.9	6.2
MSCI Europe	20.5	(12.9)	27.4	33.7
MSCI Emerging Markets	25.5	(24.1)	38.9	32.2
Industrial Metals	63.2	(19.0)	29.9	72.3
Oil	18.2	(4.9)	(11.0)	1.2
Gold	36.0	(20.3)	13.4	23.0

The Global Liquidity Glut

One major driver of asset class returns over the last few years has been the growth of global liquidity. The Federal Reserve cut the overnight lending rate to 1% in the early part of this decade to dampen the fallout from the bursting equity market bubble. Even as the Fed began to tighten monetary policy in June 2004, it seemed to have little effect on liquidity. The yield on the 10-year Treasury, which was 4.62% at the time of the first rate hike, fell over the ensuing months and finished 2005 at 4.39%. The purchase of US bonds by foreign central banks is the most likely explanation for this conundrum. Central banks in China and other emerging market countries plowed their trade surpluses back into US bonds to keep their currencies from appreciating. Oil exporters were also investing a significant portion of their energy windfall in US obligations. This kept long-term interest rates low, even as the Fed was raising short-term rates.

Low long-term interest rates had a domino effect on other asset classes. The decline in long-term interest rates has encouraged investors to take on more risk to maintain returns. This, in turn, has caused a compression in risk premiums, most observable in credit spreads. The option-adjusted spread on high yield bonds declined from 8.5% at the end of 2002 to 3.6% at the end of 2005.

In the Second Quarter 2006 edition of this report, we speculated that the excess global liquidity was being drained. Boy, were we wrong! In our defense, there were signs that this was occurring. Central banks around the world were shifting to tighter monetary policies. Even Japan abandoned its quantitative easing policy and lifted its overnight lending rate from zero to 0.25%. The tighter conditions were being felt here, as the yield on the 10-year Treasury traded as high as 5.24%. Global equity markets corrected and credit spreads ticked up, as investors became more risk averse. But, it all proved to be short-lived. In the third quarter of 2006, the 10-year Treasury yield fell back to 4.64%, as traders priced-in future interest rate cuts by the Federal Reserve and foreign central banks continued to buy bonds. The 10-year bond finished 2006 at 4.71% and credit spreads contracted to near record lows. The option-adjusted spread on high yield bonds finished the year at 2.75%.

Easy Credit

Excess global liquidity has helped push down credit spreads. The decline in credit risk premiums has also been influenced by the growth of derivative instruments and structured credit products. The ballooning credit default swap market has created a convenient way to shift credit risk to those most willing to bear it and has allowed institutions to easily diversify credit exposure. Structured credit products, such as CDOs (collateralized debt obligations), have served a similar purpose.² While derivatives can help spread credit risk more effectively, they do not reduce aggregate credit risk.

Cheap and plentiful credit is having a spillover effect on global equity markets. An interesting result of the business investment bust in the early part of this decade is that corporate America has been very conservative in recent years. Business investment remains below average as a percentage of GDP, and we're in the fifth year of an economic expansion. The current level of business investment can easily be funded from robust earnings and cash flows. As a result, corporate America has been de-leveraging its balance sheet. According to Federal Reserve data, corporate debt declined from 51% of net worth in 2000 to just 41% in 2006. Enter buyout funds. With debt so cheap, buyout funds can take a business generating attractive cash flows and lever it up, thereby increasing the return to equity

²The latest innovations in the world of structured credit are CPDOs (constant proportion debt obligations). The instruments hold a basket of investment grade bonds with an average credit rating of single A, levered up to 15x. The resulting highly leveraged security carries a triple-A rating that yields a juicy 200 basis point spread above LIBOR. It carries a triple-A rating because of diversification. While interesting, the promise of these instruments seem almost too good to be true, unless they are exposed to substantial left-tail risk.

shareholders (so long as business conditions remain favorable). Buyout funds did \$758 billion of deals (equity plus debt) in 2006. 2007 is likely to bring even more buyouts, as 2006 was a record fundraising year. Corporations are also stepping up activity. Total global M&A activity in 2006 was \$3.8 trillion, a 38% increase over 2005. The rise in M&A activity contributed to the performance of global equity markets in 2006 and it is likely to continue into 2007.

How Long Can this Last?

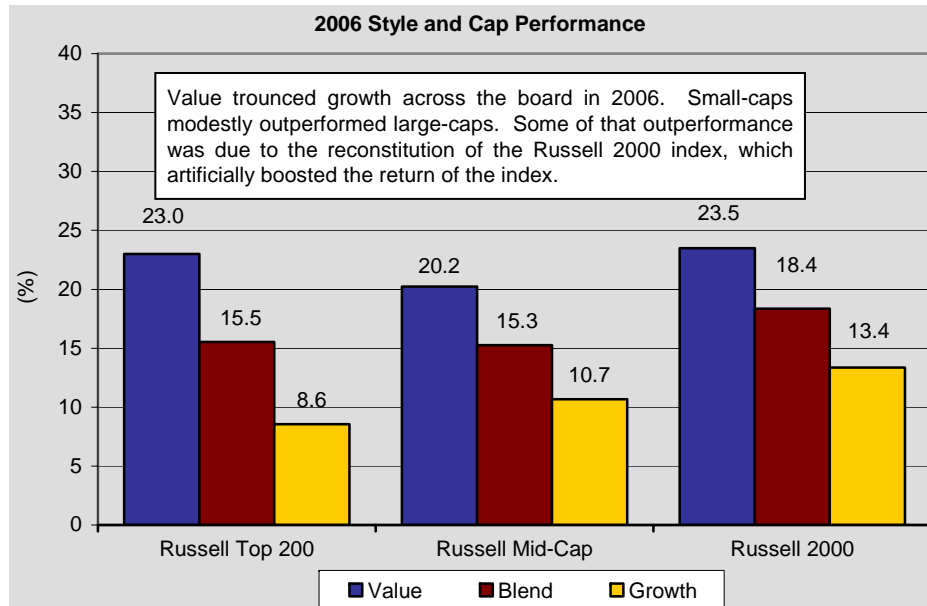
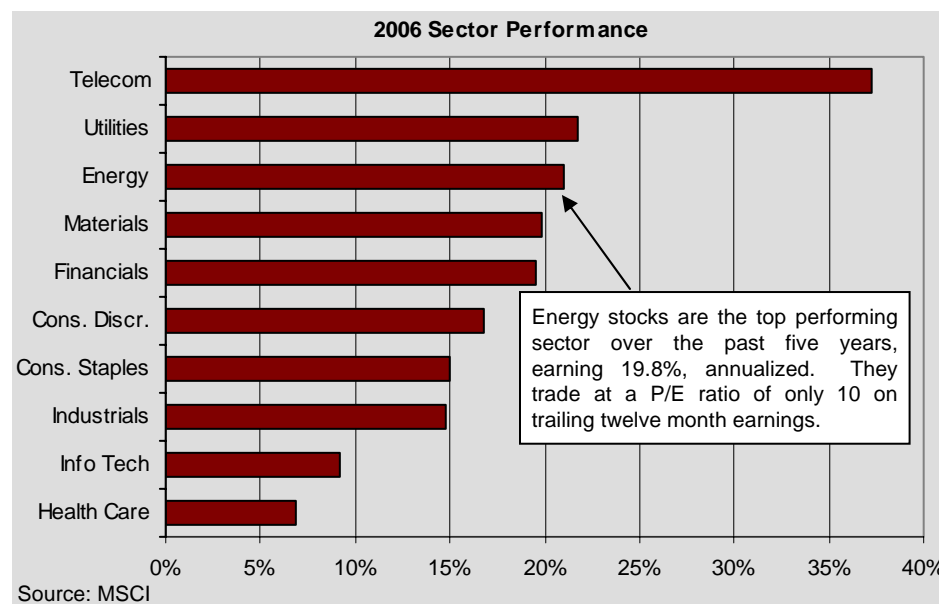
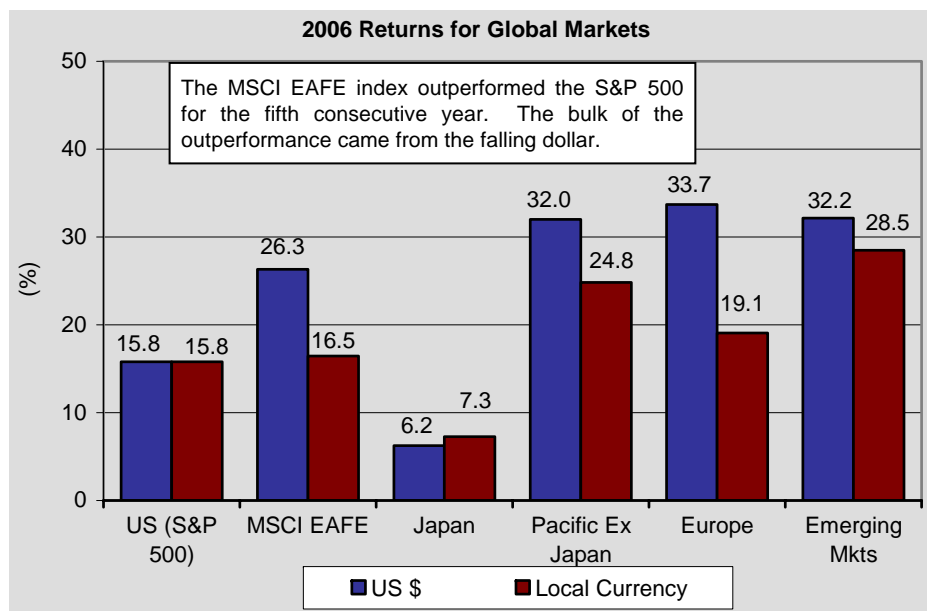
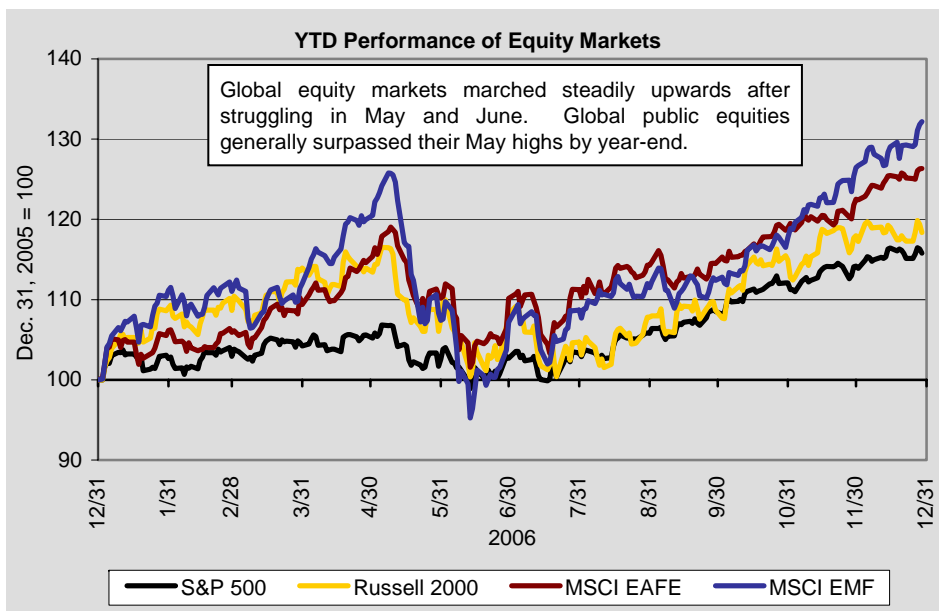
As we enter 2007, global equity markets have a tail wind from excess global liquidity. There are few signs that liquidity will dry-up in the near-term. Asian central banks are unlikely to significantly alter their policies in 2007, which should keep interest rates from rising much. Eventually, this source of liquidity will diminish as emerging markets consume more of their export income, rather than lending it back to us. However, this transition may take years.

Nevertheless, investors should be wary. Liquidity by itself does not drive asset prices higher. It must be accompanied by a willingness on the part of investors to assume risk. And liquidity can only compress risk premiums so far. Even the most aggressive investor wants to get paid for accepting risk. Furthermore, unexpected events periodically occur that cause investors to broadly reevaluate risk tolerance. Falling risk tolerance forces risk premiums higher and asset prices lower. We saw this in 1997/98 with the Asian currency crisis, in 2000 from the bursting of the tech bubble, in 2001 from 9/11, and in 2002 from corporate defaults. We even saw hints of this in May and June of 2006 with the liquidity drain head fake.

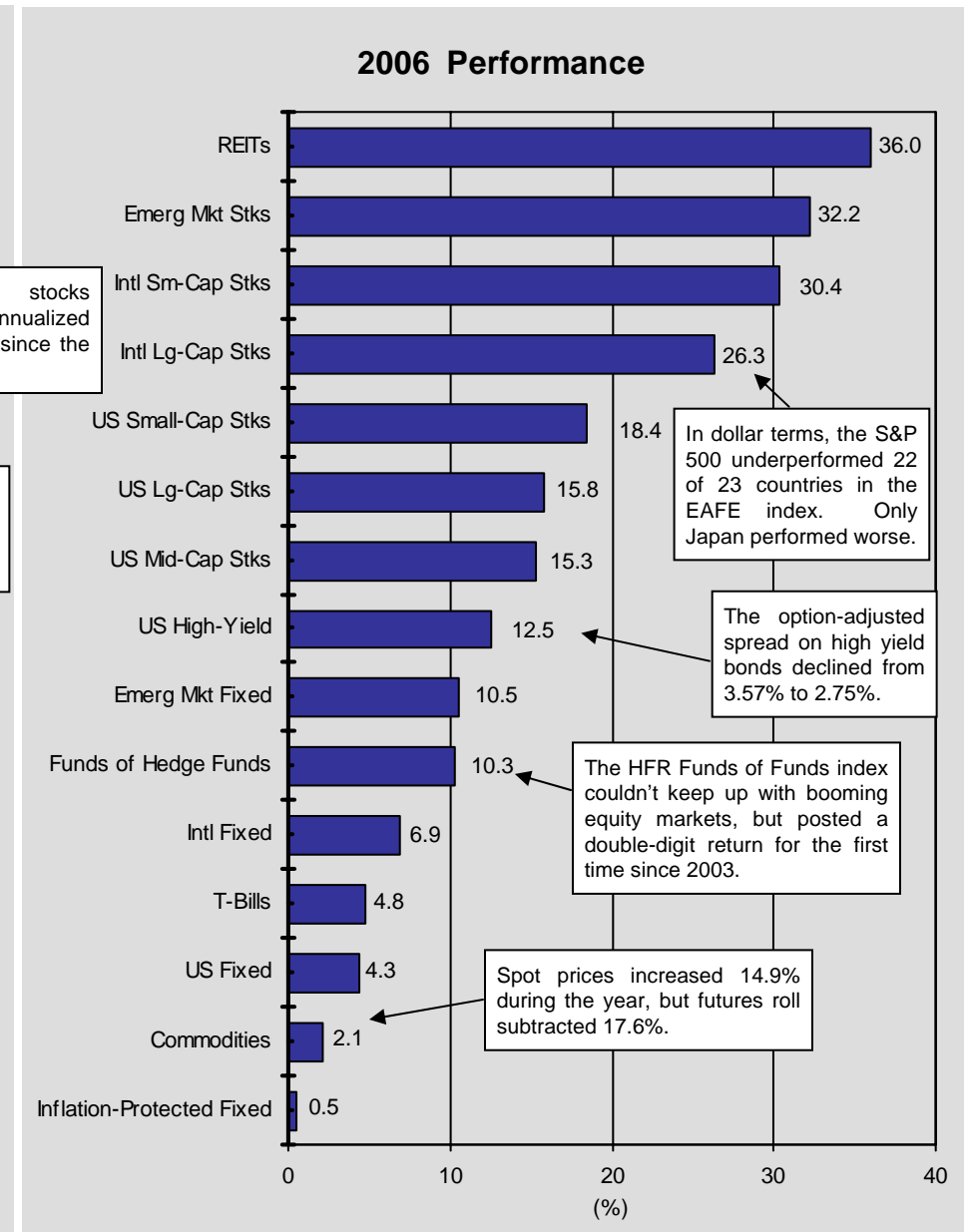
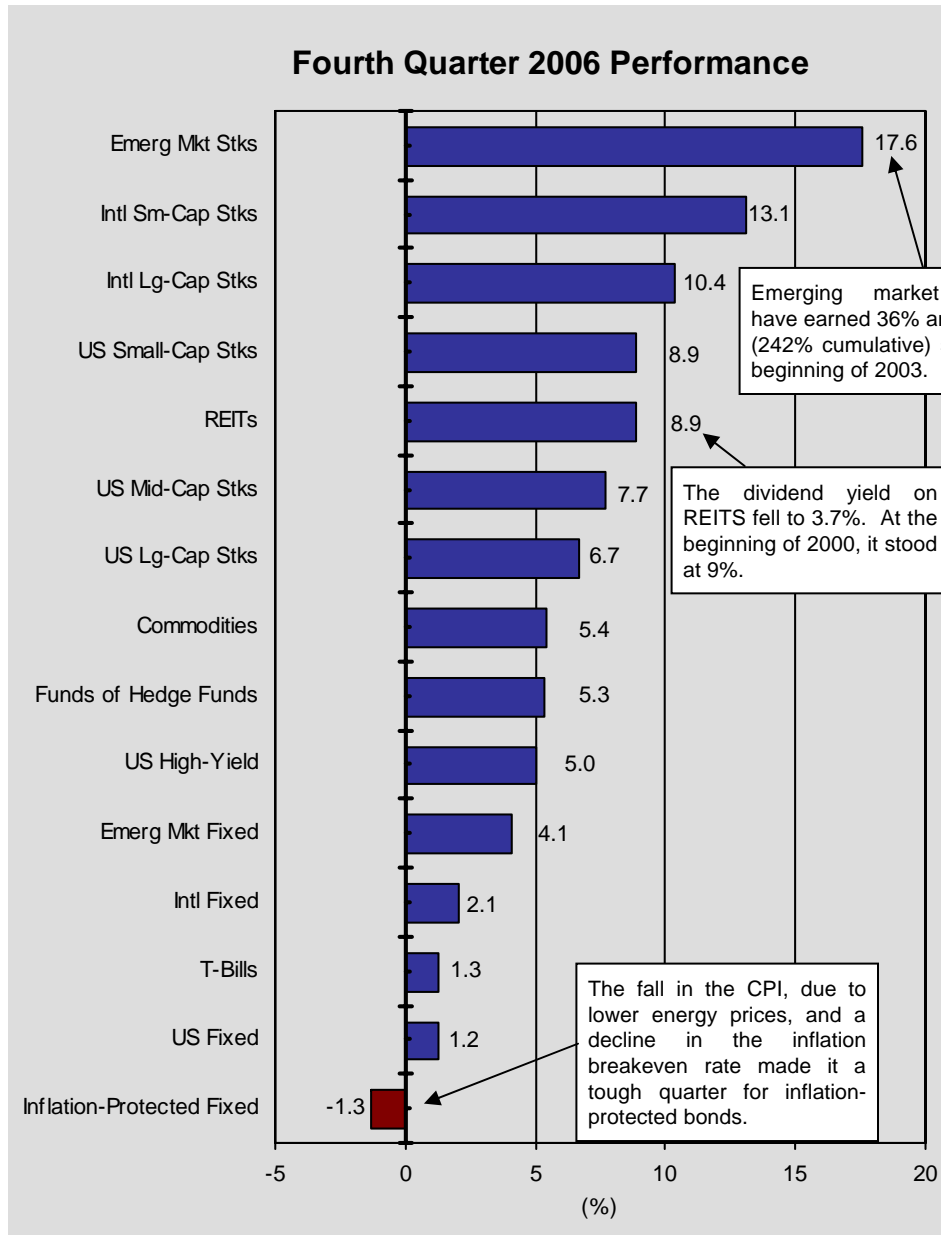
Today, there are a number of possible events that could cause a reevaluation of risk tolerance, such as a recession in the US, a hard landing for the dollar, a significant energy supply shock, a spike in high yield defaults, a major hedge fund collapse, or a catastrophic terrorist attack, to name just a few. While all of these events might seem unlikely, investors shouldn't ignore left-tail risks. They have had a tendency to occur with some frequency in the history of capital markets. Investors must guard against complacency. History has taught us that the most difficult periods for markets often occur following bouts of excessive optimism.

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Global Equity Investors Were Well Rewarded in 2006

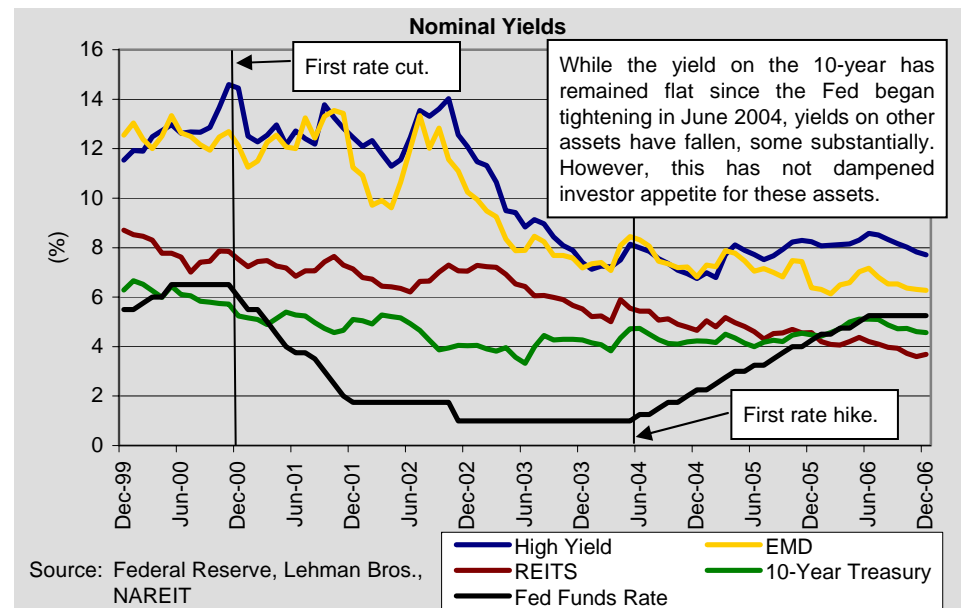
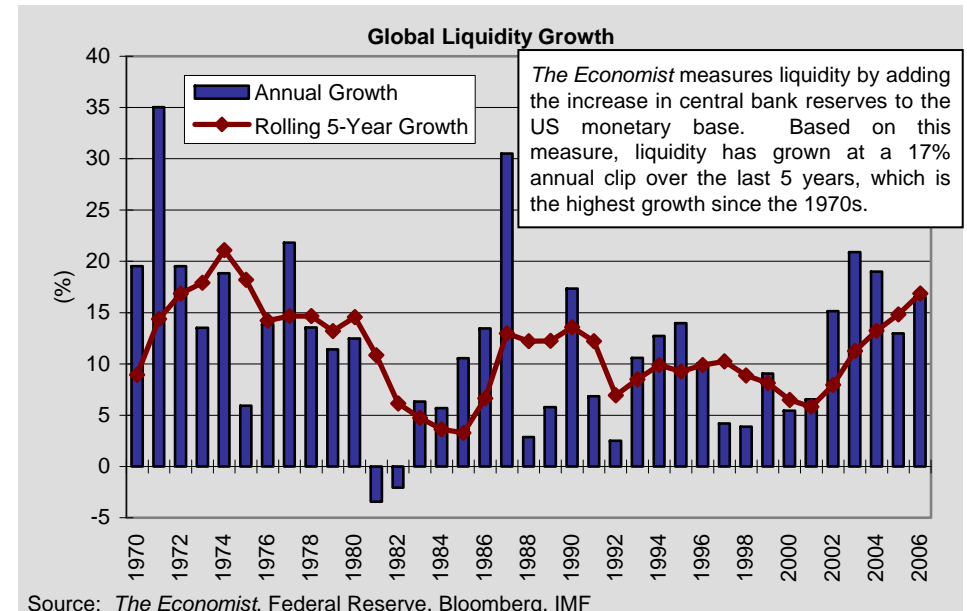


Global Equity Investors Were Well Rewarded in 2006 (cont.)

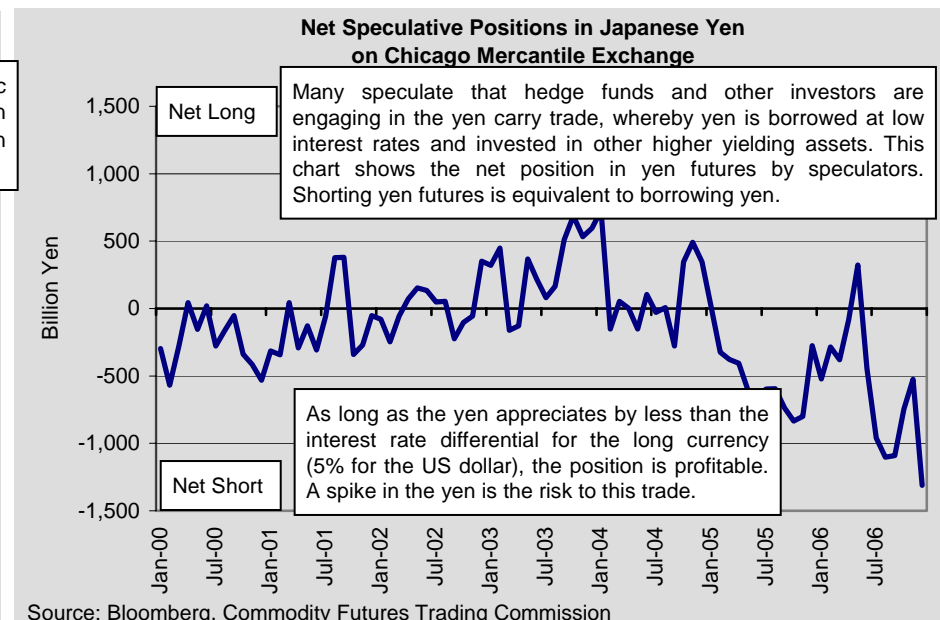
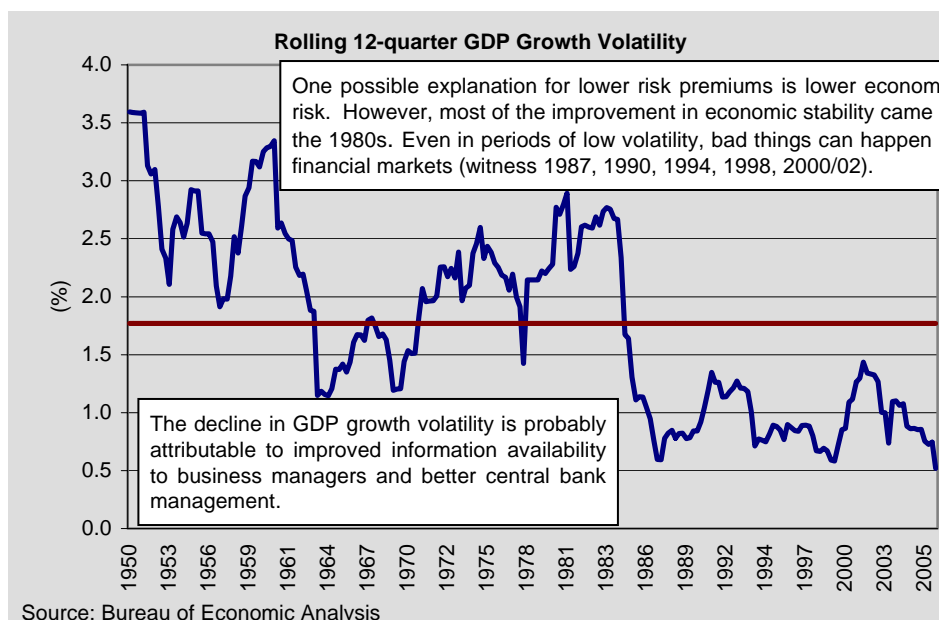
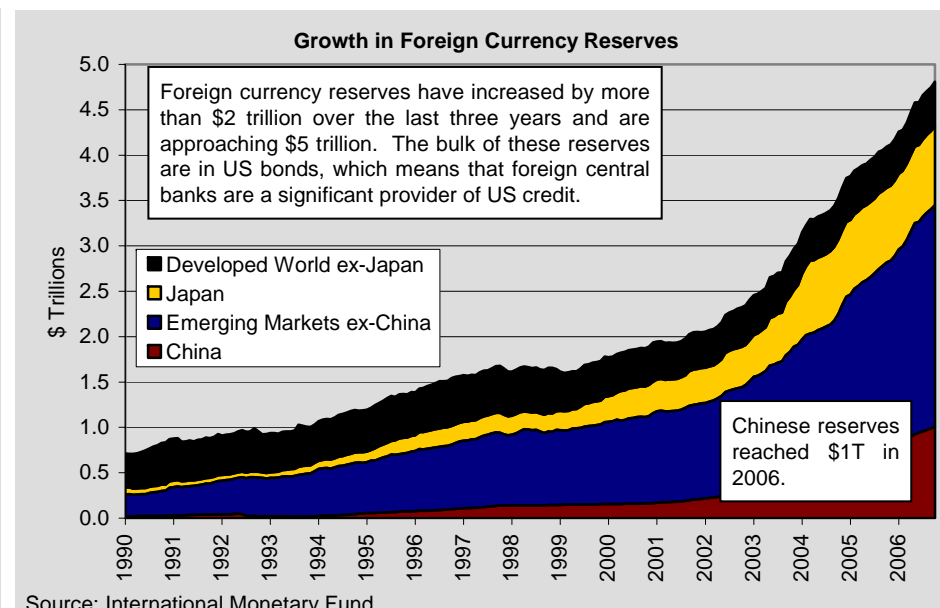
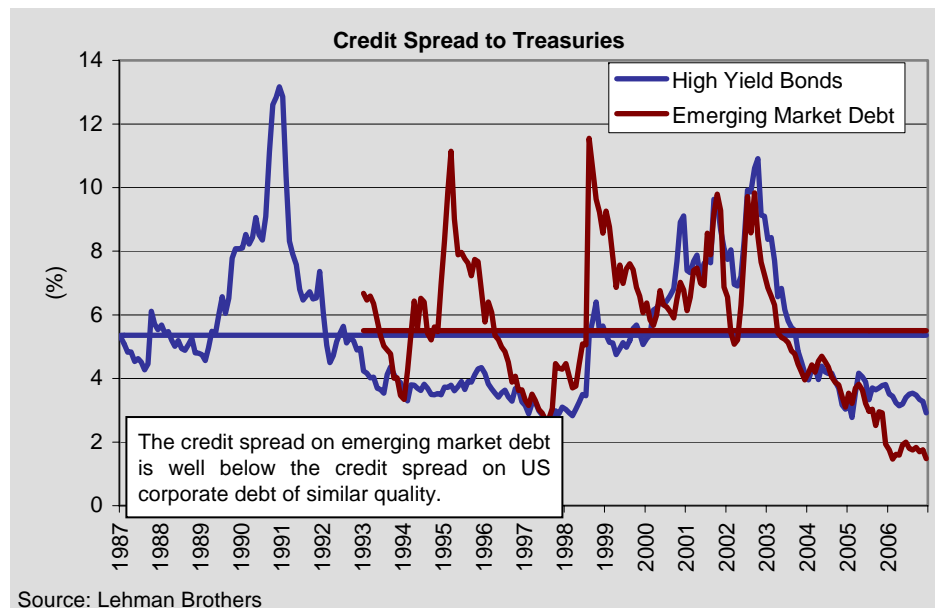


Risky Business

- Risk was well rewarded again in 2006. Growth in global liquidity has encouraged risk taking by providing abundant, cheap funds to capital markets. There was a hint that the tide of liquidity was receding in the second quarter of this year, as long-term interest rates spiked and many equity markets experienced sharp pullbacks. However, this proved to be a blip as interest rates fell in the third quarter.
- Where is this liquidity coming from? The Federal Reserve was a big contributor in the early part of this decade by cutting the Fed Funds rate to 1%, which encouraged the inflation of the housing bubble. The Fed has since increased the rate to 5.25%, which is arguably restrictive. However, the Fed may have lost some of its ability to control monetary policy. Long-term interest rates, which are more influential for the economy, have barely budged since the Fed began raising its target rate in June 2004. Credit remains cheap and plentiful.
 - Central banks in Asia and the Middle East have an increasing influence over US monetary conditions. They have poured more than a trillion dollars into US debt markets over the last few years to keep their currencies from appreciating relative to the dollar.
 - As yields on risk-free obligations have fallen, investors have pushed return premiums down on riskier assets. Credit spreads are remarkably thin. Low spreads have encouraged leverage. Cheap debt has contributed to the buyout boom, which has helped drive global equity markets higher. Hedge funds have also been putting cheap debt to full use.
- Excess liquidity has kept interest rates low and capital plentiful. Many investors have been chasing risky assets and have been rewarded for doing so. We believe investors should use this opportunity to reduce risk since it's not priced to pay much in the future. We cannot predict the timing or catalysts for risk premiums to widen. However, today's tight risk premiums make it more likely that any downturn will be painful. As Alan Greenspan warned in August 2005, "history has not dealt kindly with the aftermath of protracted periods of low risk premiums."

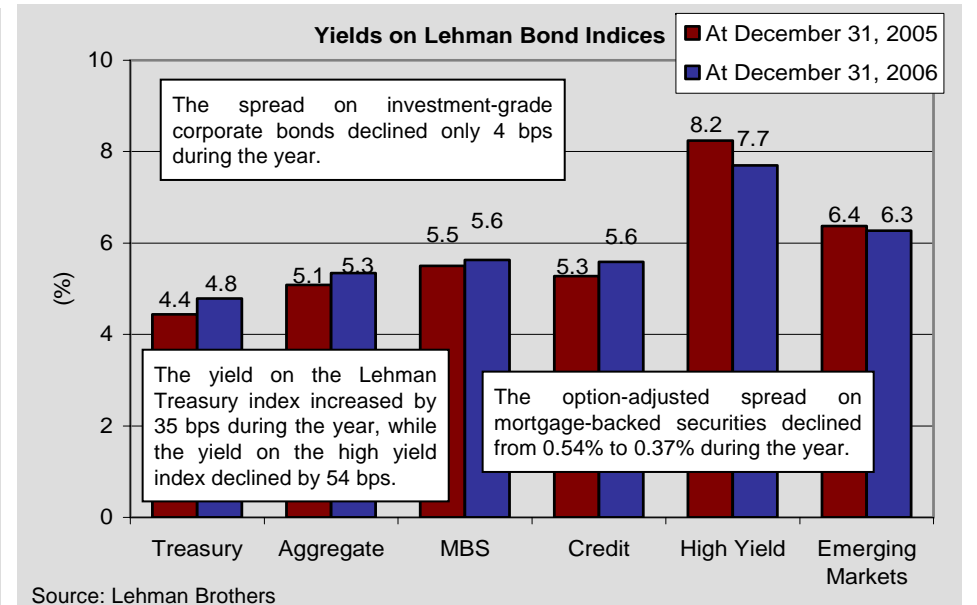
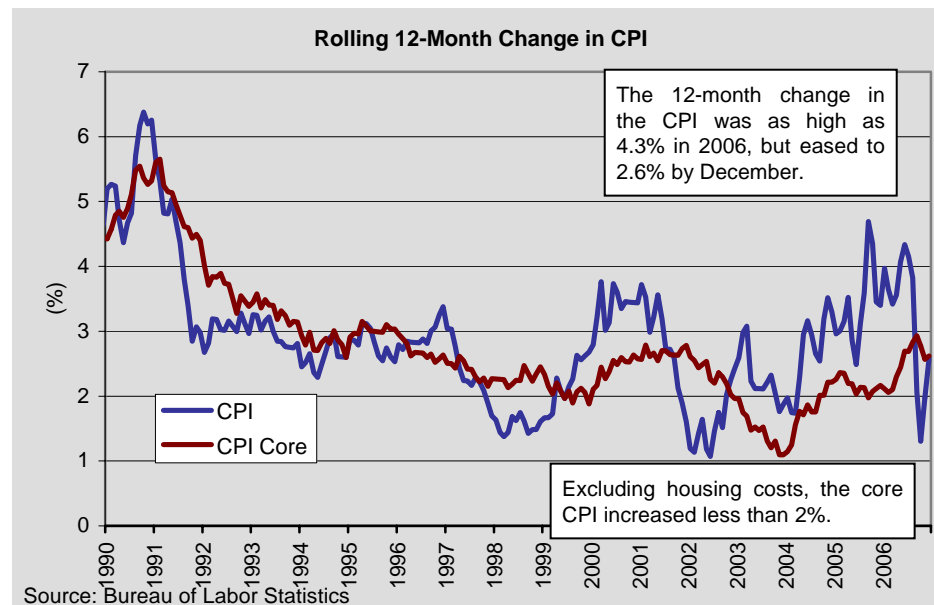
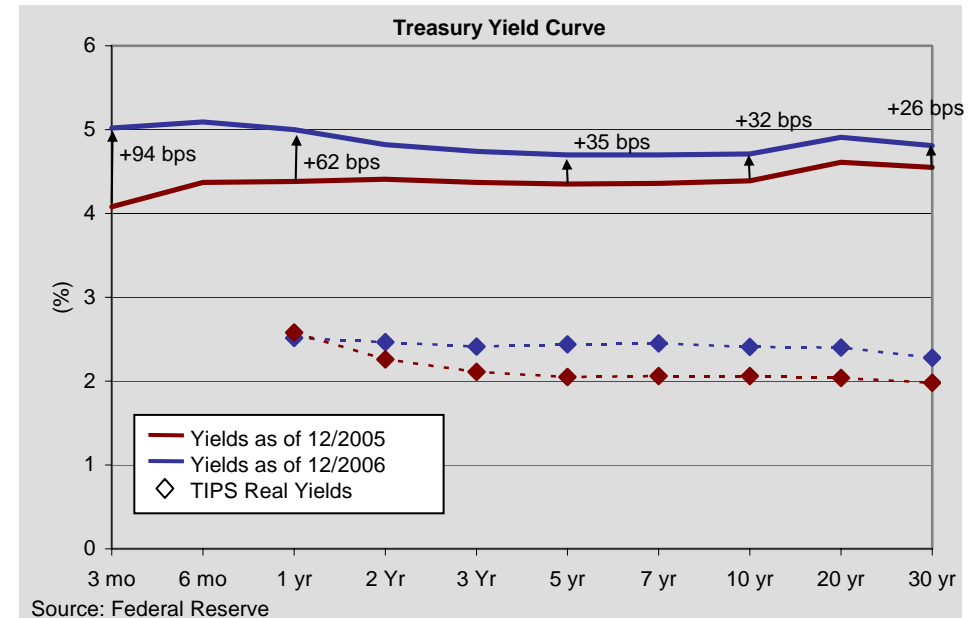


Risky Business (cont.)



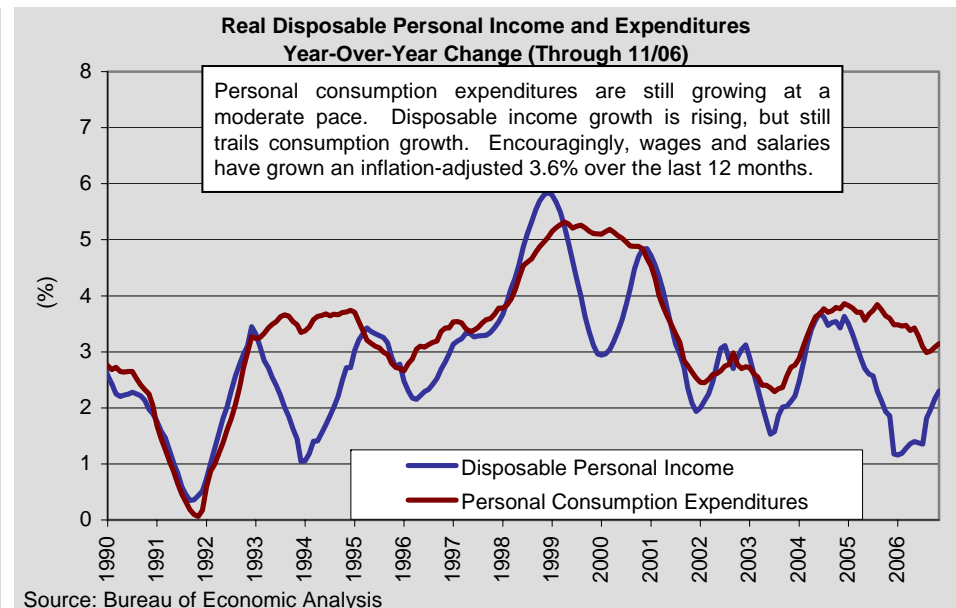
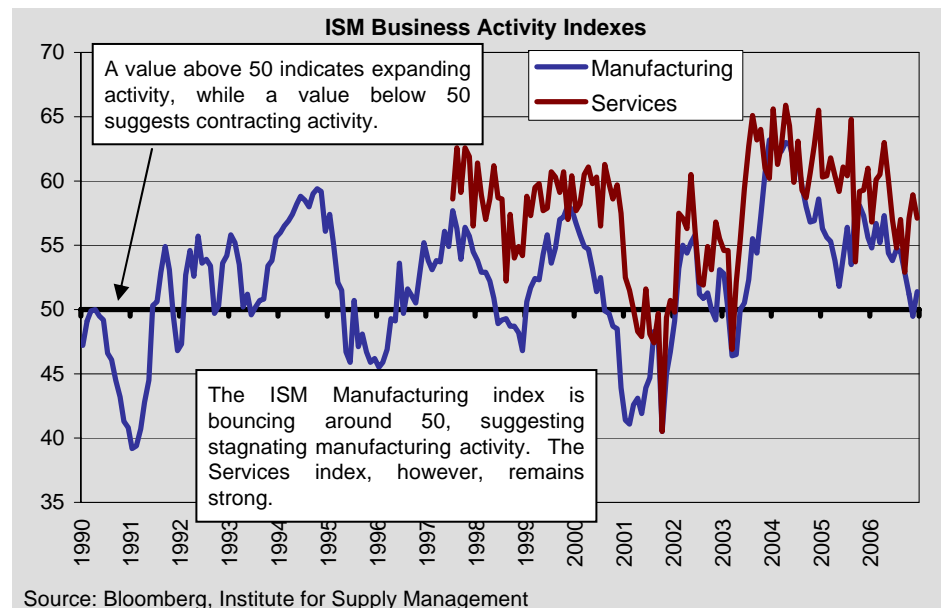
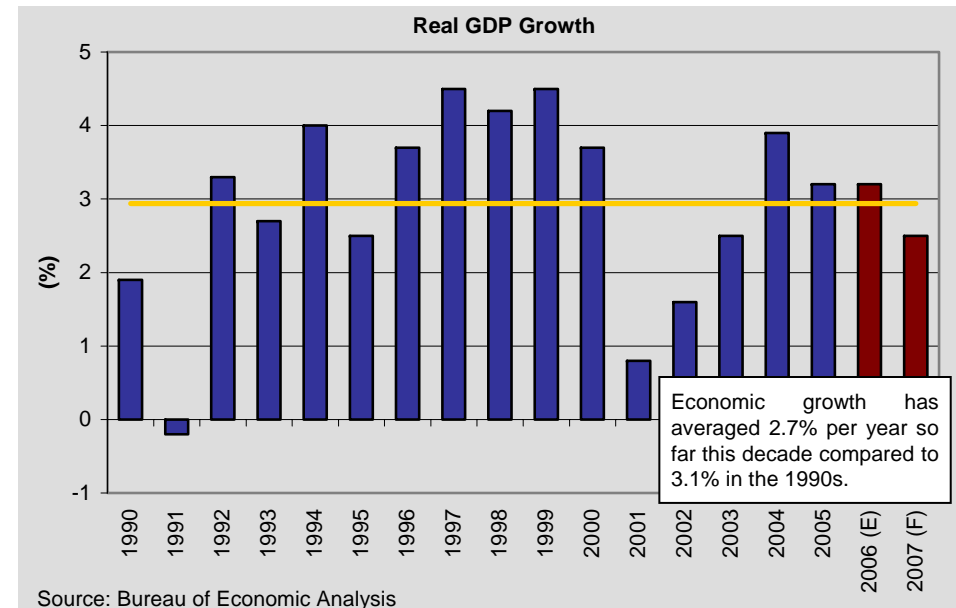
Hopes for Quick Fed Easing Fade

- As expected, the Federal Reserve left the Fed Funds rate unchanged during the fourth quarter. The overnight lending rate was 5.25% at year-end, up from 4.25% at the beginning of 2006. Despite slowing economic growth, FOMC minutes suggest inflation is the primary concern. While Fed Funds Futures predict little chance of further tightening in 2007, they indicate that investors will have to wait until the second half of the year for a cut. The futures market predicts only a 25 bp cut by year end.
- The 10-year Treasury yield finished the year at 4.71%, which was near where it started the quarter (4.64%). The 10-year yield traded as low as 4.4% during the quarter, but rose as the prospects for Fed easing waned. For the year, the 10-year yield was 32 bps higher. The yield curve remains inverted, with the 10-year yielding 31 bps less than 3-month T-bills.
- The plunge in energy prices in the second half of 2006 resulted in CPI inflation of 2.6%. The core CPI index (ex-food and energy) also increased 2.6% for the year, which is above the Fed's stated comfort range (1% to 2%). Higher rents and owners' equivalent rents continue to be the primary drivers of core inflation. The inflation breakeven rate priced into 10-year TIPS finished the year at 2.3%.



Economic Growth Slowed in the Second Half of 2006

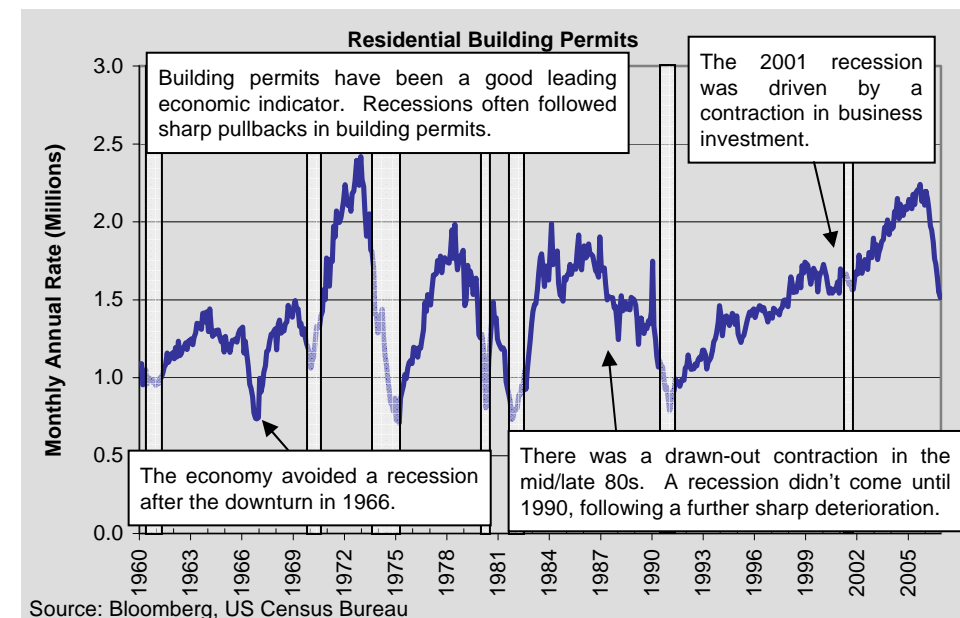
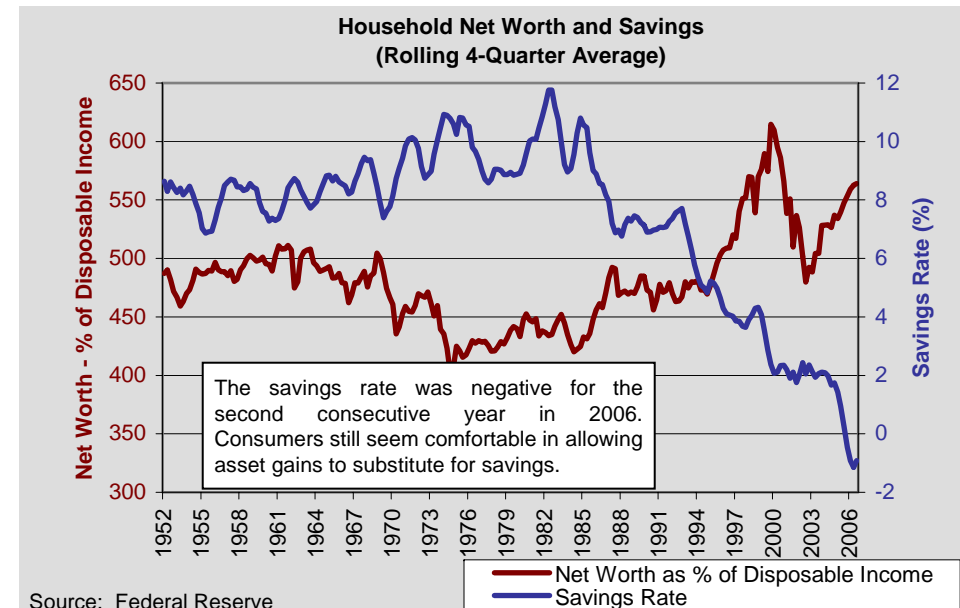
- The economy grew at a 2% annualized rate during the third quarter, which is below the long-term trend rate of 3%. Economists polled by Bloomberg think the economy expanded at a slightly faster pace of 2.5% in the fourth quarter. If so, growth for the full year was a respectable 3.3%, which was in line with expectations at the beginning of the year.
- The contraction in residential investment is the main constraint to growth. Residential investment declined at an 11% annualized rate in the second quarter and 18.7% during the third quarter. Residential investment subtracted 1.2% from overall economic growth for the quarter. The effects of the housing downturn are not yet observable in spending. Personal consumption expenditures are still expanding at a healthy clip. Third quarter growth was 2.8%. Fourth quarter growth was probably around 4%.
- As for 2007, economists expect growth to continue below trend. The consensus expectation for 2007 growth is 2.5%, which would represent a soft landing. The question now is whether the economy can shake off the effects of the residential investment bust.



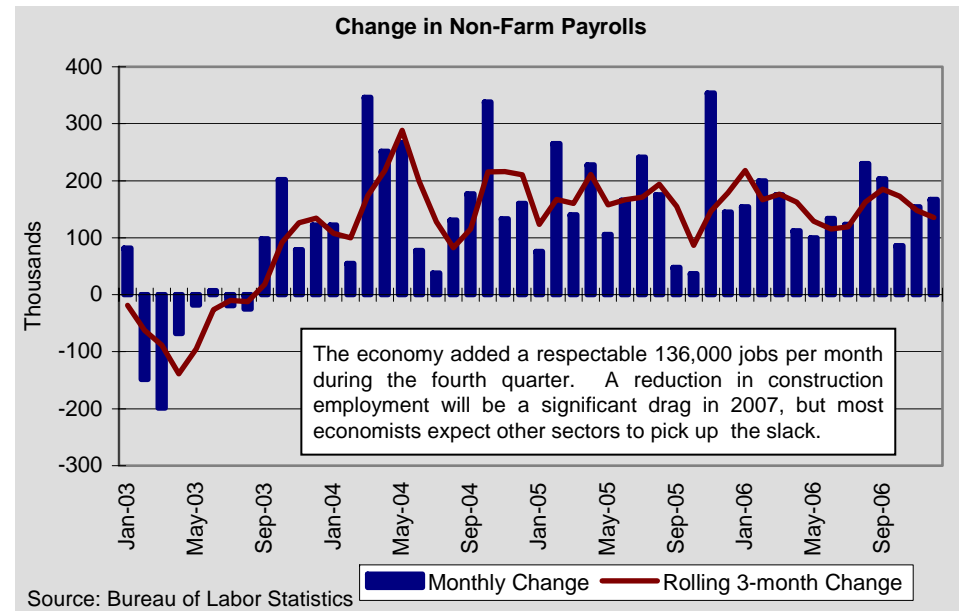
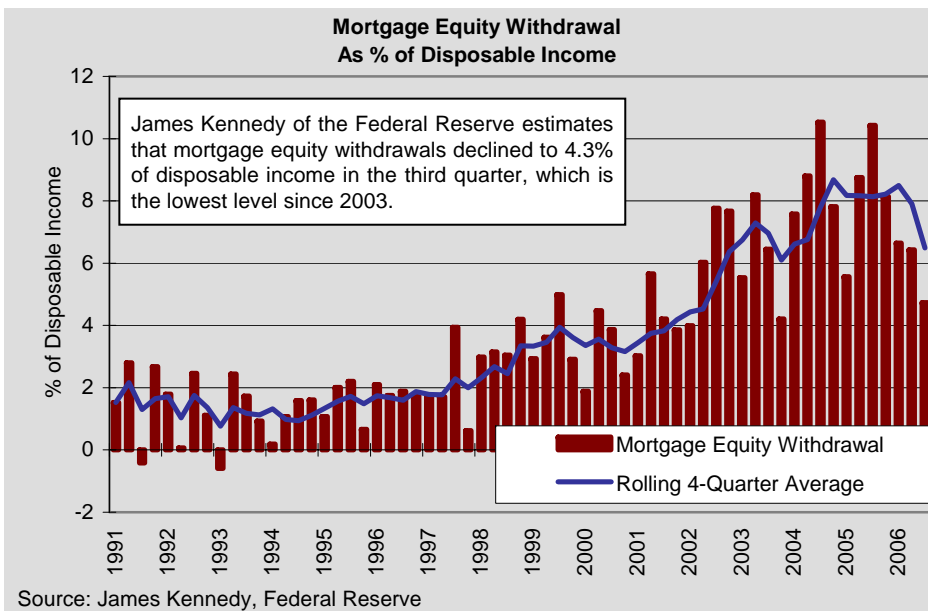
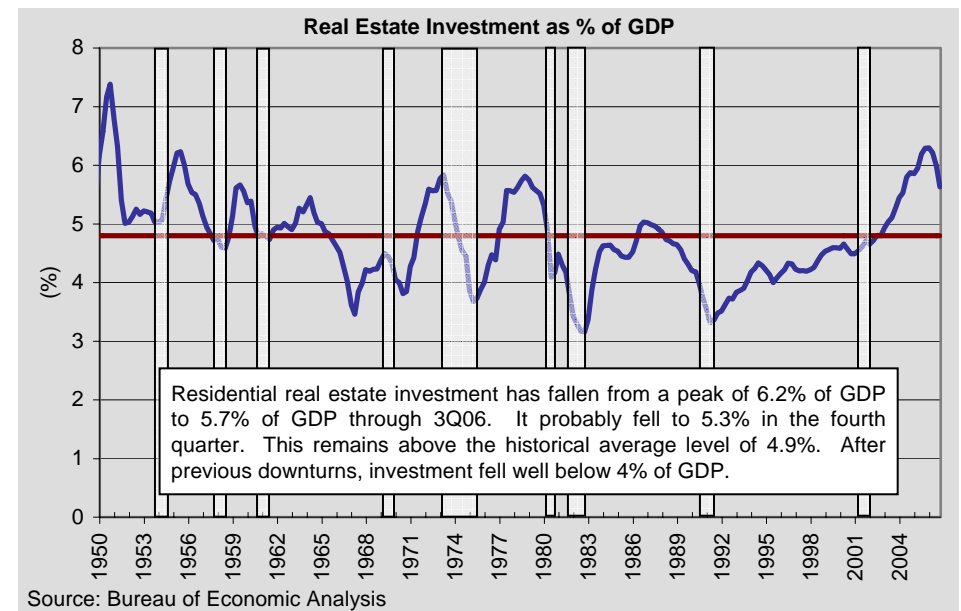
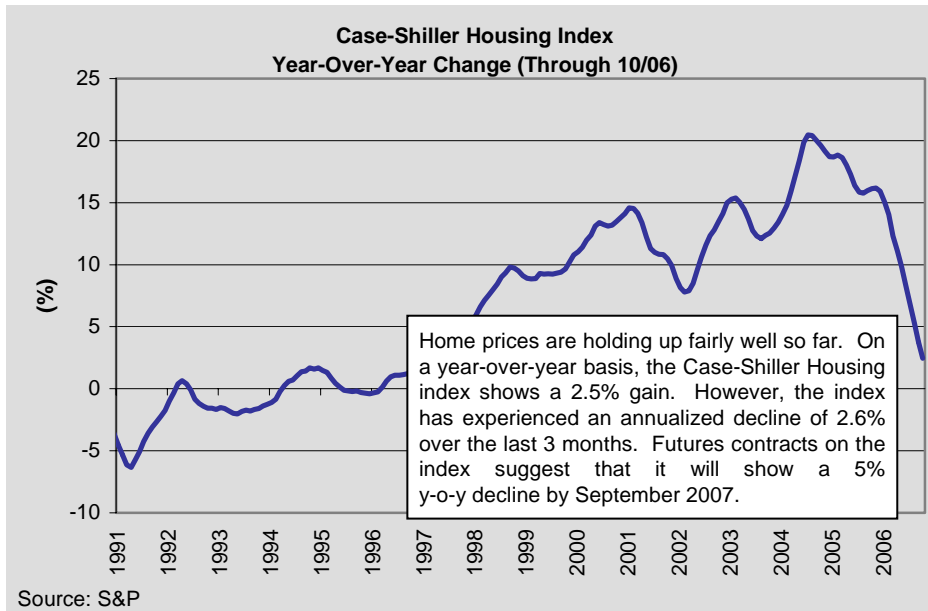
How Likely is a Recession in 2007?

- The sharp contraction in residential real estate activity that began in 2006 introduced additional downside risk for the economy in 2007. Historically, residential construction activity has been one of the more reliable leading economic indicators. Residential building permits are down 32% from their peak. Recessions have often followed declines of this magnitude.
- Some economists believe that housing construction activity bottomed in the fourth quarter. This seems optimistic. Despite a 13% pullback in residential investment, it remains 5.3% of GDP (estimated as of 4Q) and well above the historical average level of 4.9%. Past investment busts have taken this below 4%. An economist with Fannie Mae recently estimated that there is a 630,000 unit housing overhang, which is about a third of annual new demand. It seems residential investment has further to fall.
- Still, US consumers are apparently undaunted. Since consumer spending makes up 70% of the economy, it will take a sharp slowdown in consumption growth to put the economy into a recession, and as shown on the prior page, there have been few hints of that occurring so far. Mortgage equity withdrawals are falling, but households have taken on more revolving credit and have liquidated financial holdings to keep spending growth in excess of income growth. Employment growth remains healthy, and wage growth is ticking up. Lower energy prices may also support spending.
- The resilience of US consumers makes a recession unlikely in 2007. Households need to start saving more, but it probably won't happen in 2007. Some risks to this view include (1) a significant contraction in real estate prices, which has not yet occurred; (2) the bust in residential investment spilling over to other industries, hurting job and wage gains; and (3) reduced availability of cheap credit.
- While a recession is unlikely in 2007, investors should not ignore the risk. Tight risk premiums suggest that the market has priced in almost no chance of a recession. If one were to occur, financial markets could be caught flat-footed.

A futures contract on whether the US experiences a recession in 2007 (as defined by two consecutive quarters of negative GDP growth) trades at Intrade.com. The contract currently suggests about a 25% chance of a recession.

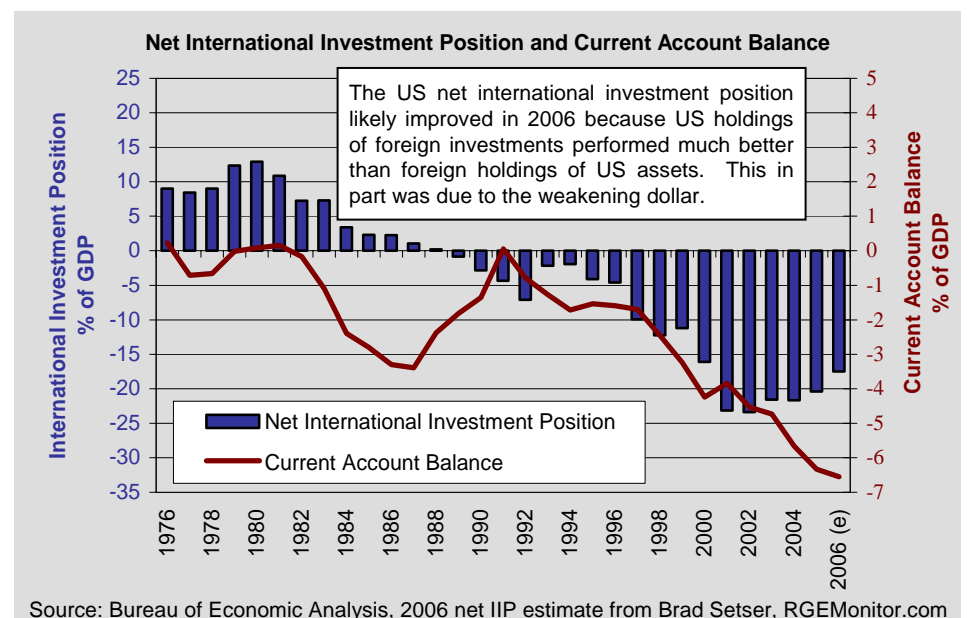
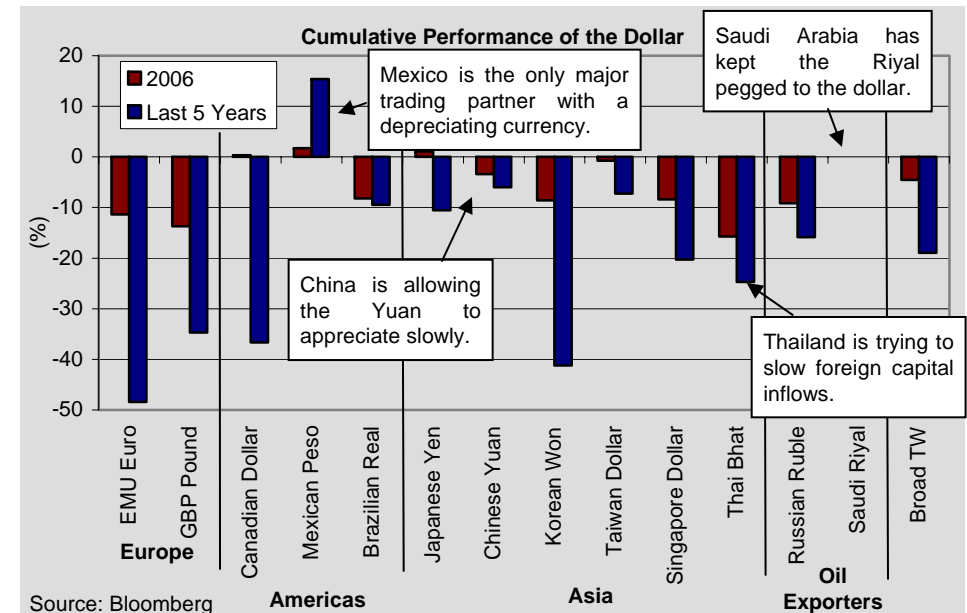


How Likely is a Recession in 2007? (cont.)

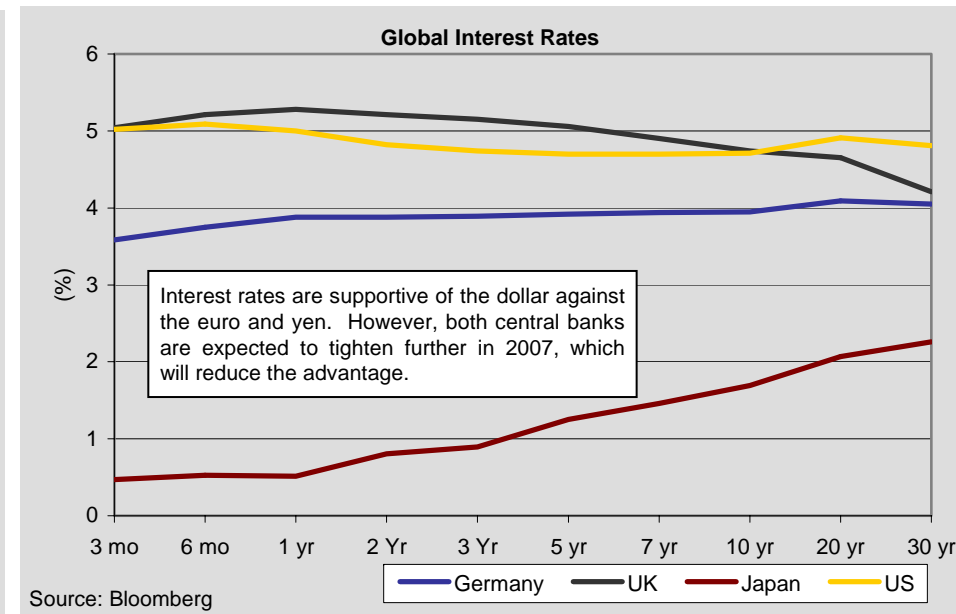
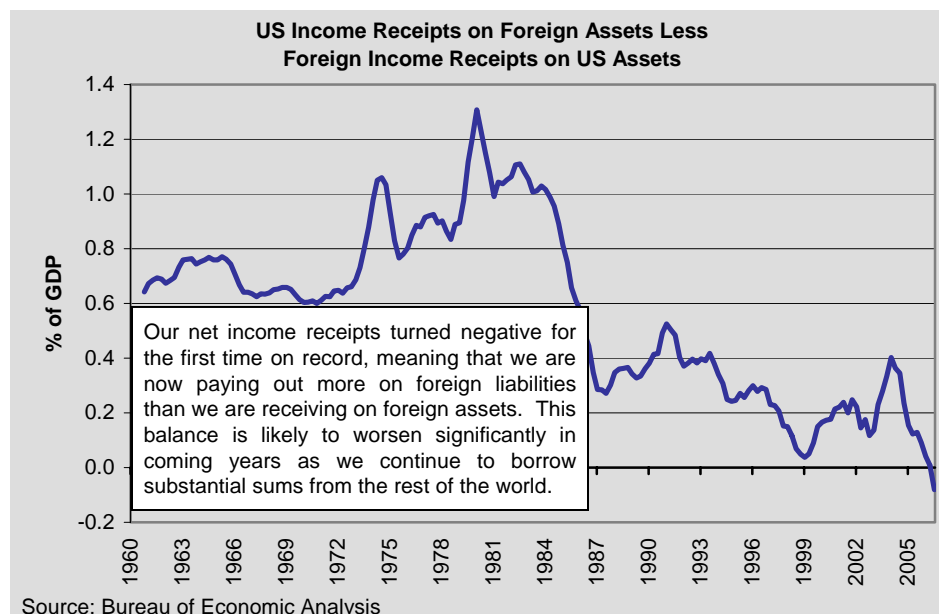
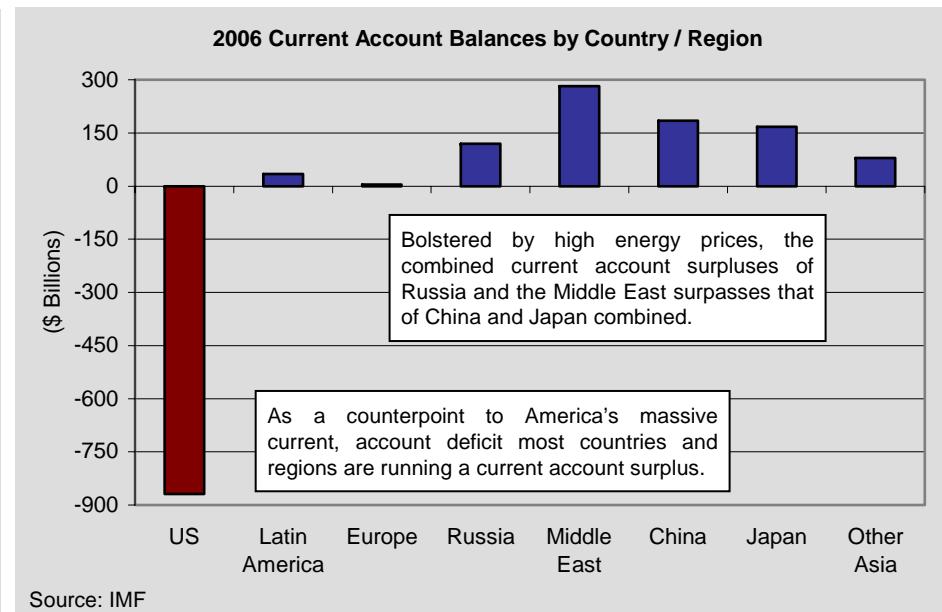
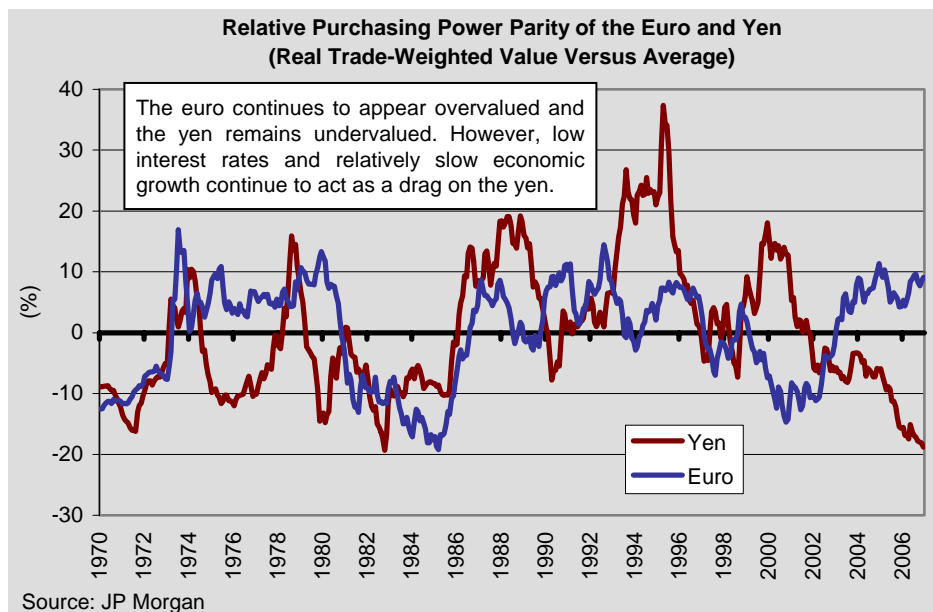


The Dollar Resumed its Descent in 2006

- After rebounding in 2005, the dollar continued its descent in 2006. It fell 11% against the euro and 14% against the British pound. The dollar rose slightly against the yen in 2006 after rising 15% against it 2005, but fell against other major Asian currencies. The trade-weighted dollar declined 5% for the year.
- The US current account deficit worsened in 2006. It reached 6.8% of GDP in the third quarter, up from an average of 6.4% in 2005. The deficit may stabilize in 2007, especially if energy prices stay lower. While the US continues to borrow massive amounts from the rest of the world, the net investment position (US holdings of foreign investments less foreign holdings of US investments) improved again as foreign assets held by US investors substantially outperformed US assets held by foreign investors.
- China and other Asian central banks have amassed huge reserves, with China's reserves exceeding \$1 trillion. In order to prevent their currencies from fully appreciating against the dollar, foreign central banks have continued to use their reserves to buy mostly US dollar assets. Also, while higher oil prices have hurt consumers, the recycling of petrodollars back into the US has helped keep domestic interest rates low. While central banks may begin diversifying their reserves, the dollar seems unlikely to lose its position as the world's reserve currency. Many Asian countries are reliant on the US to purchase their exports, and central banks would rather lose money on their reserves than risk their economic growth.
- While the euro appears overvalued, it would not be surprising for it to continue to face upward pressure due to the fact that many Asian countries continue to resist allowing their currencies to rise to fair value. Reserve diversification may put further upward pressure on the euro. The yen may be poised for a rally. It is nearly 20% undervalued on a purchasing power parity basis. It may also be a beneficiary of reserve diversification from Asian banks. Investors must be cautious in making an allocation to the yen, however. Since US cash rates are 5% above Japanese rates, the yen must appreciate 5% just for investors to break even.
- The dollar seems likely to continue to fall. A continued slow bleeding, increasingly against Asian currencies, is probable. However, a hard landing of the dollar remains a serious risk. While unlikely in the near-term, if this should happen, it could lead to a spike in interest rates and a sharp reduction in global liquidity. **We continue to recommend that investors diversify into foreign currency-denominated assets.**

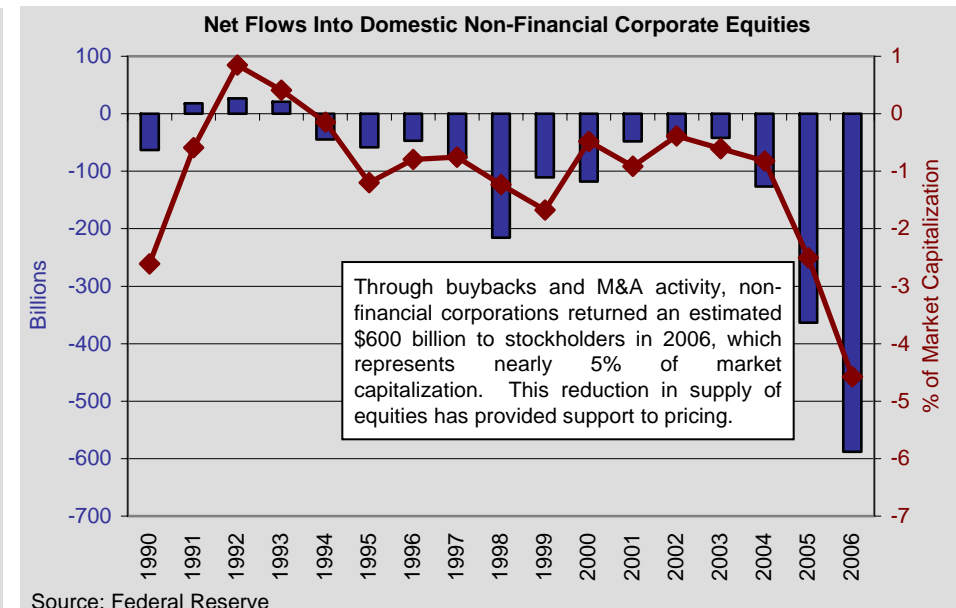
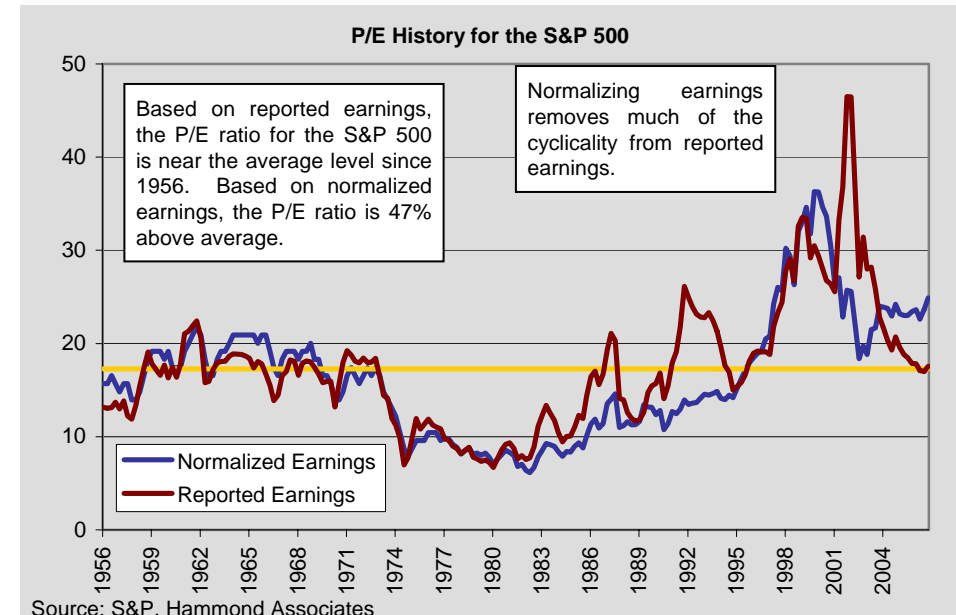
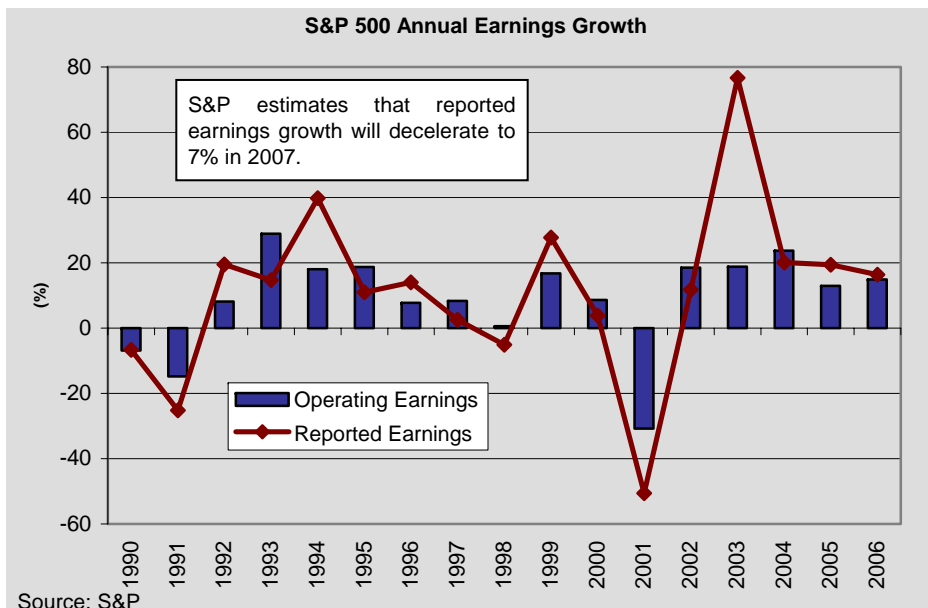


The Dollar Resumed its Descent in 2006 (cont.)



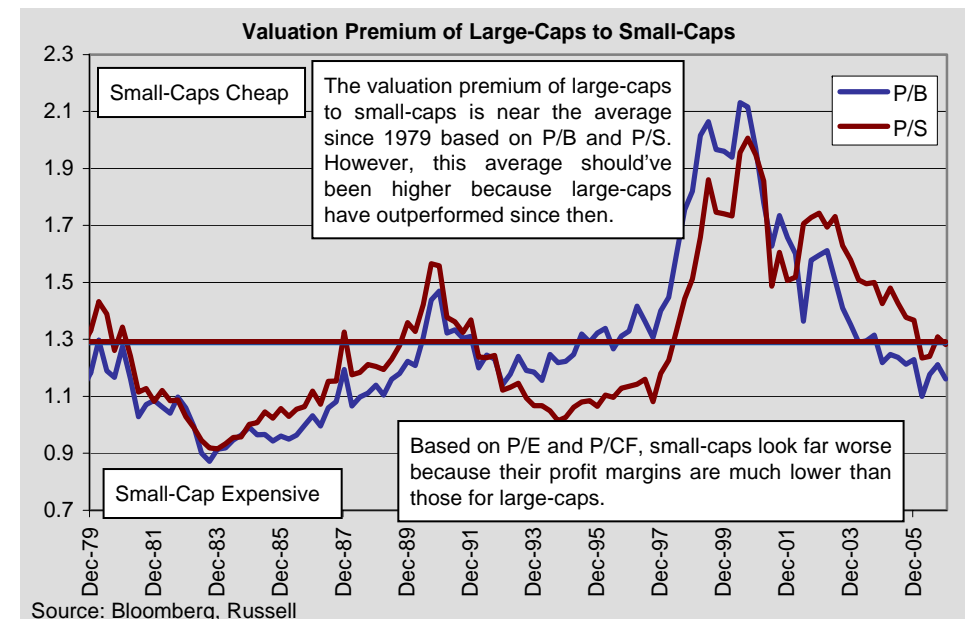
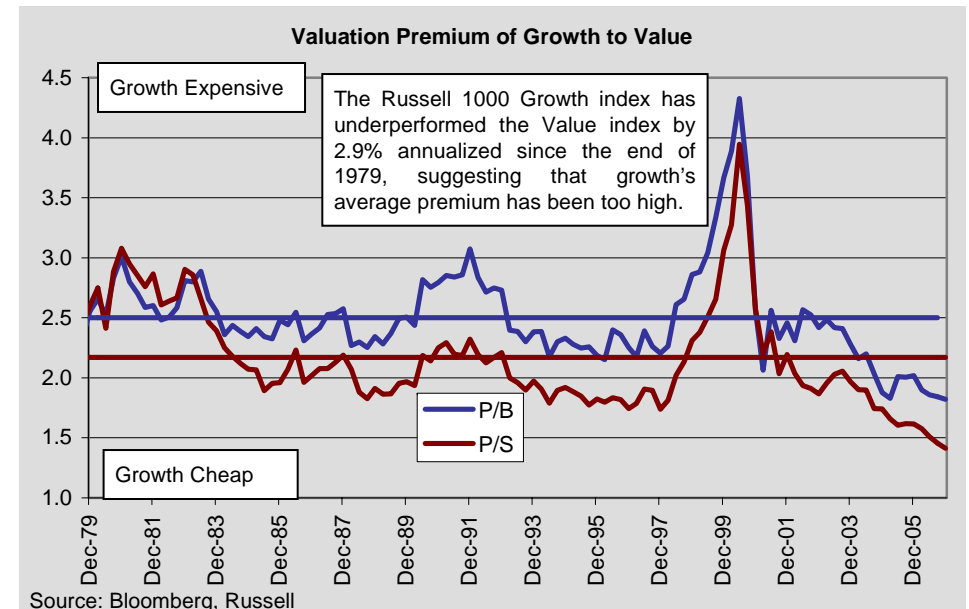
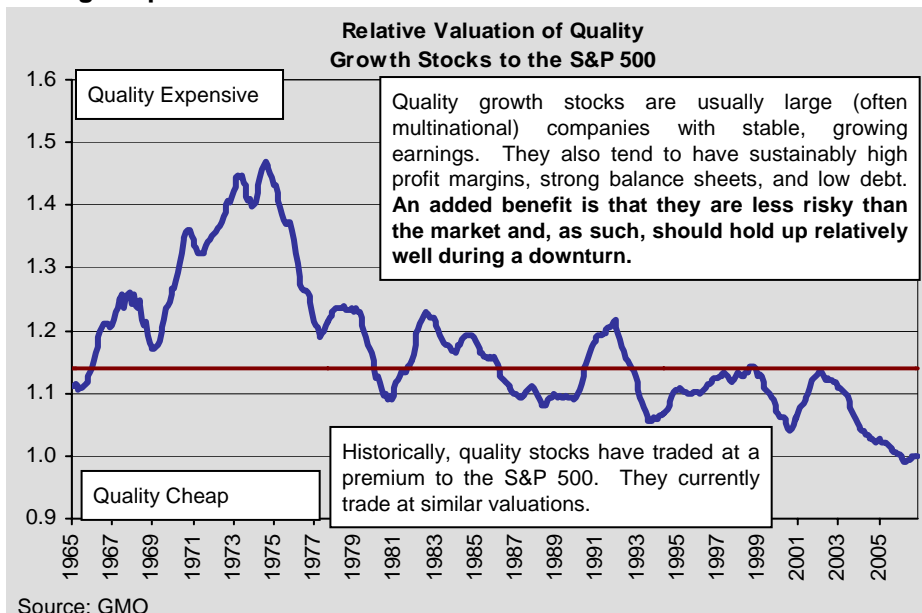
Robust Earnings Growth and M&A Activity Drove Domestic Equities Higher

- The S&P 500 had a very strong year, earning 15.8%. The index is benefiting from continued double-digit earnings growth. Reported earnings jumped 16% for the year. As we have pointed out before, much of the increase in profits has come from margin expansion. The profit margin on the index is now 52% above the historical average. The bad news is that profit margins tend to be mean reverting. Based on our normalized earnings measure, which assumes that profit margins return to average, the P/E on the index remains very high at 25.
- Equities also benefited from rising corporate activity. Corporations are using a substantial portion of their record profits (and sometimes additional debt) to buy back shares. M&A transactions are accelerating sharply, encouraged by easy credit and rising commitments to buyout funds. They topped \$1.6 trillion in 2006, a 36% increase over 2005.
- As for 2007, we wouldn't be surprised to see stocks have another strong year. Excess global liquidity and high profit margins are supportive of equity markets over the near term. However, the good times won't last indefinitely. Eventually profit margins and valuations will revert to more normal levels. **We expect a real return on the S&P 500 of only 2% to 4% over the next decade.**



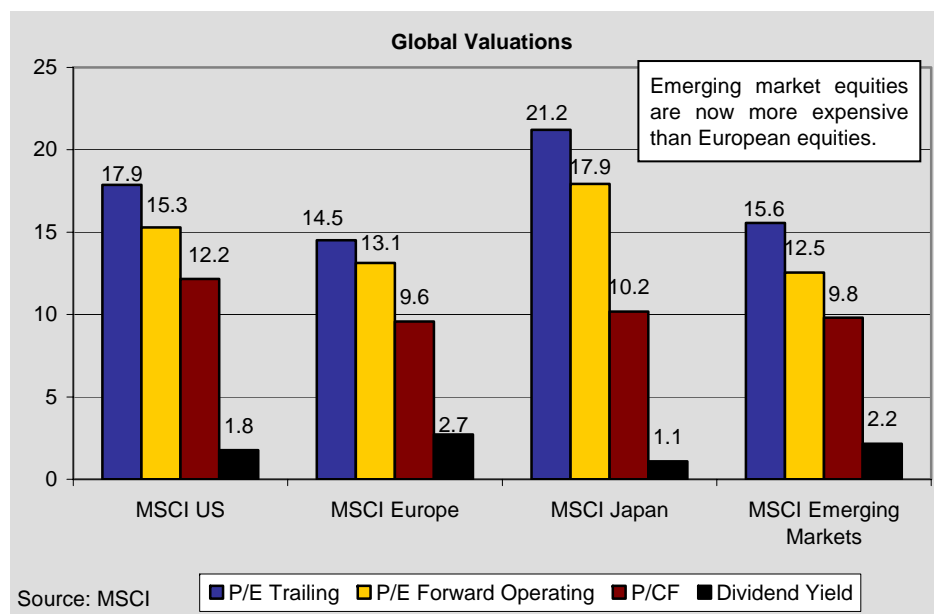
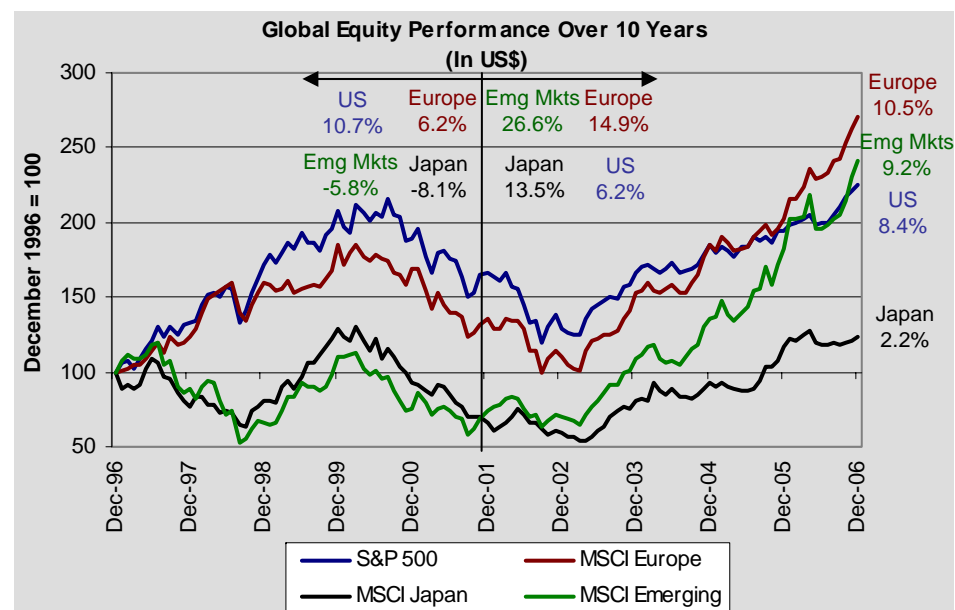
Large-Cap Growth Poised to Outperform in 2007 and Beyond

- Based on Russell style indexes, small-cap value stocks were the best performing style in 2006 (23% return), while large-cap growth was the worst (9% return). Large-cap value stocks were close behind small-cap value stocks. Small-cap value and large-cap value stocks have outperformed large-cap growth stocks for seven consecutive years. While calling turns in style performance is difficult, large-cap growth leadership seems likely to return soon.
- Investors currently are not willing to pay enough for growth. The valuation premium for growth relative to value is well below average. In addition, small-cap stocks appear expensive relative to large-cap stocks. According to Bloomberg, the trailing P/E ratio on the Russell 2000 index is 38, compared to 18 for the S&P 500.
- Historically, we have urged clients to overweight small-cap stocks and value stocks within their domestic equity portfolios. However, valuations no longer support this position. **We recommend that investors overweight large-cap growth stocks, with a particular emphasis on high quality growth stocks, and underweight small-cap stocks and large-cap value stocks.**

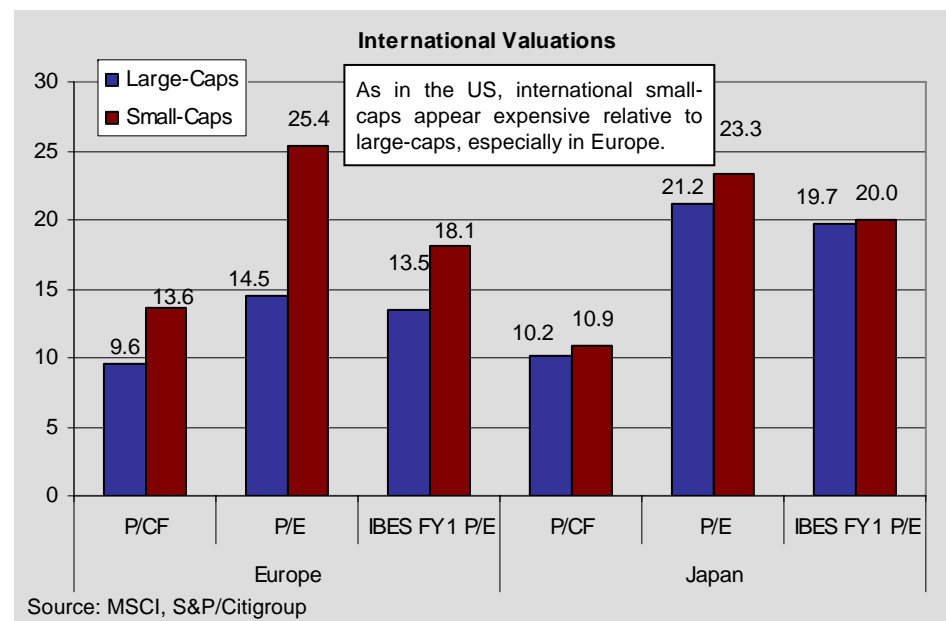
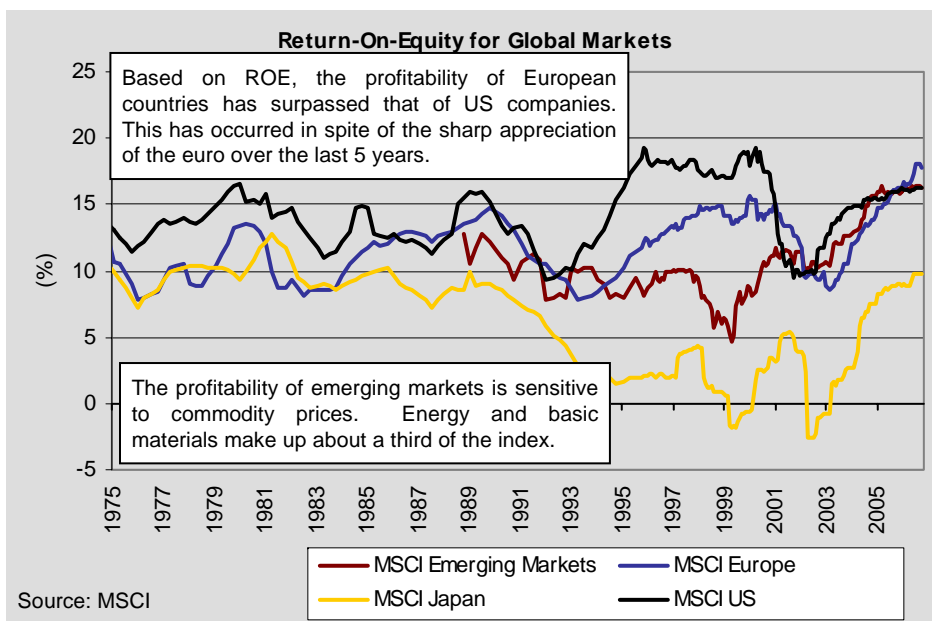
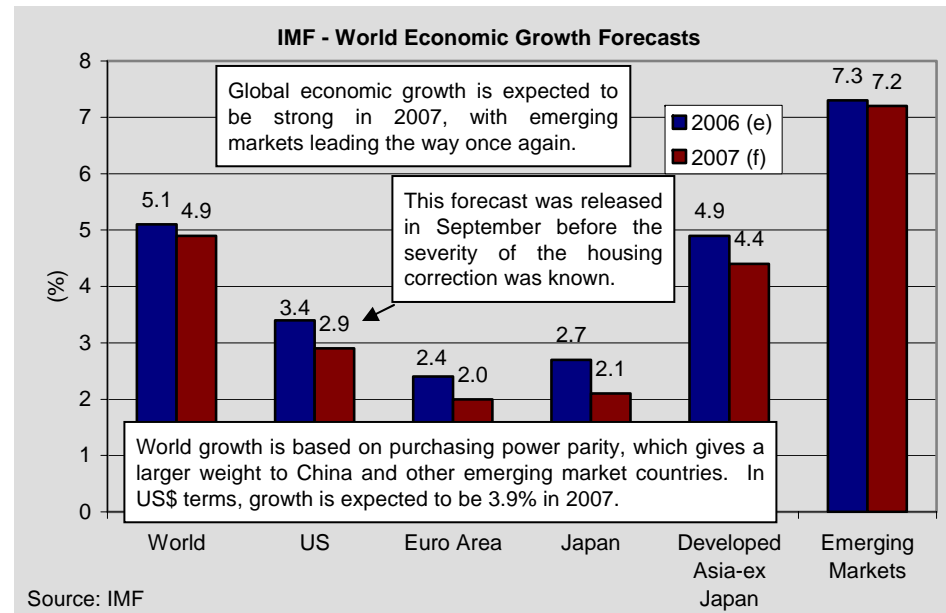
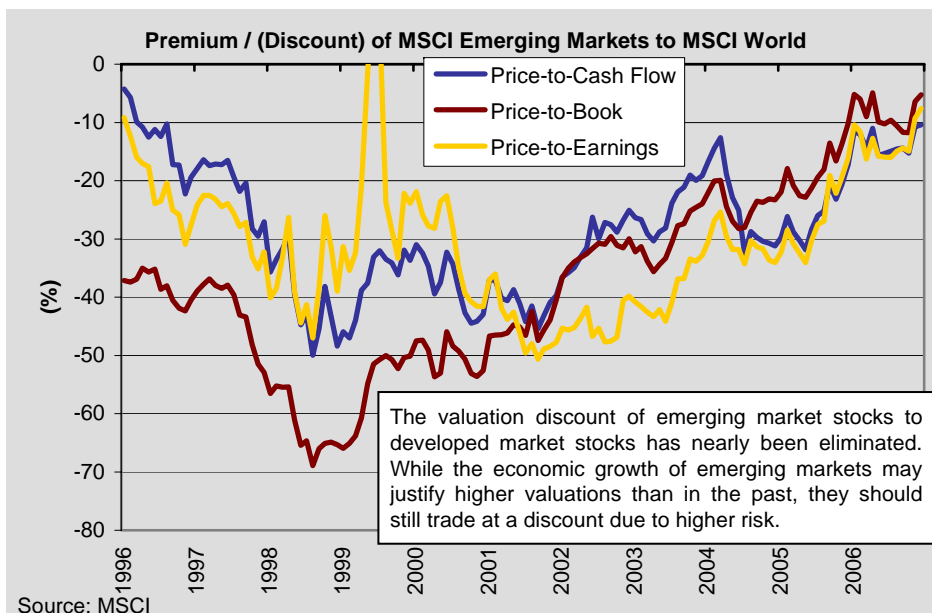


Will International Equities Maintain Their Performance Advantage?

- International equities had another great year in 2006. The MSCI EAFE index outperformed the S&P 500 by more than 10 percentage points (26.3% vs 15.8%). Most of the outperformance was due to the weak dollar. In local currency terms, the MSCI EAFE index only outperformed by 70 bps. Emerging equities outperformed the S&P 500 by more than 16 percentage points in 2006. Less than four percentage points of the outperformance was due to dollar depreciation.
- Currency is unlikely to add much value to developed market equities in the coming years. While we expect the dollar to continue to weaken on a trade-weighted basis, the case for it weakening against European currencies, which make up 70% of the MSCI EAFE index, is less compelling. Both the euro and the British pound appear overvalued. The Japanese yen, which represents 20% of the EAFE index, has the most potential for appreciation versus the buck.
- On a valuation basis, international developed markets remain modestly more attractive than the domestic market. Like in the US, earnings in Europe are booming, and European equities trade at a P/E of only 15. On a normalized basis, the P/E is far less attractive at 21, but it's still a 16% discount to the normalized P/E on the S&P 500. Japan is a tougher call. Valuations appear very high, but Japan has not enjoyed the sharp increase in profitability of other markets. Japan probably has more upside than other developed markets if the economic recovery continues and profitability improves. However, Japan has burnt optimistic investors many times over the last fifteen years. **Overall, we still favor international stocks over domestic stocks. We expect the MSCI EAFE index to continue to outperform the S&P 500 in the coming years.**
- Emerging market equity valuations are an increasing concern, as they have converged with those of developed markets.** At the beginning of 2003, they traded at a 30% discount to the MSCI World index based on P/B. Now, they only trade at a 5% discount. One can argue that the transformation in emerging market economies since the Asian crisis justifies higher equity market valuations than those for developed markets, but we are cautious. Emerging market equities are likely to continue to be a high beta play on the world economy and equity markets.

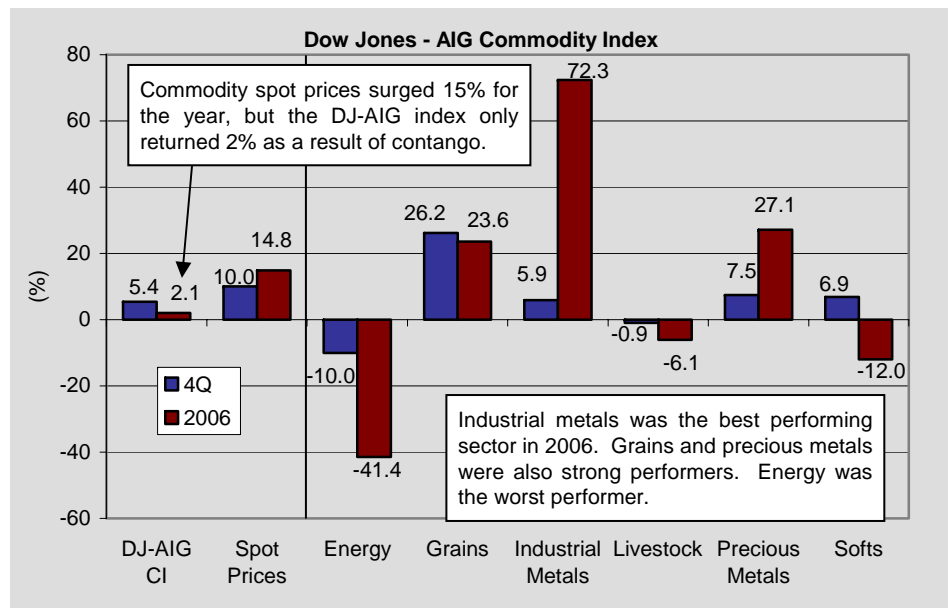
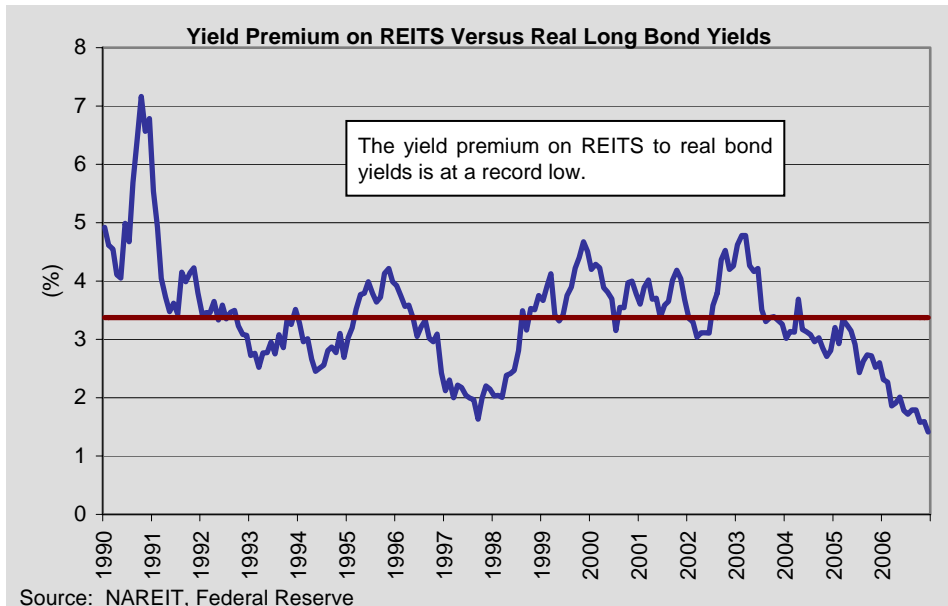


Will International Equities Maintain Their Performance Advantage? (cont.)



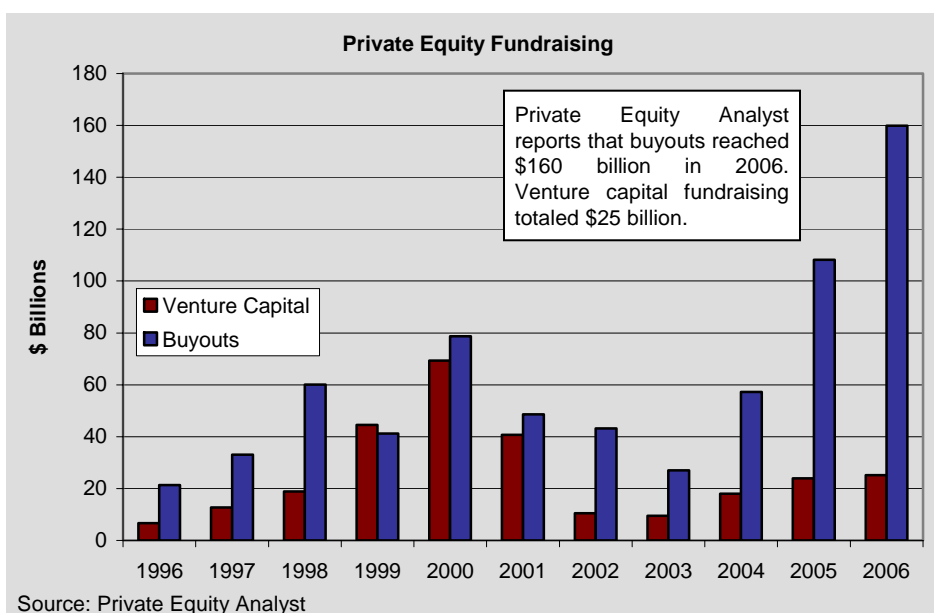
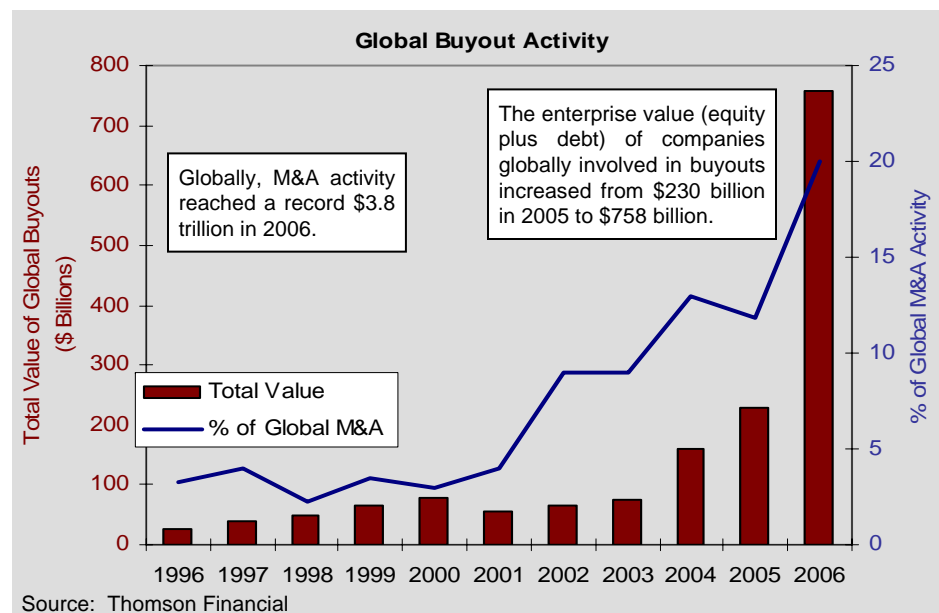
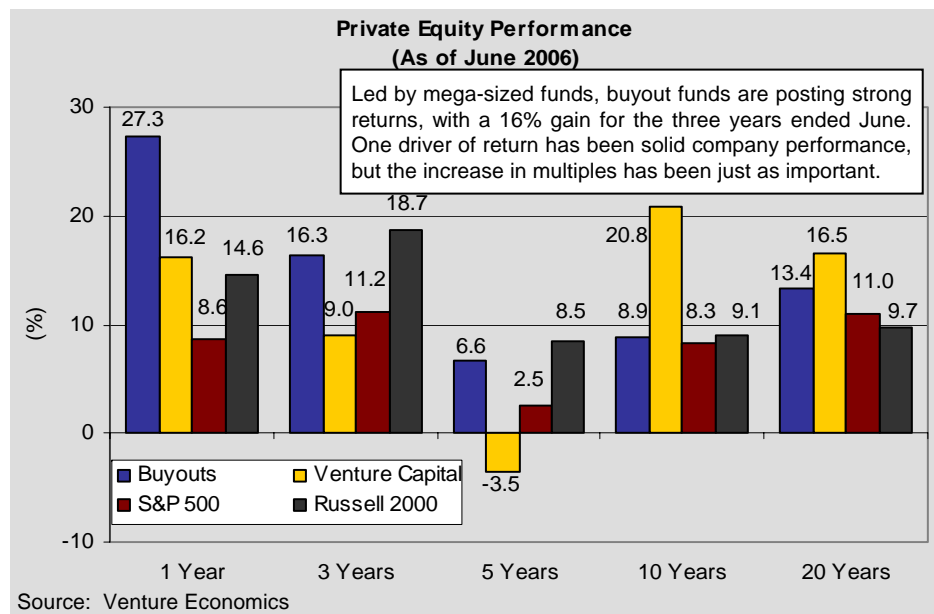
Real Assets: REITs Surged, Commodities Stumbled

- REITs earned 36% in 2006 and 24% annualized over the last five years. Valuations are reaching dizzying levels. The dividend yield on REITs is only 1.4 percentage points above the real yield on long-term bonds, which is a record low. Green Street Advisors reports that REITs are trading at a 7% premium to net asset value.
- The buyout offer of Equity Office Properties, one of the largest REITs in the world, by Blackstone Group added fuel to REITs during the quarter. Blackstone's offer was at an 8.5% premium to the market price. (As of this writing, there are rumors of a higher bid coming from a second group.) The offer supports the argument that REITs' run is being driven by real estate fundamentals and may still have legs. However, one must take caution from Sam Zell's (the founder and CEO of Equity Office Properties) decision to sell.
- Overall, the pricing of REITs probably reflects the pricing of the underlying real estate. With capitalization rates on core real estate below 6%, it's hard to get excited about this sector. We continue to prefer implementing real estate through value-added strategies. Through their potential to make operational improvements, we believe they can still offer reasonable risk-adjusted returns.
- Timber is becoming more attractive on a relative basis. Timber should be able to yield nominal returns of 8% and more aggressive managers may be able to top 10%, which is in-line with value-added real estate, while offering low correlation to other strategies. While end-use pricing is very weak and the decline in the residential construction is a concern, 2007 may be an attractive entry point for timber.
- Commodity futures indexes had a tough year. The energy-dominated GSCI shed 15.1% during the year. The broader DJ-AIG index eked out a 2% return for the year after a 5% spike in the fourth quarter. Contango continues to be a drag. For the year, the DJ-AIG index had a negative roll yield of 17.6%. Spot prices were up 14.8% in 2006. With many commodity futures still trading at significant premiums to spot prices, **we do not recommend passive exposure to commodity futures.**



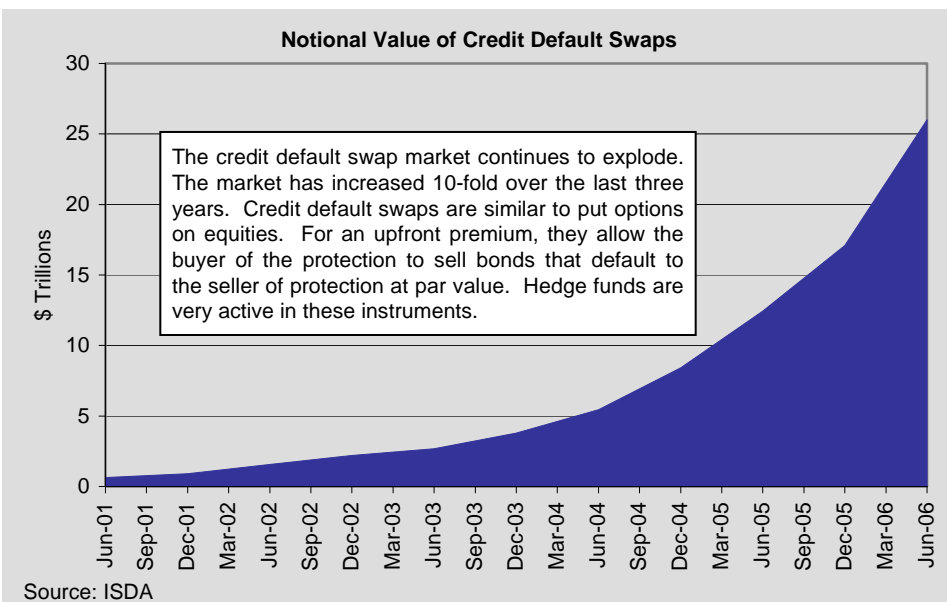
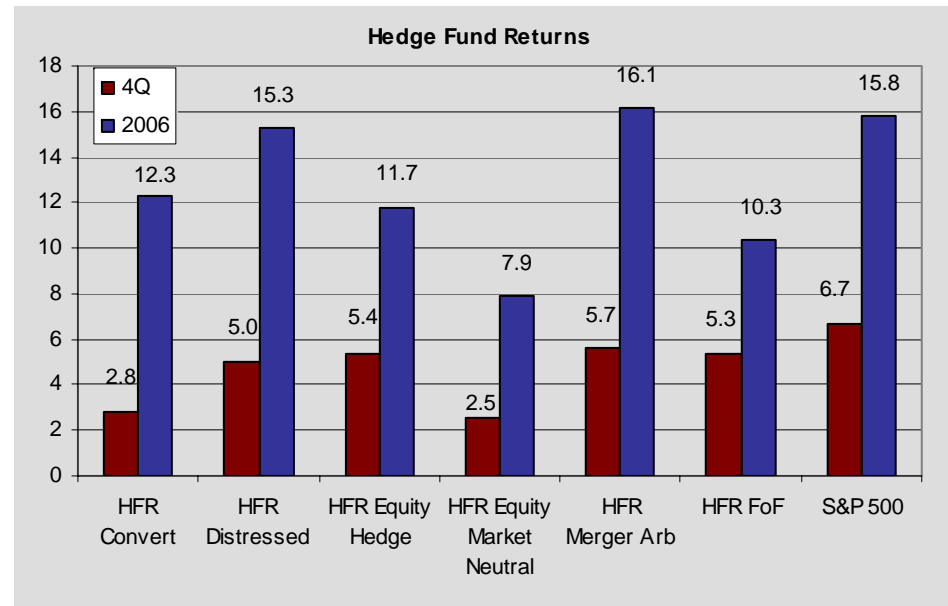
Buyout Commitments Reached \$160 Billion in 2006

- Led by mega-sized funds, buyouts have been strong performers, and they continue to raise substantial capital. Commitments reached \$160 billion in 2006. Combined with cheap, easily-available debt, funds have been very aggressive in putting capital to work. The valuations of buyout transactions are a significant concern. Mid-sized transactions are being done at over 8x EBITDA versus 6x in 2002. Large public to private deals are at 10x to 12x EBITDA. It is hard for us to get excited about these types of transactions.
- Venture capital returns remain disappointing as IPO activity is still weak. Venture-backed IPOs totaled \$5.3 billion in 2006, only modestly above the \$4.5 billion in 2005 and a fraction of the \$25 billion raised in 2000. VC funds raised \$25 billion of new commitments in 2006, which was virtually the same as 2005. It remains to be seen whether this is the "right" amount of capital.
- The increase in defaults anticipated by distressed debt managers failed to materialize in 2006 and credit spreads remained low. While an increase in default rates seems inevitable in the coming years, there is an abundance of capital on the sidelines, both in private equity and in hedge funds, waiting for opportunities to arise. As a result, the next cycle is not likely to be as rewarding as the last.



Hedge Funds: 2006 in Review

- Event Driven strategies led the way for hedge fund investors in 2006. M&A activity remained at a fever pitch, activist investments proved to be fruitful for most, and many established distressed securities positions (such as Enron) made significant distributions throughout the year. Increased leverage coupled with solid base returns allowed the strategy to lead the way in 2006. With corporate balance sheets flush with cash, and with expectations that earnings yields will remain significantly higher than the cost of debt, driving demand from large buyout funds, there is a good chance that this will continue into 2007.
- Emerging markets exposure also proved to be a major story in 2006. Increased liquidity, US dollar weakness, a commodity bull market, muted volatility, and depressed expectations for US assets all worked to drive demand for emerging markets securities. The liquidity hiccup in May failed to concern investors and exposure to the emerging markets continued to accelerate. The HFRI Emerging Markets (Total) Index finished 2006 up 25.1%.
- The demise of the hedge fund registration rule in the US and the collapse of Amaranth dominated the press throughout 2006. The former impacted the hedge fund marketplace by making many of the better hedge funds less liquid. Further, registration didn't address the smaller funds, which tend to be where the majority of frauds occur. Amaranth turned the term "multi-strategy" into a dirty word. However, Amaranth hopefully opened investors eyes to the need for analyzing risk in conjunction with returns.
- The most important story of 2006 may be that it was the "Year of Leverage." Increased liquidity and low volatility emboldened investors across the board to increase their leverage. The rapid adoption of 130/30s (long 130% / short 30%), portable alpha, and various credit derivatives, combined with massive amounts of capital available for large, leveraged buyouts, have worked to accelerate leverage like never before.

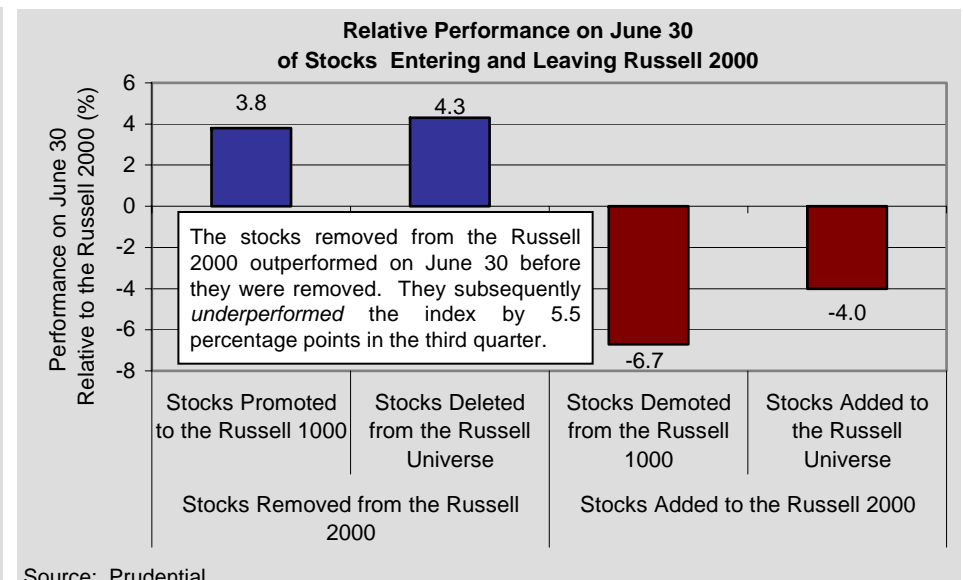
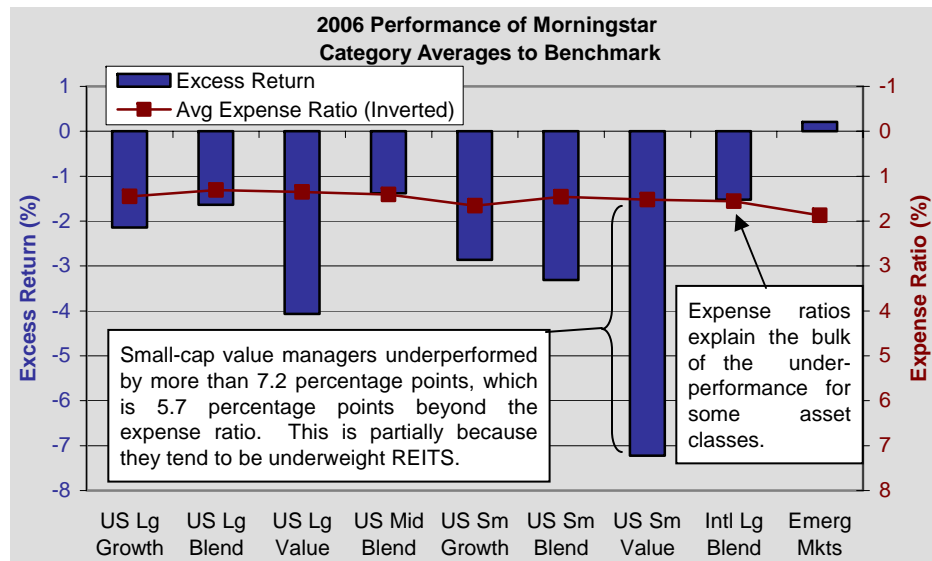


Active Managers Struggled in 2006

- Active mutual fund managers had a brutal year. The median active manager underperformed their respective index in every equity asset class shown to the right except for emerging markets stocks (and just barely outperformed there). The index ranked in the top quartile in five of the ten asset classes. One reason is high absolute returns. The 4% cash position of the typical active manager had a negative effect. Of course, since these are mutual fund universes, fees also had a substantial impact.
- Small-cap managers significantly trailed the Russell 2000. This was partially due to distortions in the index from the reconstitution on June 30. Typically, the index takes a performance hit in June as hedge funds and other investors attempt to front-run the indexers. This year, however, the index received a boost from reconstitution. Stocks leaving the index outperformed those entering. This added about one percentage point to the return of the index on June 30.
- Value managers performed worse relative to their index than blend and growth managers. This is not too surprising. Most active style managers are not as pure as style benchmarks. Therefore, when a particular style is outperforming, it is tougher to keep pace. Active growth managers have performed better (albeit still below the index) since the style has underperformed.

% of Surviving Morningstar Mutual Funds that Outperformed Their Index (as of 12/31/06)					
Asset Class	Index	1 Year (%)	3 Years (%)	5 Years (%)	10 Years (%)
US Large-Cap Growth	Russell 1000 Growth	33	53	55	62
US Large-Cap Blend	S&P 500	22	38	43	33
US Large-Cap Value	Russell 1000 Value	6	11	11	15
US Mid-Cap Blend	Russell Mid-Cap	33	20	19	48
US Small-Cap Growth	Russell 2000 Growth	31	43	50	82
US Small-Cap Blend	Russell 2000	17	48	56	77
US Small-Cap Value	Russell 2000 Value	6	18	29	35
International Large Cap	MSCI EAFE-Net	33	37	38	57
International Small-Cap	S&P/Citigroup EMI-EPAC	24	36	32	84
Emerging Market Equities	MSCI EMF	52	43	49	52

Source: Morningstar, PerTrac
Managers in red underperformed their benchmark and numbers in blue outperformed their benchmark. Numbers in bold red indicate that two-thirds of managers underperformed their benchmark and numbers in bold blue indicate that two-thirds of the managers out-performed their benchmark.



Source: Morningstar

Source: Prudential



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