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2005 – Riskier portfolios pay off yet again!

With only a few weeks left in this calendar year, a review of world investment markets highlights the fact that investors willing to accept high levels of risk in their portfolios have been rewarded again in 2005.

Of the 66 mutual fund categories we monitor¹, eleven have generated returns above 10% in the first eleven months. Latin American Stock Funds (up 51.28%), Natural Resources (up 33.49%), and diversified Emerging Market funds (up 24.7%) have gained the most. Only two categories (world bonds and bear market funds) have declined in value in 2005.

An investment in the S&P 500 returned 4.89% for the first eleven months, a return right in the middle of total fund returns (34 fund categories have generated returns lower than 4.89%, 32 have returned more than 4.89%).

Diversification and superior fund selection continues to add value in client portfolios. When investment platforms offer funds with lower expense ratios, long manager tenure, and consistent style, equity funds have generated performance well above market averages and have allowed investors to enjoy portfolio growth without accepting additional market risk.

Historical perspective on investment returns

For most investors and investment professionals, the experience of the last ten to fifteen years provides the entire historical perspective. For example, if you have owned an S&P 500 index fund for the last fifteen years, your investment has enjoyed a compound annual return approaching 13% per year. A fixed income fund has probably generated returns in excess of 7% over the last ten years. A moderate allocation portfolio, using stocks and bonds, probably has exceeded 9% investment growth since 1994.

The last decade or two, however, provide an incomplete perspective on investments and investment returns. One of the more popular data compilations² reaches back to 1926. Others utilize return data back to 1871, when earnings data became somewhat reliable, or farther back to 1802³.

¹ Data supplied by Morningstar, Inc.

² Ibbotson Associates Stocks, Bonds, Bills and Inflation®

³ Stocks for the Long Run, Jeremy Siegel, McGraw-Hill, 2002

These longer-term analyses paint a different picture of returns expectations. Fixed income returns have been closer to 5%-5½% historically, while stock returns have been closer to 8%-9%. A 60%/40% mix of stocks and bonds has averaged 7%-7½%, not the 9-10% to which we have become accustomed.

Short-term interest rates make the acceptance of risk even more difficult

On January 1, 2005, you could have invested your money in a two-year treasury note and received a safe interest return of 3.06% for 2005. Today, that same purchase will provide you with an interest return of 4.38%, over 1 ¼% higher!

The challenge for investors is to decide whether it is worth the extra risk to try to achieve higher returns from equities, more aggressive fixed income instruments, or more specialized investment classes.

A risk premium is one way to look at that tradeoff. We decided to look at the tradeoff between the purchase of a two-year Treasury note and a purchase of the S&P 500. The purchase of a common stock entitles you to a portion of the earnings of the company, usually received in the form of a dividend. The earnings of the company divided the price that you pay can be compared to the interest you receive divided by the price you pay for a fixed income investment.

Analysts evaluate the S&P 500 as if it was a company, and currently they expect that "company" to earn approximately \$80 per share in 2006. At today's price of 1,257.04, the "earnings yield" of the S&P 500 is approximately 6.37%, or about 2% more than the two-year treasury.

We think, and history supports this, that you should be compensated more than 2% for the risk of owning a common stock versus the risk of owning a safe bond. If 3% were the low range of what is acceptable (and we believe it is), the S&P 500 would have to decline by 13-14% to reach a fair trade-off.

Long-term investors still do not have to take unacceptable risks!

From 2000 through 2002, the investor who held only large cap stocks lost over 36% of their investment. Even with three straight years of positive returns (assuming 2005 stays positive), that person still only has 93% of their original investment. The point is clear – long-term investors need to accept some level of risk to enjoy growth in their portfolio, but when those risk levels are too high (as we see currently), a more conservative asset mix will help avoid the losses we saw earlier this century.

Investors are accepting a great deal of risk in this environment to generate additional returns

Year to Date Performance Review (Through November 30th)

Domestic Equities

Standard & Poor's 500 Index.....	4.89%
Large Cap Value (Russell 1000 Value)	6.40%
Small Cap Value (Russell 2000 Value)	5.52%
Large Cap Growth (Russell 1000 Growth).....	5.59%
Small Cap Growth (Russell 2000 Growth).....	4.31%

The S&P 500 Index hit a four-year high at the market close on the Friday after Thanksgiving. Strength has come from all sectors, but value stocks and large-cap stocks in particular.

Standard and Poor's expects that dividend payouts for 2005 may exceed \$200 billion, an increase in excess of 12% over 2004. With 34% of the S&P 500 held directly by individual investors, the net tax savings from the 2003 dividend tax rate change is estimated at \$30 billion for 2005, and will probably exceed \$100 billion through 2008, when sunset provisions may change back the tax rate.

Even with the rapid rise in dividend payouts, the return from the dividend portion of common stocks remains near historical lows. We feel the continued push to return capital to shareholders by companies will be the driving force behind any continued equity gains in 2006.

International Equities

Foreign Large Blend Funds.....	8.92%
Foreign Large Value Funds.....	8.28%
Foreign Large Growth Funds	9.07%
Diversified Emerging Market Funds	24.65%

Funds which concentrate on smaller, higher risk markets (such as South Africa, South Korea, Brazil, Taiwan, Mexico, etc.), foreign equities have led the outperformance of foreign equity markets this calendar year.

The Japanese equity markets have been hailed for the returns generated from mid-2003. However, the Nikkei's current level only brings it back to the levels first seen more than twenty years earlier, in the second quarter of 1985.

Risks for foreign investing including changes in the valuation level of the United States dollar, as returns need to be adjusted for the translation back to the currency we spend. For example, the MSCI EAFE index, a common measure of foreign market returns, is up over 22% for the year to date when measured by the local currencies, but changes in the US dollar value versus those currencies have reduced that return to 8.3%. This type of additional volatility must be constantly evaluated when make commitments to foreign investments.

Currency risks have impacted international investment returns, but foreign stock investments still paid off in 2005.

Fixed Income Markets

Average Intermediate-Term Bond Fund	0.95%
Average Intermediate-Term Government Fund	1.00%
Average Long-Term Bond Fund.....	1.07%
Average Long-Term Government Fund	1.67%

While short-term interest rates have risen, long-term rates, particularly on high quality bonds, have fallen (30 year Treasuries now yield 4.69%, versus 4.83% at the beginning of the year). A variety of phenomena have contributed to this move, but the bottom line is that investors now have a difficult time gaining additional current yield by increasing the risk of their fixed income portfolio.

Our strategy for the fixed income portion of the portfolio remains the same. The use of conservative bond portfolios, funds that maintain high quality and shorter maturities, make more sense than ever in today's fixed income environment.

Conclusion

We have insisted for some time that equity market risks remain well above normal. We still believe the risks of market declines have increase significantly for the next twelve to eighteen months. Even if the economy continues to expand and the Federal Reserve continues to flood the market with new capital, investors must begin to assess the prices they pay for the investments they own.

Proper asset diversification and an emphasis on quality mutual funds in your retirement account remains key. In conditions like the present, this means a higher weighting on more stable asset classes, like fixed income and cash equivalents, and slightly less exposure to growth-oriented stock mutual funds.

We will continue to evaluate the funds available in your account to make sure that expense ratios, manager tenure and consistent returns provide you with an advantage. Meanwhile, maintaining or increasing contribution levels to provide retirement asset growth when returns are not significant will be important.