

*An investment in the S&P 500 has provided a total return of 4.21% for the first three months of 2006.*

## An Optimistic Start to the Year

Despite several reasons to be cautious during the start of 2006, investors eagerly traded equities. A slowdown in the housing market, the Federal Reserve's fifteenth consecutive quarter-point increase in the federal funds rate, turmoil in oil-producing countries, and an ever-present undercurrent of inflationary warnings failed to dampen the spirits of equity investors buoyed by optimism.

Twelve of the 66 mutual fund categories we monitor saw a return in excess of 10% for the first quarter.<sup>1</sup> Funds specializing in precious metals were up 20.17% for the period, Latin American stocks increased by 17.22%, and Asian stocks excluding Japan gained 15.07%. On the domestic side, the S&P 500 Index returned a higher than expected 4.21%, with small- to medium-sized company stocks outperforming those of large companies. For more information on how different indexes compare with each other, see Chart 1.

There are many explanations for the bullish behavior of investors. For example, there was an increase in personal consumption brought about by a warmer January and the resulting lower home heating bills. Employment and productivity levels were high. Consumer confidence, as measured by the University of Michigan, also beat analyst expectations.<sup>2</sup>

This is certainly a trying time for investors wanting to make sense of a torrent of information in an unpredictable market. The economic scenario underscores the need for good diversification and superior fund selection. Funds with solid long-term returns, long manager tenure, lower expense ratios, and consistent styles should stand up to greater volatility.

## Looking Ahead...Reasons for Caution?

While the confidence in the equity market has brought about high stock returns, it has also ignited concerns over inflation. Higher employment and productivity levels could translate into higher demand for goods and services. This, in turn, has the effect of pushing prices higher. The Fed would be forced to continue its aggressive tightening policy, with interest rates rising until the economy slows.

The U.S. housing market poses another concern. The National Association of Homebuilders saw its housing market index of builders' sentiment fall to its lowest level since the period directly after 9/11. Housing starts fell

---

<sup>1</sup> Data supplied by Morningstar, Inc.

<sup>2</sup> Data supplied by Bloomberg, LP.

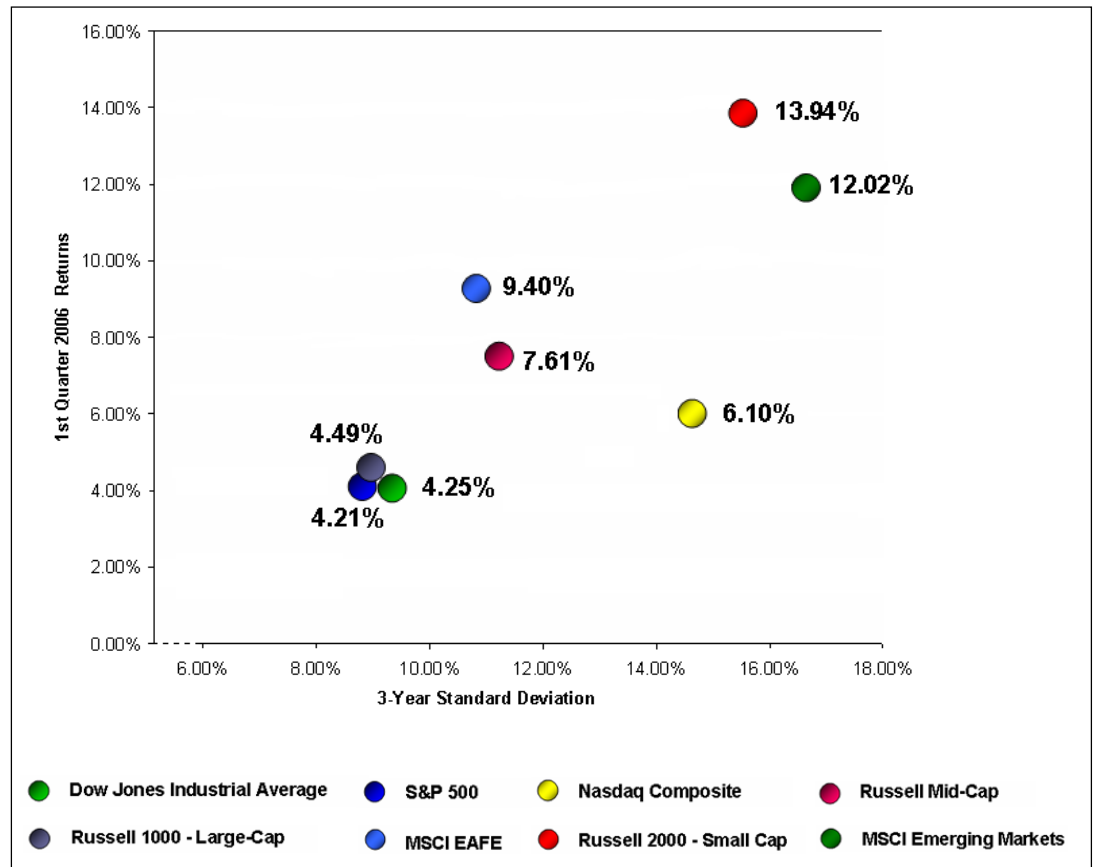
7.8% in both February and March as higher interest rates make it more difficult to finance new homes. In the last few years, with rates as low as they were, the housing market benefited as people felt more capable of affording new homes. Equity extraction from property is proving more difficult. As the reality of this sets in and American homeowners feel less wealthy (and, as a result, spend less) the economy may well contract.

Rising oil prices is yet another factor that could leave the average consumer counting pennies. With a barrel costing upwards of \$70, everything from the commute to work to airfares is becoming more expensive. It remains to be seen whether the increase in oil price will have a significant impact on consumption, but with certain major producing countries experiencing supply turbulence it seems the price is unlikely to fall much in the near future.

*Inflation, a slowdown in the housing market, and high oil prices are among the concerns for the near future.*

*International and small-cap funds continued to perform well in the first quarter.*

**Chart 1: Return and Risk of Various Indexes**



## Year to Date Performance Review (Through March 31<sup>st</sup>)

### ***Domestic Equities***

Standard & Poor's 500 Index.....	4.21%
Large Cap Value (Russell 1000 Value) .....	5.93%
Small Cap Value (Russell 2000 Value) .....	13.51%
Large Cap Growth (Russell 1000 Growth).....	3.09%
Small Cap Growth (Russell 2000 Growth).....	14.36%

Much of the enthusiasm for U.S. equities stems from the high levels of cash on corporate balance sheets.<sup>3</sup> As much as \$2 trillion in cash is available for use for a variety of purposes, from dividend increases to merger and acquisition to other shareholder-friendly activities.

StraightLine's diversification strategy ensures allocation across investment style (from growth to value) and across company size (from large to small caps). The higher returns from the stocks of smaller companies have benefited the portfolios we manage, while value stocks generally outperformed growth. Our decision in February 2004 to overweight value stocks relative to growth continues to pay dividends. We expect the disparity between value and growth stocks to become minimal in the coming quarters, as large growth stocks may see long-awaited gains.

### ***International Equities***

Foreign Large Blend Funds.....	9.64%
Foreign Large Value Funds.....	9.55%
Foreign Large Growth Funds .....	9.92%
Diversified Emerging Market Funds .....	12.33%

Funds investing in international equity markets performed well for the start of 2006. Once again, the funds that concentrate on smaller, higher risk markets outpaced those that focus on the more developed regions. The surge in commodity prices helped the economies in the developing world, with Latin American countries like Brazil and Argentina benefiting greatly.

We believe that international funds offer an important dimension to diversification. However, care should be taken to ensure that the recent good run in international funds does not lead to portfolios with a drastically high international allocation. According to the Investment Company Institute, over 70% of new money going into equity mutual funds went into world equity funds in the first two months of 2006.<sup>4</sup> With so much new money chasing returns from this market segment, and with the knowledge that market categories are marked by performance cycles, investors should be alert to the need for appropriate allocations.

A good example of what might happen when chasing returns in the international equity market can be found by examining the emerging market case for the last 10 years. Consider the growth of two \$10,000 investments made at the start of the March 1996. StraightLine compared

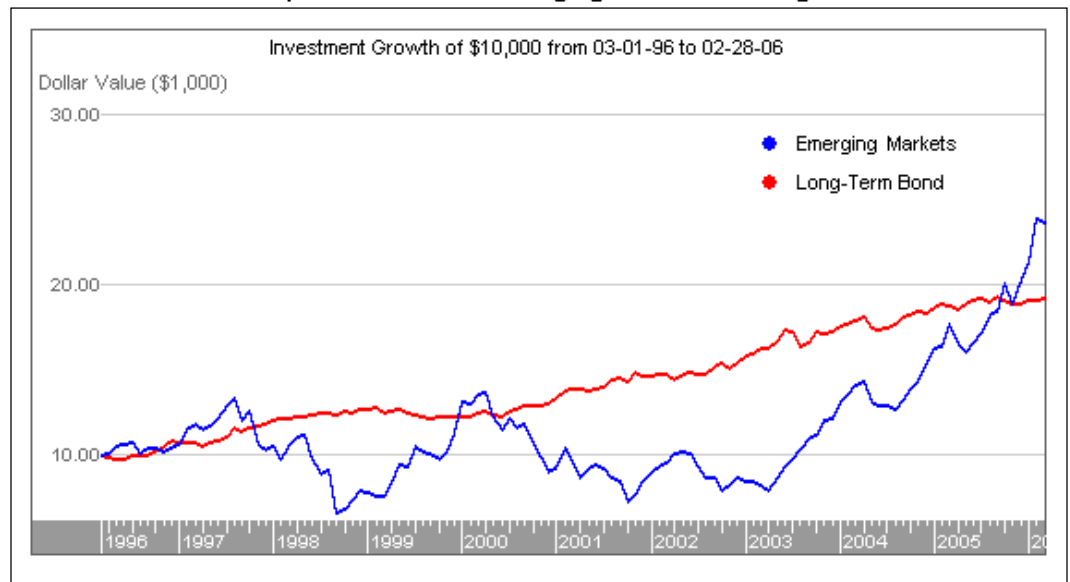
*Investors should be wary of chasing returns in a very heated emerging market.*

<sup>3</sup> Source: Evergreen Investments.

<sup>4</sup> Trends in Mutual Fund Investing: February 2006.

an investment in an average emerging market fund to an average long-term bond fund. The emerging market fund would have seen a growth of \$13,752, or 9.04%, for the 10 years ending 28 February 2006. For the same time period, a far less volatile investment in a long-term bond fund would have grown to \$19,260 (an annualized return of 6.77%). Considering that the emerging market category has a ten-year volatility roughly three and a half times greater than that of the Morningstar long-term bond category, is the 2.77% higher return worth all the added risk? Investors should bear in mind more than the return of an investment when evaluating it. Much can be gleaned from an analysis of the security's risk-reward trade-off. See chart 2.

**Chart 2: Return Comparison between Emerging Market and Long-Term Bond Funds**



*Bonds have suffered in the rising interest rate environment.*

**Fixed Income Markets**

Average Intermediate-Term Bond Fund .....	-0.52%
Average Intermediate-Term Government Fund .....	-0.58%
Average Long-Term Bond Fund.....	-1.47%
Average Long-Term Government Fund .....	-3.54%

Fixed income mutual funds investing in bond issues have had a rough time of late. With the Fed raising interest rates periodically (the most recent hike brought the target rate to 4.75%) bond investors have less incentive to be locked into bonds at lower rates. Hence bond prices are down and fixed income mutual funds are struggling.

Fixed income funds still perform an important role in portfolios, however. With their low volatility, they protect accounts against the more unpredictable movements in the equity markets. Should the equity markets perform poorly, fixed income securities prevent well-diversified portfolios from falling at the same rate.

## Conclusion

Well-diversified portfolios remain the best approach to combating uncertainty. The appropriate allocation of various asset classes ensures exposure to market segments that may be enjoying positive returns – while concurrently reducing volatility. We analyze a tremendous amount of data when selecting mutual funds for your retirement account. Our research process aims to create portfolios that best serve your long-term goals.

The beginning of 2006 has seen investors provided with noteworthy gains to their portfolios. These gains have beaten many analysts' expectations. With several unanswered questions about the health of the overall domestic economy, investors should be cautious as they make investment decisions. Concerns over higher inflation, an uncertain interest rate environment, the effects of the slowdown in the housing market, and oil supply that remains susceptible to disruptions, all provide a basis for vigilance in the months ahead.