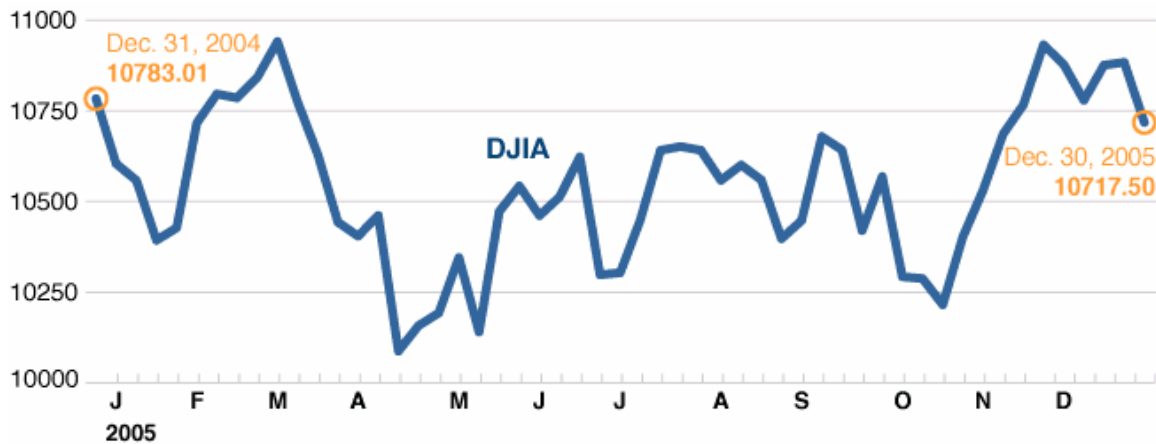




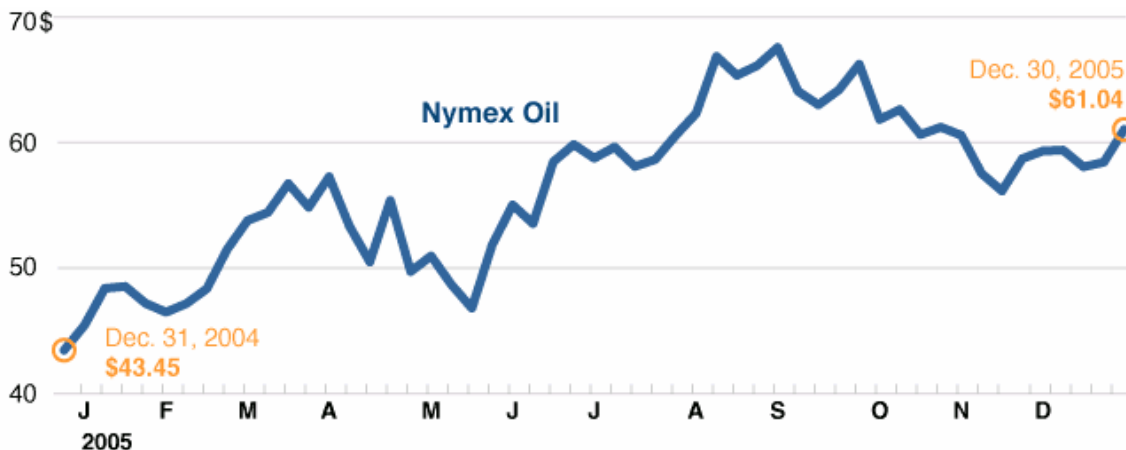
A Rational Market

January 8th 2006

Fundamentals continued to improve during the course of the year, but the markets generated less than stellar returns. After trading range-bound for 2005, the S&P 500₁ closed the year with a 3% gain, the Russell 2000₁ representing the small caps were up 3.32%, while the NASDAQ₁, selling off late in the fourth quarter, finished up 1.37%. The Dow₁ completed the picture with the smallest percentage change since 1926 closing down 0.61%.



However, there were pockets of strength. The EAFE Index_{1,2} representing the international markets closed up 10.96% in U.S. dollars. Japan led the way with a 40.24% return. And let's not forget the energy markets with Oil up 40% for the year and Gold rallying 18.19%.



In considering 2006, there exist a number of positive trends for the markets that could lead to higher prices, but with higher prices could come increased volatility. In addition, investors



should realize there are still a number of concerns that could alter that perspective and cause the markets to stumble. The following represent some of the issues that we will be focusing on as the year unfolds.

- Corporate earnings were up 13.3% in 2005 and are forecasted* to be up 10.6% in 2006. With the continued increase in earnings, coupled with a flat market, price to earning ratios have contracted and are closer to historic averages. In the late 1990s, P/E levels were in the low 40s; today they are closer to 18, with the historical average falling in the neighborhood of 15 to 16 times earnings. Valuations have improved, but are still not cheap. In the 1970s corporate earnings continued to grow but share prices remained flat to down for a prolonged period.

*The forecast for earnings growth in 2006 has been determined by calculating the average forecast of 50 leading economist's projections and for that reason alone is most assuredly inaccurate and flawed, but it at least it represents a base line.

- Companies continued to get their financial house in order by paying down debt, controlling spending, and increasing dividends to shareholders. From a balance sheet perspective, companies are financially stronger today than at anytime in the past decade. It is anticipated that in 2006 IT spending on the corporate level will increase, as an upgrade cycle will begin. The cycle should benefit hardware and software companies that can provide immediate improvement to the bottom line and productivity enhancements. This should also help counter any slow down by the consumer.
- Oil has settled in the area of \$55 to \$65 a barrel and is anticipated to drift lower in 2006 to trade in the \$50 to \$60 a barrel range. While this is down significantly from the hurricane induced highs, this still represents a potentially significant drag on consumer spending and corporate profits. As stated in previous commentaries, we believe the impact, while real, has been marginalized so far by consumer spending which has been enabled by rising home prices. GDP growth remained strong in 2005, not because high energy prices do not impact the economy, but because consumers continued to spend with abandon.
- The Federal Reserve signaled, not an end to rate increases in the latest minutes release, as investors interpreted, but rather a position that future rate increases will be based upon the unfolding economic data. With a new Fed president it will be necessary to closely monitor the data points with the assumption that the Federal Reserve will increase the Fed funds rate by at least 50 basis points in 2006 before a possible reduction.
- Long-term consumer debt levels have continued to rise at the same time interest rates on installment and revolving debt has increased. If the Fed continues to increase rates, the cost of maintaining this debt could create a further deterrent to spending.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical.

¹ All indices are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

² International investing involves special risks such as currency fluctuation and political instability



The American consumer, in our opinion, will continue to spend until no one will lend them money. When that day finally comes, GDP growth will fall by several percentage points. (The bond market may have been forecasting the possibility of this scenario when the yield curve inverted in late December.)

- Much is relying on the real estate markets. The speculation in equities in the late 90s found a home in real estate over the past several years. With the rise in home values has come the ability for consumers to fund their spending habits by using their homes as a giant ATM machine, thereby supporting the economy. In addition, the increased value of individual's homes has been a boost to consumer confidence which has led to a higher risk tolerance.

What will happen if the housing market flattens or worse, declines?

As you can see, there are a number of issues to concern us this year. To that end we offer some initial observations.

We continue to believe we are experiencing a secular bear market similar to the 1970s with periods of positive moves represented by cyclical bull markets. Theoretically this should continue until the markets revert to the historical averages. We don't believe it's different this time. We didn't believe it before and we certainly don't believe it now. That doesn't mean there won't be opportunities to generate positive returns, but it will be necessary to be selective, disciplined, and patient

The energy markets remain attractive, as we believe that the fundamentals supporting this area; supply demand issues and geo-political risk, will continue for several years. In addition, the commodities\materials sectors should benefit from growing global expansion and demand as countries build and improve their infrastructures. This would include not only specific companies that represent raw materials, but countries like Australia whose economy is based predominately on raw materials and is providing the building blocks for Asia.²

Healthcare, focusing on biotech and pharmaceutical companies could provide strong risk adjusted returns. There is obvious risk in the biotech field and indeed big pharma has not been immune from its own troubles, but valuations and demographics combine to make this an attractive area. Staying with growth, if IT spending increases, companies such as Cisco Systems, Applied Materials, and Microsoft could benefit and if bought on weakness provide returns in excess of the major averages.

Regarding portfolio allocations, we continue to recommend short-term higher quality bonds. With the two-year Treasury yield comparable to the ten year, we do not believe it is necessary to take additional risk on the yield curve at this time.

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Equities that have high dividend yields, providing the company's financials are strong, may offer an attractive substitute to fixed income. We would therefore continue to recommend and hold companies that reflect these attributes namely financials and utilities.

In closing we expect the market will be volatile as the bulls and bears try to gain dominance in the markets and *that* volatility should provide us with opportunities to put capital to work intelligently. We remain focused on the long-term where fundamentals such as earnings, dividends, cash flow and the economy dictate the allocation of assets. In addition, we remain committed to the management and protection of our client's wealth.

We would like to thank you for the confidence you have placed in our firm and look forward to working with this year.

Sincerely,

Brad L J Griswold
Partner

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