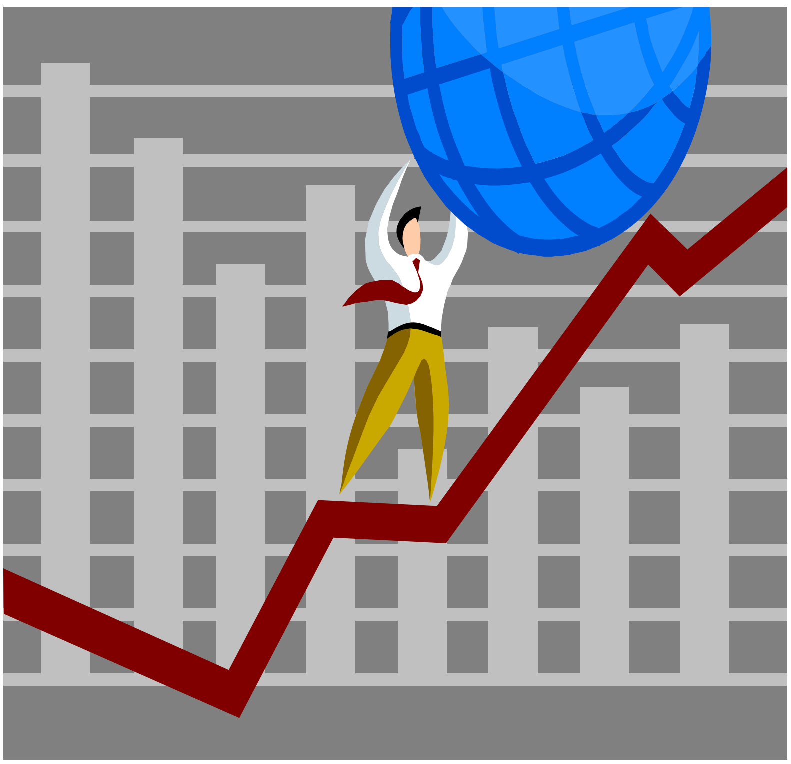
Research

When Vanilla Tastes Best

2006 Q3 Quarterly Commentary



Robert W. Henkel
Chief Investment Officer
bhenkel@weyland.com

When Vanilla Tastes Best

In this quarterly commentary, we are going to get a bit more technical. We are going to take a look "under the hood" of your portfolio, describe its current allocation, and share with you the reasoning why we think this allocation makes sense.

As you know, we run balanced portfolios. Clients have in their accounts a combination of stocks (or equities), bonds (or fixed income), cash and commodities. We chose and continue to believe strongly in a balanced approach because it tends to garner a solid rate of return with less volatility. This sweet combination allows clients to "ride the storms out" and achieve their financial objectives.

While our approach has always been balanced, it has never been ordinary or pedestrian. Our overweighting of alternative asset classes like small company (or small cap) stocks, value stocks, emerging market stocks and our embracing of commodities were, at the time of their introduction, progressive and unconventional.

Similarly, we believe our current approach is progressive and unconventional, but not in the typical way. Today, while not underweighting these alternative asset classes, we have temporarily, reduced their overweighting. The money that we have shed from our alternative asset classes has been put to work in Blue Chip companies (mostly S&P 500). Therefore, we come close to owning "the Market." What this means is that the portion of securities that you own in your portfolio is generally similar to the portion of securities that exist in the world, i.e. the Market.

In speaking with clients, I've compared our strategy to ice cream. Sometimes you may want something rich and dark, like Rocky Road, or Double Chocolate Chip. Other times you may want something wacky like some Ben and Jerry flavor. But at times, plain vanilla just tastes best.

So how has this approach worked recently? Below are the six month returns of major equity asset classes from March 31, 2006 through September 30 2006:

Benchmark Index Returns 3/31/2006 - 9/30/2006

Vanilla ↑	U.S. Large Companies (S&P 500)	4.14%
	Foreign Developed Large Companies (MSCI EAFE)	4.65%
Alternative ↓	U.S. Small Companies (Russell 2000)	-4.61%
	Emerging Markets Companies (MSCI EMF)	-1.22%
	Commodities (GSCI Total Return)	-9.83%

So, at least temporarily, large company stocks (or large cap stocks) have regained the upper hand in performance after receiving a seven year pummeling by small caps and other alternative asset classes.

(Keep in mind when looking at the chart above that MSCI EAFE [Europe, Australia and Far East index], the foreign developed large cap index, is also out-performing. Like the S&P 500 domestically, our clients are invested more in EAFE as a percentage of their international holdings than ever before).

And the good news is that you're in these large cap asset classes precisely at a time when most investors are still chasing and committing capital to small and mid cap strategies.

Now the big question is, "What is the likelihood that large cap stocks' out-performance will persist?"

One way to help answer this question is by looking at relative valuations or how cheap large cap stocks are versus small cap stocks. Being value investors we believe that assets selling more cheaply will, on average, appreciate more. And that is exactly what has a happened: large caps are "cheapish" when compared to small caps. In addition, when we compare how cheap large cap growth stocks are to large cap value stocks we find that growth is relatively cheap as well. Please keep in mind that the S&P 500 is more of growth index than a value index.

(For the technically oriented, please view the fine charts that Frank put together at the end of the commentary. They show the historical relative valuation ranges between large cap stocks and small caps stocks and between large cap growth stocks and large cap value stocks.)

So these are the conclusions that we can probabilistically draw regarding large caps:

- They should at least match the return of small company stocks and value stocks over an intermediate period, say 3 years.
- They should be more resilient and hold their value better should we experience volatility.
- They will be far more tax-efficient than small cap stocks or value stocks – i.e. you will keep more of your return rather than forking it over to the government.

Changing Tax Code

The election is upon us and no matter who wins this year or in 2008, it is our belief that both capital gains and ordinary income tax rates will go up in the next three to five years. This means that if you are currently distributing from your IRA, and your IRA represents more than say 30% of your investment portfolio, you may want to consider withdrawing more than the required minimum distribution over the next couple/few years in order to potentially receive more favorable tax treatment in the long run. Or if your situation allows, you may want to perform a Roth Conversion for part of your IRA.

Please keep in mind that we are not tax accountants, and we whole-heartedly recommend that you consult your tax advisor on this issue. But, having constructed a simple model that compares tax savings given accelerated distributions and subsequent tax increases, the strategy appears to have merit.

Bob Henkel
Chief Investment Officer

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