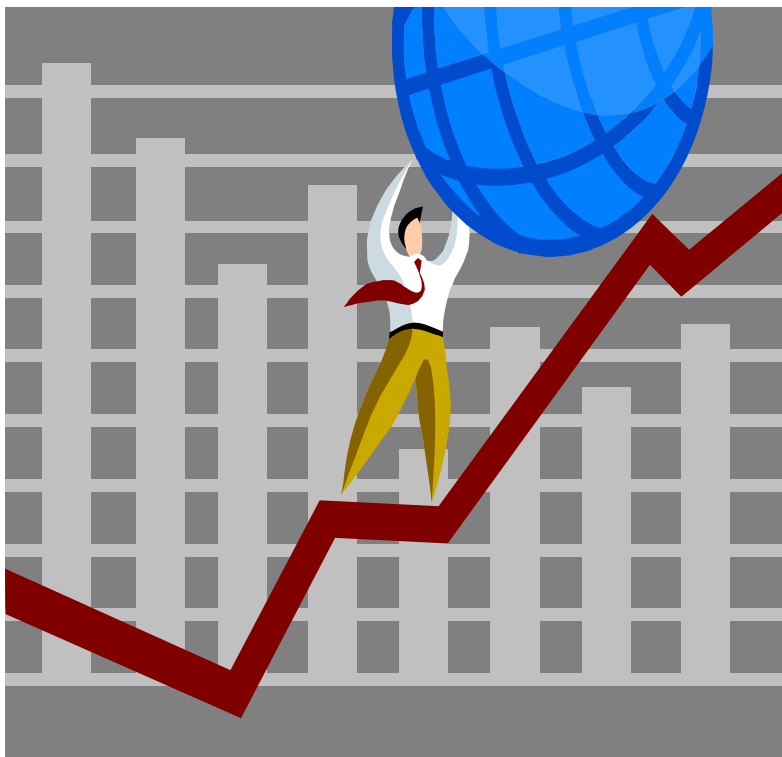


2007 Outlook & Investment Strategy



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Robert W. Henkel

Chief Investment Officer
bhenkel@weyland.com

Frank C. Sabin, CFA

Portfolio Manager
fsabin@weyland.com

Review of 2006 Outlook Summary

Prediction	Result
<p>Grade: A</p> <ul style="list-style-type: none"> ▪ “US stocks should enjoy strong returns and outperform bonds for the fourth straight year. Positives include a pause in the interest rate cycle, increased corporate share buy-backs and dividends, and a lower expected dollar (which will promote export/manufacturing activity).” ▪ “Fixed income will deliver tepid absolute and relative performance. The short end of the curve will outperform the long end of the market. The yield curve will steepen, though it will continue to be relatively flat.” ▪ “The U.S. dollar will weaken against the major world currencies. We believe the secular bear case against the dollar is intact as a result of the substantial current and trade account deficits the U.S. is running. International currencies will look increasingly attractive as the U.S. slows its interest rate increase campaign, while countries abroad tighten.” ▪ “International stocks will continue to outperform US stocks, but mostly as a result of currency translation.” ▪ “Gold and gold shares should continue their bull run as the dollar-weakness story gains traction again and as hedge funds continue to build positions on momentum.” ▪ “As in any year, surprises are bound to occur. Who would have predicted Katrina last year? It is our opinion that 2006 could provide markets significant volatility with a resurgence in geopolitical concerns.” 	<ul style="list-style-type: none"> ▪ Stocks returned 16% and bonds returned 4%; stocks outperformed bonds by 12%. ▪ Bonds delivered an anemic 4% return in 2006. ▪ Currency added 10% to foreign holdings in 2006, as a result of dollar weakness. ▪ International markets up 26% vs. 16% for US stocks. Currency translation was 100% of the 10% return differential between US and International Stocks. ▪ Gold was up more than 22% with gold shares performing even better. ▪ To name three: Ascending Iranian hegemony, Israeli-Hezbollah conflict, and Korean Nuclear Test.
<p>Grade: B</p> <ul style="list-style-type: none"> ▪ “Large stocks should outperform small stocks, as quality stocks at reasonable valuations take center stage. Large multinationals will be in a position to take advantage of a cheaper dollar abroad.” ▪ “The secular bull story for energy and energy stocks will continue as a result of continued global economic strength and tight supply. Energy stocks should continue to outperform the S&P 500, as their share of S&P 500 profits will again exceed their relative market cap.” 	<ul style="list-style-type: none"> ▪ The largest 100 US stocks outpaced the smallest US stocks for the first time in nine years. However, the margin was a razor thin 0.20%. ▪ Energy stocks up 23%, but the investable energy-centric GSCI Commodity Index was down 15%. We give ourselves a B due to our significant reduction in our commodity exposure in July.
<p>Grade: C</p> <ul style="list-style-type: none"> ▪ “Japanese equities will outperform the international EAFE index, as structural changes in consumer and corporate behavior continue.” 	<ul style="list-style-type: none"> ▪ Japan returned a paltry 6% in 2006. But as appropriate entry point never materialized, we did not deploy.

Notes: Data is from iShares, Interactive Data, MSCI, Russell, American Century and Federal Reserve. All data assumes the reinvestment of dividends. Bonds are Lehman Aggregate Bond Index, Stocks are the S&P 500, Currency is the difference between the unhedged and hedged MSCI EAFE Index, gold shares is the American Century Gold Fund, Energy Stocks is the Dow Jones Oil & Gas Index, Small Stocks is the Russell 2000 Index, and Japanese equities is the MSCI Japan Index.

2007 Outlook and Strategy

***“On balance,
2007 should be a reasonably good year.
But risks are increasing.”***

- **Baseline Outlook.** US stocks should enjoy average to good returns and outperform bonds for the fifth straight year. Positives include at least a pause in the interest rate cycle with possibly one or two rate cuts in the second half. High LBO activity should also add support to equities. Bonds returns will continue to be tepid, but bonds may exhibit short-term rallies as expected housing/growth weakness tests the markets.

- **Risk Assessment.** *The risks to the economy and the stock market are greater than they were in 2006. We are in the late stage of the economic cycle, which tends to have higher than average volatility (although a 1995-style soft landing is possible).* Our internal forecast of a recession over the next year is higher than the consensus forecast of a 27% chance. In addition, market sentiment indicates that risk appetite is high (which typically is not a positive for future returns).

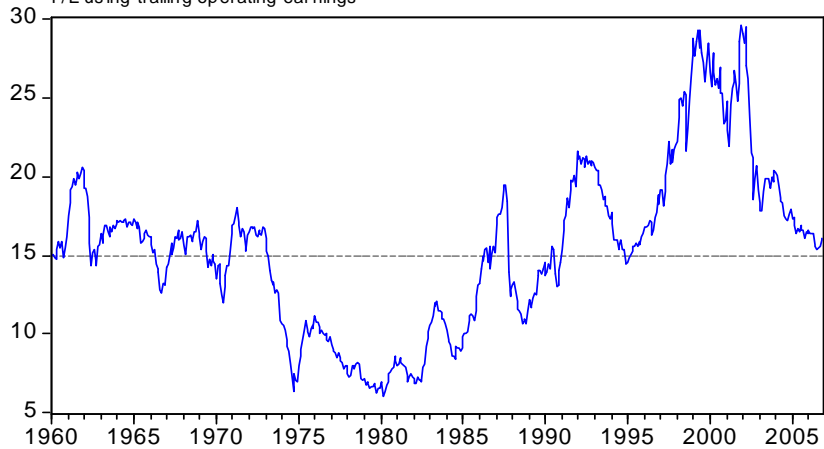
- **Strategy.**
 - **Maintain a neutral stance on stocks vs. bonds.** Stock valuations are reasonable especially considering their balance sheets. Other positives are low Interest rates, falling inflation, and continued merger, LBOs and share buy-back activity. However, profit margins are receding, and recession risks are rising.
 - **Underweight commodities.** As the world economy, at least temporarily, slows to a more restrained growth rate, so should demand for commodities. The shape of the futures' curve (contango) will continue to weigh negatively on commodities' total return.
 - **Underweight U.S. small cap and value stocks.** Small cap stock valuations are not as attractive versus large cap stocks as they have been. Plus in a late-stage economy, we prefer to be neutral-to-light in these segments, especially as liquidity is extracted.
 - **Overweight Japanese small cap.** Japan small caps are one of the cheapest asset classes in the world, period. And they posted anemic returns last year, thereby increasing their attractiveness.
 - **Overweight foreign denominated bonds, TIPS and maintain reasonable gold share exposure.** We continue to believe in the long-run dollar weakness thesis due to US deficit position. In addition, gold share exposure should provide insurance given a crisis.

Valuation of Stocks vs. Bonds: Stocks Look Better, But...

Stocks look fairly valued on an absolute basis versus history. Not-too-cheap, but not-too-rich. Stocks are hovering at average multi-decade valuation multiples. The better news is that their balance sheets are the healthiest in a half century.

S&P 500 Price-to-Earnings (P/E)

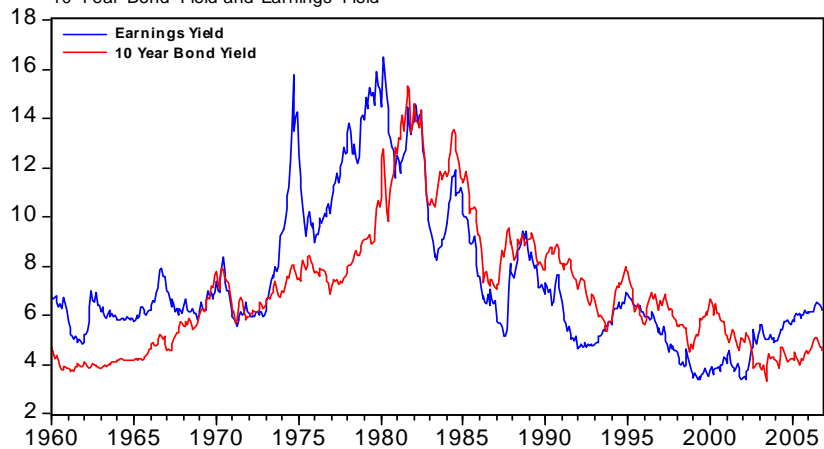
P/E using trailing operating earnings



Yields are higher in the stock market than they are in the bond market, suggestive of better returns in the stock market.

Earnings Yield (Inverse of S&P 500 P/E) vs 10-Year Bond Yield

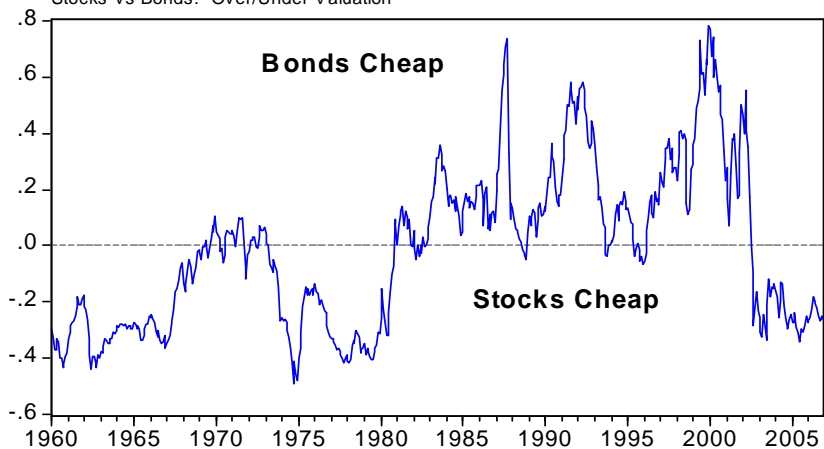
10-Year Bond Yield and Earnings Yield



Stocks look relatively attractive versus bonds based on the historical relationship between bond and earnings yields.

Stock Valuation Model (Fed Model)

Stocks vs Bonds: Over/Under Valuation

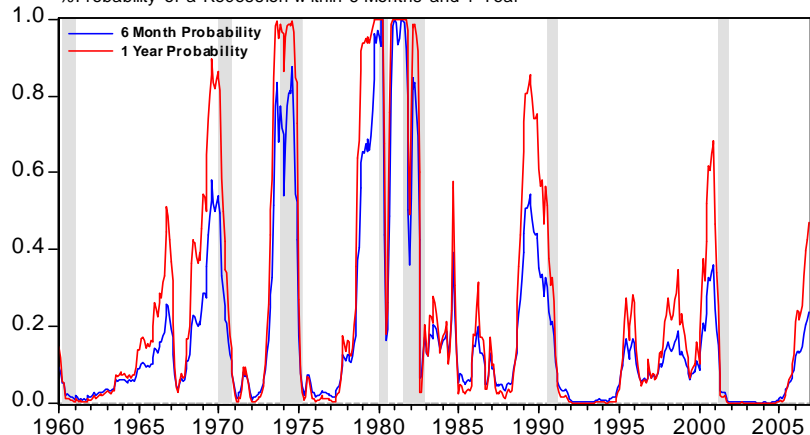


Notes: Earnings are operating earnings, from Standard & Poors 1988-Present. Prior to 1988 operating earnings are WCM estimates based on total reported earnings. Bond yield data is from Federal Reserve.

Risk of Recession: Risks Are Increasing

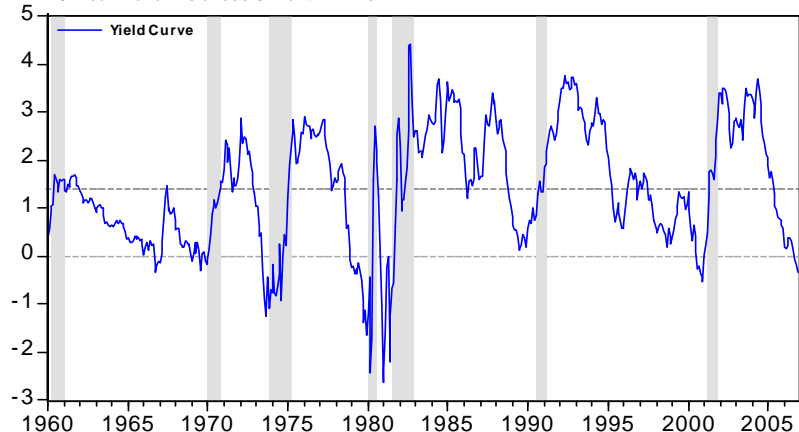
The risk of a recession is rising, and is almost at 50%, which is significantly higher than the 27% consensus forecast probability for a recession. One year risk of recession is trumping six month risk.

Internal Federal Reserve Recession Probability Forecast
%Probability of a Recession within 6 Months and 1 Year



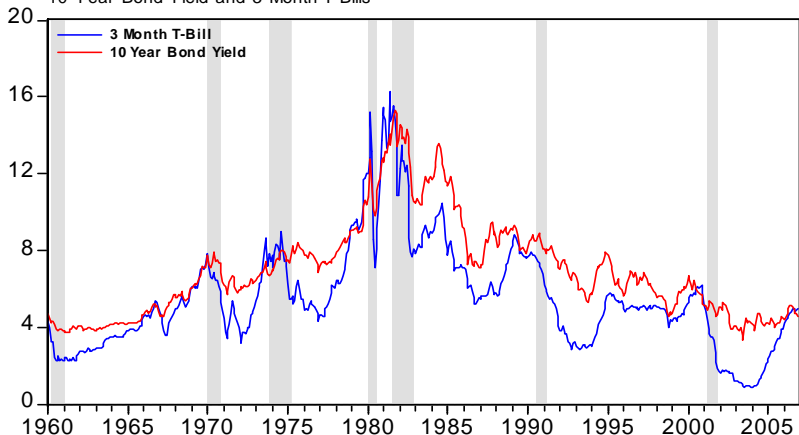
The curve is inverted.
An inverted yield curve (when short-term rates are higher than long-term rates) is a strong predictor of a weakening economy and of recessions. However, pension liability immunization and “excess” global savings might be the culprit.

Yield Curve
10-Year Bond Yield less 3 Month T-Bills



Interest rates are at historically low levels, but short-term rates are significantly higher than they were 18 months ago. Higher interest rates have the tendency to reduce consumption and economic activity – the key question is did the Fed go too far?

Long Term and Short Term Interest Rates
10-Year Bond Yield and 3 Month T-Bills



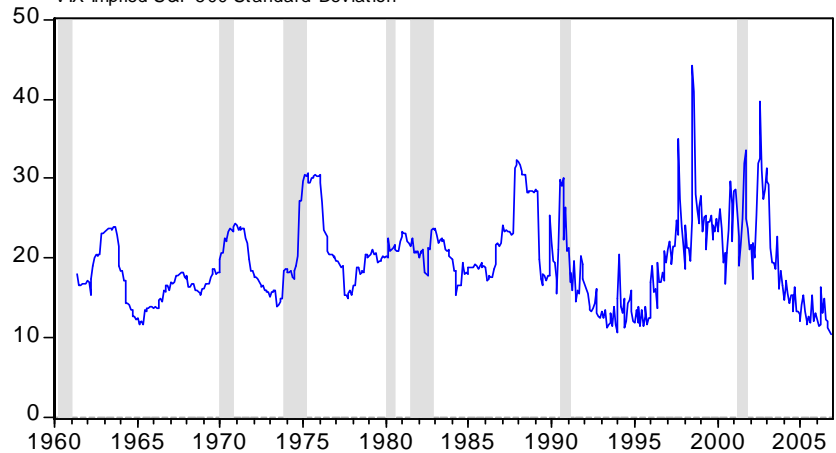
Notes: Shaded areas are NBER defined recessions. “Internal Federal Reserve Forecast Prediction” based on Federal Reserve Staff Working Paper by Matthew Wright, The Yield Curve and Predicting Recessions, 2006. The model is a probit regression (Model B) based on the yield curve and the level of the short term interest rates.

Investor Sentiment: Are Investors Too Sanguine?

Investors seem overly sanguine regarding risk. Implied volatility, or the market's pricing of risk, is at multi-decade lows. Investor risk appetite seems especially high given the economic backdrop of a slowing economy with attendant risks.

Implied Market Volatility (VIX)

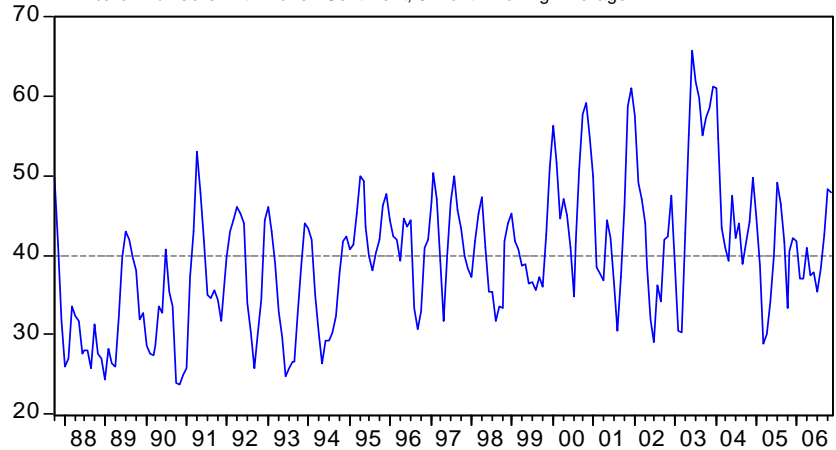
VIX Implied S&P 500 Standard Deviation



Investor sentiment is above average. On average, it is more profitable to invest when optimism is running low.

% of Advisors with Bullish Sentiment

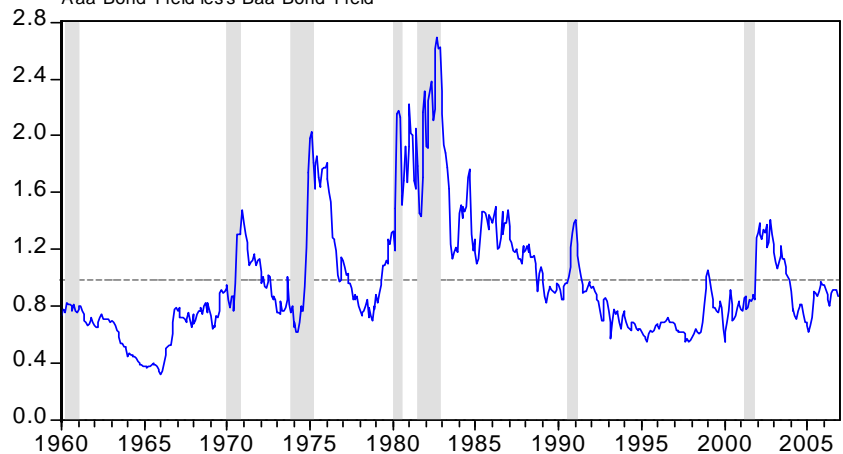
AAll % of Advisors with Bullish Sentiment, 3 Month Moving Average



Credit spreads also indicate a higher propensity to take on risk. We are below the long term average credit spread, which is close to 1%.

Credit Spread

Aaa Bond Yield less Baa Bond Yield



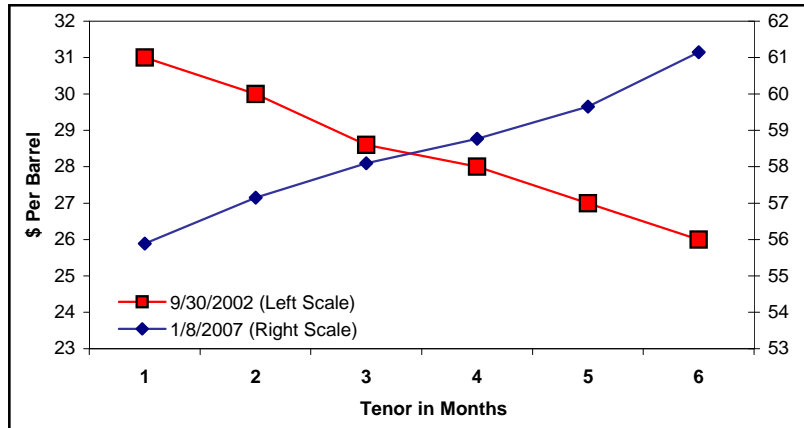
Notes: Shaded areas are NBER defined recessions. VIX data is WCM estimated from 1960 to 1989, and utilizes actual data thereafter. AAll is the American Association of Individual Investors— it is among the most popularly cited sentiment gauges.

Oil & Gas Based Commodities: Are They Turning Again?

The forward curves for oil are currently downward-sloping, or in a state called “contango.” If futures prices do not change, this implies investors must pay a cost to maintain this position. At current levels the cost is north of 15% per annum.

Crude Oil Futures

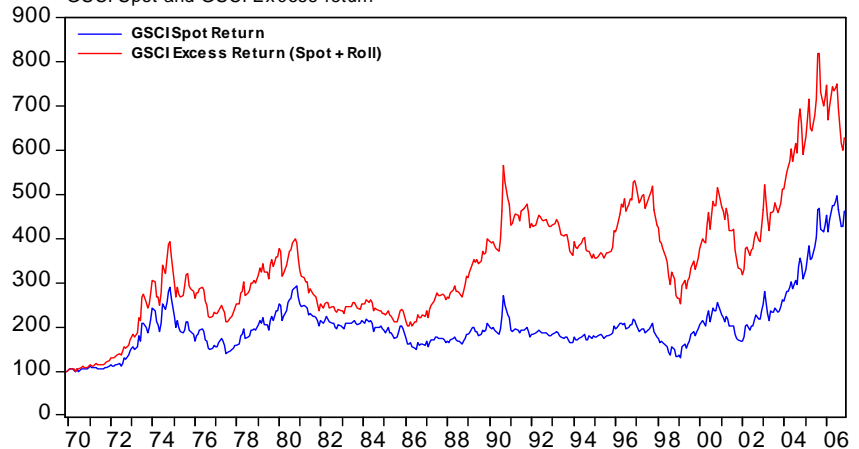
Current Futures Curve vs More Normal Curve (9/30/2002)



Historically, commodity future curves have been downward sloping (“backwardated”), and have been a key driver to the historical returns of commodities.

The Contribution of the Roll Yield to Commodity Returns

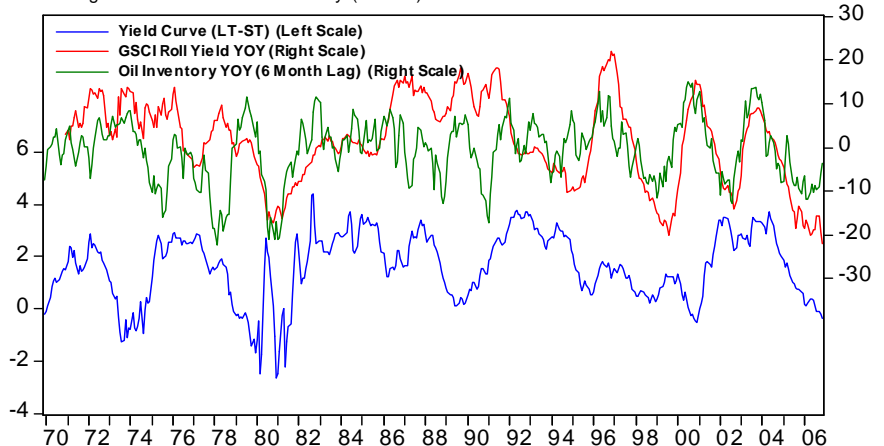
GSCI Spot and GSCI Excess return



The Negative Roll Yield is currently explained by the shape of the yield curve and crude oil inventories (which are high). However, the boom-bust profile of commodity returns appears to be supportive of positive future returns.

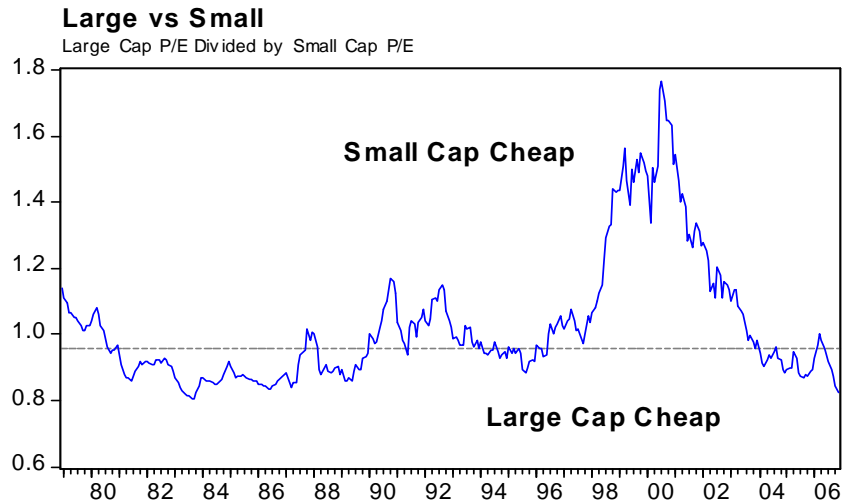
Key Drivers of the Roll Yield (YoY Change)

Change of DOE Crude Oil Inventory (Inverse) and the Yield Curve

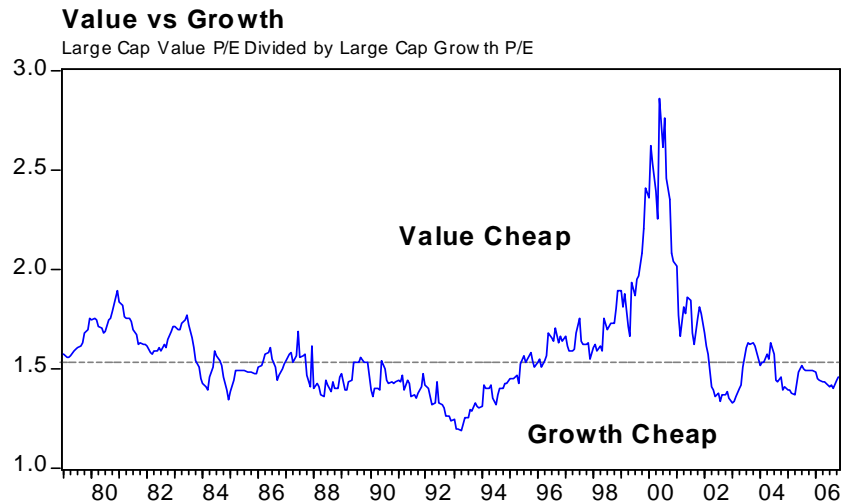


Equity Style Valuations: Large Growth Looks Good

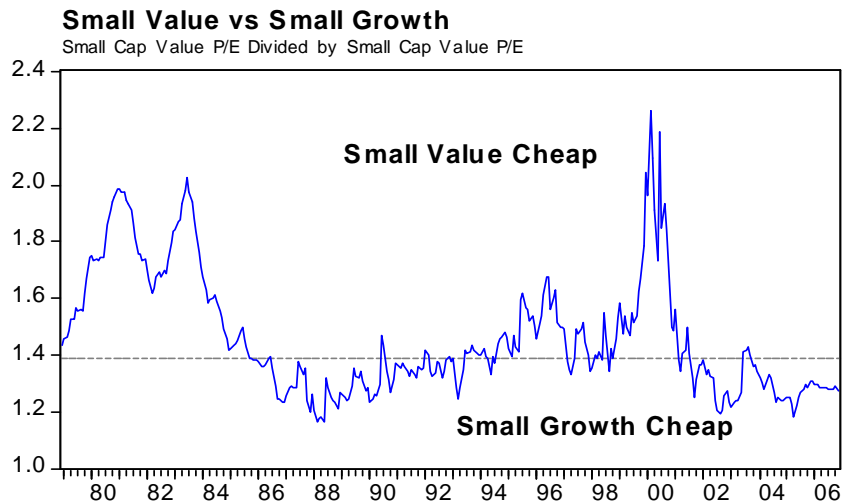
Large caps look relatively cheap vs. small cap stocks on a valuation basis.



Growth looks cheap compared to value, though not as cheap as large vs. small.



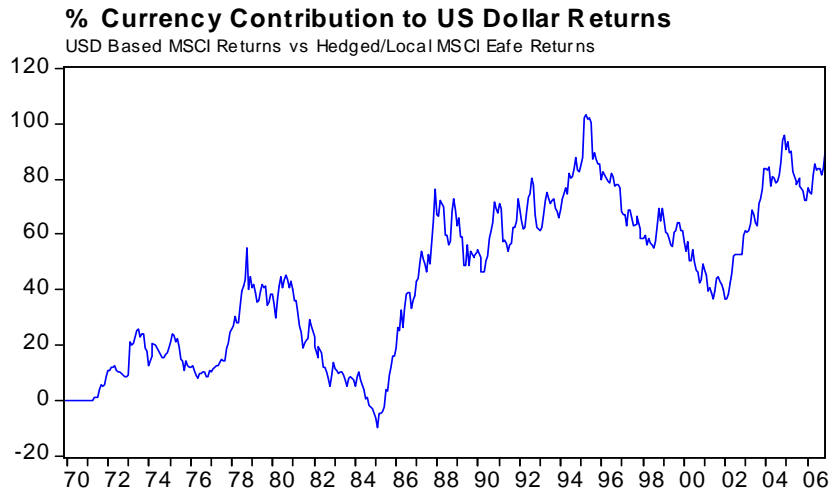
Growth looks cheaper among the smallest stocks too.



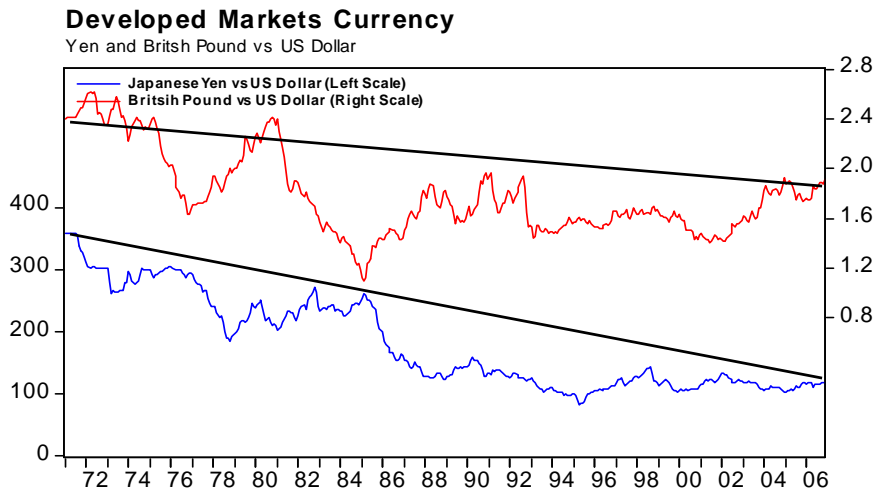
Notes: Source Frank Russell. P/E exclude negative earnings. Large is Russell 1000 and Small is Russell 2000. Value and Growth are the value and growth variants of the Russell 1000 and Russell 2000.

Currency: Dollar Likely to Slip More

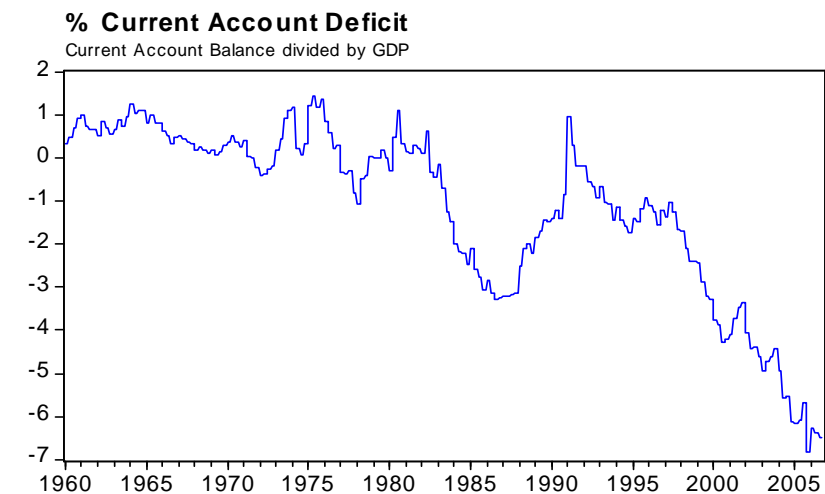
A weakening dollar has contributed significantly to US investor foreign investment returns. Since 1970, currency has augmented US investor returns in international markets by a full 100%.



The dollar is in a long-term decline against its major partners, and we believe that this trend will continue in the long-run.



Fundamentally the dollar should weaken from these levels. The current account deficit, or the excess of our country's imports over exports is cited as the key driver of the dollar.



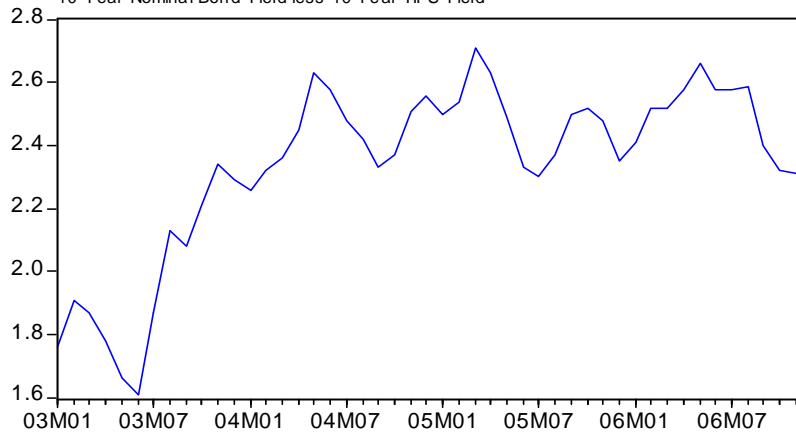
Notes: Current account and Yen/Pound currency data is from Federal Reserve. Currency contribution is from MSCI, and is calculated as the cumulative difference between the unhedged and hedged MSCI EAFE Index. The importance of the current account is well described in "The Unsustainable US Current Account Position Revisited" by Maurice Obstfeld (UCBerkeley) and Kenneth Rogoff (Harvard) 2005.

Inflation: Under Control?

Inflation expectations have moderated since 2005. Crucially, there are no signs of deflation so far.

Inflation Expectations: TIPS Breakeven

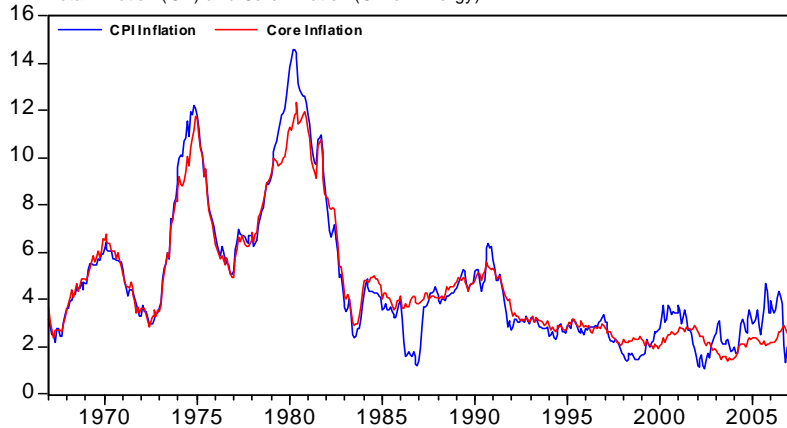
10 Year Nominal Bond Yield less 10 Year TIPS Yield



Inflation appears contained. Commodity price declines are helping out.

Inflation

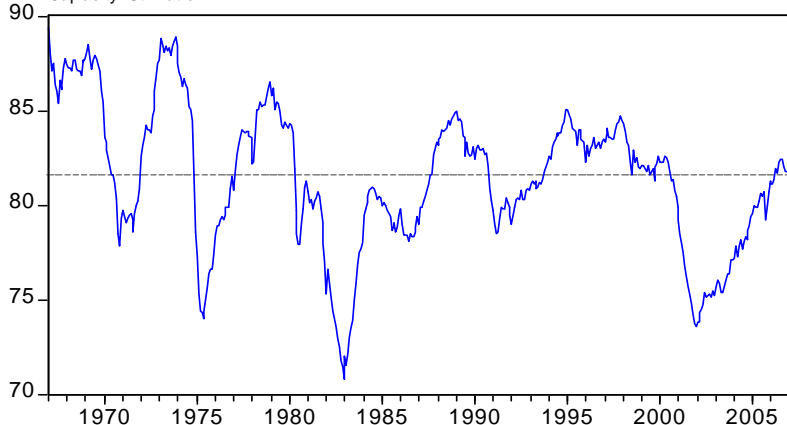
Total Inflation (CPI) and Core Inflation (CPI ex Energy)



But another key factor driving inflation is not moderating, suggesting contained inflation may not be contained. Capacity utilization (or opposite of the “slack” in manufacturing plants) is at average historical levels, but is growing.

Capacity Utilization

Capacity Utilization



Notes: Data is from Federal Reserve. To understand what drives inflation, and the specific role of capacity utilization in inflation, the following is a good reference: U.S. Inflation Dynamics: What Drives Them Over Different Frequencies? Ravi Balakrishnan and Sam Ouliaris, International Monetary Fund, 2006.

Disclaimer

Past performance is not a guide to future performance and the value of investments and the income derived from those investments can go down as well as up. Future returns are not guaranteed and a loss of principal may occur.

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