



FOCUS POINTS

The economy and the markets performed well in 2006 despite international and domestic concerns. Most of those problems are unresolved and new ones have developed, but ***our optimistic outlook for the economy and the markets remains intact at the start of 2007.***

Bonds – Opportunities in a Range:

The world is awash with excess liquidity, so yields in the bond market makes sense, but understanding the market and determining how to make money in it are two different things. Longer-term and lower-quality bonds are being purchased by those with growing cash flows and, in some cases, e.g. China, for political rather than financial objectives. Meanwhile, central banks in the U.S., Europe, Japan and elsewhere seem to have a bias toward raising short-term rates. This creates a market that is difficult to forecast, laden with risk and with little, if any, implied return for taking risk.

For investors with a need for fixed income securities we think that the best approach is to stay with very high quality issues and try to identify and then ride the “faster growth – slower growth” sentiment cycle that is likely to move bond yields fairly nicely, but within a 1% or so range. Currently that cycle is moving in the direction of “slower growth” sentiment, so an ***above average duration*** is still appropriate.

Stocks – Less Here, More There:

Although most stocks, save those in the technology sector, are at or close to all-time highs, the market does not seem frothy entering 2007. The primary reasons for this seeming contradiction are the extraordinary growth of corporate profits and the reduction in financial leverage. Yet, even with profit growth likely to slow and financial leverage likely to increase, we remain ***positive on stocks***. Several distinct themes are visible in our portfolios and allocations to some will be expanded:

Natural Resource Companies:

Years of under-development of resources have led to longer-term shortages in many basic materials, including energy. While short-term pricing of these commodities will be subject to cyclical pressures, a period of above average profit will be necessary to fund the necessary expansion of supply. We plan to continue to build our exposure to these areas, particularly on any weakness.

Mergers & Acquisitions:

We expect to see a mounting wave of mergers and acquisitions. In screening our ideas, companies with a strong financial position, competitive operating facilities and reasonable growth prospects seem likely to be targets.

Expanding Valuations:

For many companies their profit growth has not been matched by their stock price performance in the last few years. As a result their P/E multiple has declined. In fact, there has been a general compression of multiples between “growth stocks” and “value stocks.” Our time-tested process has always included relative earnings growth in assessing valuations, so we are looking at and using more stocks that some would label as “growth stocks.” We expect to see P/E multiples expand in 2007, generating good performance even if earnings growth slows.

Stocks still more attractive than bonds:

Although extreme risks can never be ignored and stocks always fare worse under such conditions, 2007 seems an unlikely period for such risks to be realized. When we adjust probable returns for likely risk, stocks are still much more attractive than bonds. Consequently, we are maintaining our strategy of ***maximizing the equity allocation*** of portfolios going into 2007.