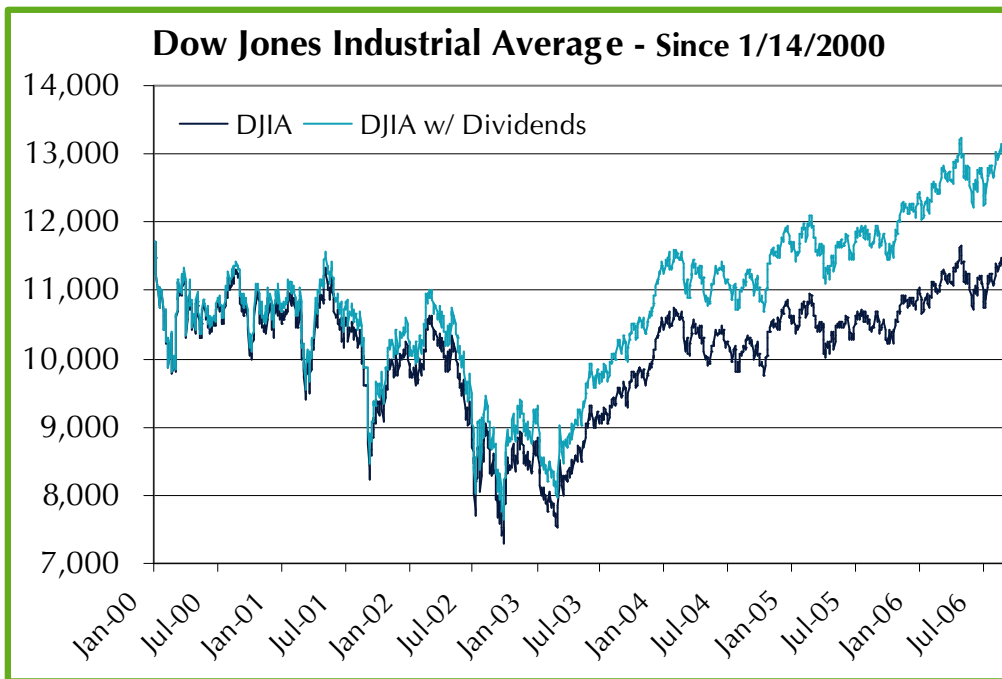


Third Quarter 2006 – Market Review

The third quarter was a productive one for the financial markets. In fact, it was the best quarter for U.S. stocks in two years and the best for bonds in five years. On signs the Federal Reserve might be concluding its program of interest rate hikes, falling oil prices, a foiled terror plot in the U.K. and dwindling tension in Lebanon, investors' actions propelled the markets higher.



The “big event” for the financial markets at quarter end was the news that the Dow Jones Industrial Average (“DJIA”) was set to challenge its all-time high set on January 14, 2000. The DJIA eventually set a new record on October 3, 2006. Between the two record highs prowled one of the worst bear markets in financial history. From its 2000 high to its 2003 low, the DJIA fell 37.9%. Recently, the Wall Street Journal observed that “the new record for the Dow Industrials means they have

recaptured their losses, but it also means they have made virtually no progress in more than six years. Of the 30 stocks in the Dow average, only 10 have surpassed their levels of January 2000.” Microsoft is down 46% since Jan. 14, 2000. Intel is off 60% and General Motors has fallen 59%. The stocks that pushed the DJIA to its new high include Altria, up 214%; Caterpillar, moving 151% higher; United Technologies, with a 103% gain; Boeing, up 86%; and Exxon Mobil, gaining 56%.

Of course, all this talk of new highs may not be particularly relevant to most investors' situation. There are several reasons why the DJIA as presented by the media is not a good barometer for the stock market. First, the DJIA does not take dividends into account. The total return that any investor receives is a combination of price gains AND dividends. Why the media does not report the market's results including dividends confounds us. Dividends are the total return component that is the most reliable, yet they are often ignored. Factoring in dividends, the DJIA reached new highs almost two years ago on December 14, 2004 (we don't recall any celebration back then). Since then the average is up another 17% (dividends are real money!). Second, the DJIA is not adjusted for inflation. And, taking the corrosive effects of inflation into account reduces the DJIA by about 21%, offsetting the positive impact of dividends and meaning that the DJIA has yet to reach a new inflation-adjusted all-time high.

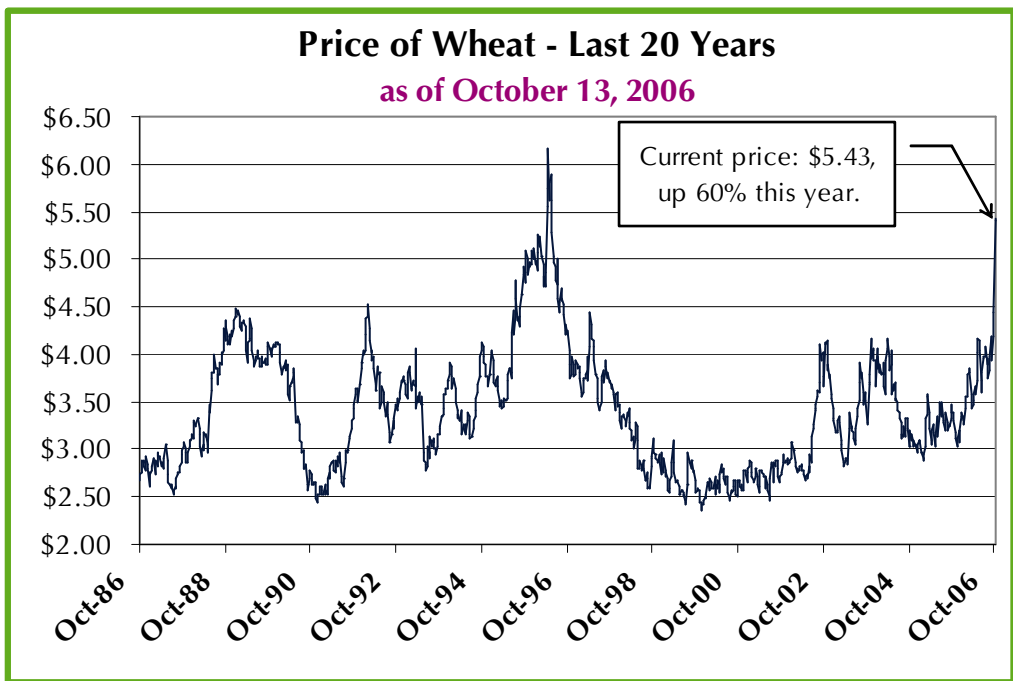
“And I had an old-fashioned idea that dividends were a good thing.” James MacArthur

The third reason why the DJIA is not a particularly good barometer for the stock market is that it's not the stock market. The DJIA is just an average of the prices of 30 stocks. Granted, they are big, important companies, but it's still only 30 companies. Whether or not we include dividends or adjust for inflation, measuring the returns of only 30 companies is not very reflective of the entire U.S. stock market. Nevertheless, whether we approve or not, the DJIA will continue to be quoted as the market barometer. And, we'll be happy to continue collecting the dividends.

Third Quarter Review: As usual the components of the financial markets moved at various paces. Large company stocks, as measured by the S&P 500 were up 5.7% in the quarter and finished the first nine months of the year up 8.5%. Small and mid-sized companies had a more difficult quarter, up 0.4% and down 1.1%, respectively. However, year-to-date small company stocks are still up 8.7% and mid-sized companies are up 3.1%. The more volatile Real Estate Investment Trusts (REITs), whose fortunes depend on the commercial, rather than residential real estate market, rose 9.3% during the quarter and are up 23.4% year-to-date. Vacancy rates in many major U.S. cities are low and declining, and construction of commercial properties has not kept pace with demand, allowing landlords to increase rents. REITs, which are up 273% since Jan 2000, have now outpaced returns on large company stocks in each of the last seven years. We expect that returns from REITs will be more modest going forward.

Foreign stocks rose 3.9% in the quarter and are now up 14.5% thru the end of September. Stocks in Europe rose 6.4% in the third quarter, while Asian stocks fell 0.1%. Stocks in the Spain led the way, gaining 12.2% in the third quarter while stocks in Norway posted the largest loss, falling 6.2%. This year Spanish and Portuguese equities lead the way, each up more than 30%, while New Zealand is the only developed market with a negative return, down 4.3%. Emerging market stocks rose 4.9% in the quarter and are up 12.4% year-to-date. Chinese stocks rose 8.8% in the quarter and are up 34.6% so far this year, while stocks in India roared ahead 18.1% in the quarter and are up 29.9% year-to-date.

Bond market indices came to life in the third quarter. The Lehman Brothers Aggregate Bond index (a mix of government and corporate bonds) rose 3.8%, inflation adjusted bonds as measured by the Lehman Brothers U.S. TIPS index rose 3.6% and international bonds as measured by the Lehman Brothers Global Credit index gained 3.1%. Oil prices fell 15% during the quarter and are now only up 3% for the year. Not all commodities declined; wheat prices are up 60% this year as an extended drought in Australia may cut its wheat production by two-thirds. Normally a major exporter, Australia may have to import wheat to meet its needs this year.



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“Do you know the only thing that gives me pleasure? It's to see my dividends coming in.”
John D. Rockefeller