

## 2005 Market Review

**"Having been in the stock market for more than four decades, I believe that the best time to invest for those with a long-term time horizon is when they have the money."** Shelby M.C. Davis

2005 was a year of severe weather events. At Madison, we endeavor to create 'all-weather' portfolios for our clients (using investments from many different asset classes and rebalancing in a disciplined fashion). While we build these portfolios with uncertainty in mind, little did we know that the all-weather portfolios would need to survive both tsunamis and hurricanes! The good news is that in 2005 both the economy and the financial markets withstood the impacts of these severe weather events and ensuing higher oil prices.

The S&P 500 Index rose 2.1% in the fourth quarter and closed 2005 with a modest 4.9% total return. Over longer periods of time, the S&P 500 Index has produced gains of 0.5% per year over the last five years and gains of 9.1% per year over the last ten years. At the end of 2005, the S&P 500 was 279 points or 22% below its all-time high of 1,527 in March of 2000. Large company stocks have been among the poorer performing asset classes over the last five years (please see the blue boxes on the reverse page - available in a larger version at [www.madisonadvisors.com](http://www.madisonadvisors.com) under the Client Resources tab). We suspect that large company stocks will perform better in the years ahead.

Mid-size companies outperformed smaller companies in the fourth quarter and 2005. Mid-caps (S&P 400 Index) gained 3.3% in the quarter and 12.6% in 2005. Mid-caps have averaged 8.6% per year over the last five years and 14.4% per year over the last ten years. Small-caps (Russell 2000 Index) rose 1.1% during the quarter and rose 4.6% for 2005. Small-caps have averaged 8.2% per year over the last five years and 9.3% per year over the last ten years.

Other areas of the equity markets also continued to perform well in 2005. International stocks (MSCI EAFE Index) rose 4.1% in the quarter and gained 13.5% for the year, led by strong gains in many Asian and Pacific Rim markets. During 2005, the Canadian market, on the strength of rising oil and commodity prices, rose 28.3%, Japan rose 25.5% as their economy showed signs of coming back to life and Norway enjoyed a 24.3% gain, also on the strength of rising oil prices. Despite these stellar results, over the last five years the MSCI EAFE index has produced gains of 4.6% per year and gains of 5.8% per year in the last ten years.

Real Estate Investment Trusts (REITs) also continued to perform well, gaining 1.5% for the quarter and posting a 12.2% gain in 2005. REITs have now been among the top one or two major asset classes in each of the last six years (see the yellow boxes on the reverse page). Over the last five years REITs have produced an annual return of 19.1% per year and are up 14.5% per year over ten years. That said, with the entire market value of the 197 publicly traded REITs at \$330 billion, just a little less than the market value of General Electric (\$370 billion), the double digit investment returns are unlikely to persist. This relatively small asset class can be subject to some very volatile price movements, as witnessed by the decline of 14.6% in just one month in April of 2004. We anticipate further volatility in the REIT market in the coming years.

Despite on-going interest rate increases by the Federal Reserve the bond market managed to produce positive results in 2005. Government and corporate bonds, as measured by the Lehman Government/Credit Index, posted a 0.6% return during the quarter and gained 2.4% for the year. Over the last five years bonds have produced an annual return of 6.3% per year and 6.2% per year over the last ten years. Municipal bonds, as measured by the Lehman 1-10 Year Blend Index, rose 0.5% in the quarter and gained 1.7% for the full year.

The yield on the 10-year U.S. Treasury bond at the end of 2005 was 4.4%. Interestingly, the yield on the 1-year and 5-year U.S. Treasury bonds was about the same as the 10-year bond, resulting in a very flat yield curve and indicating a potential economic slowdown in 2006.

Returns on cash improved in 2005, as U.S. T-Bills earned 0.9% over the last three months and 3.1% in 2005. Adjusting for inflation, cash has lost nearly 4% of its purchasing power in the last three years. Cash, while a safe place to be for a short period of time, is not a long-term investment strategy for most investors.

**"The secret of staying young is to live honestly, eat slowly, and lie about your age."** Lucille Ball

# Why Asset Class Diversification is so Important...

Because Performance is Cyclical and cannot be Definitively Anticipated

Annual Returns of Key Indices (1986 - 2005) - Ranked in order of performance (Best to Worst)

RANK	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
1	MSCI EAFE 69.44%	MSCI EAFE 23.63%	MSCI EAFE 28.27%	S&P 500/ BARRA Growth 36.40%	LB Agg 8.96%	LB High Yield Bonds 46.19%	Russell 2000 18.41%	MSCI EAFE 32.56%	MSCI EAFE 7.78%	S&P 500/ BARRA Growth 38.13%	Real Estate Inv. Trusts 35.27%	S&P 500/ BARRA Growth 36.54%	S&P 500/ BARRA Growth 42.15%	S&P 500/ BARRA Growth 28.25%	Real Estate Inv. Trusts 26.37%	Real Estate Inv. Trusts 13.94%	LB Agg 10.25%	Russell 2000 47.25%	Real Estate Inv. Trusts 31.58%	MSCI EAFE 13.54%
2	S&P 500/ BARRA Value 21.67%	S&P 500/ BARRA Growth 6.50%	Russell 2000 24.89%	S&P 500 Index 31.69%	S&P 500/ BARRA Growth 0.20%	Russell 2000 46.05%	LB High Yield Bonds 15.75%	Real Estate Inv. Trusts 19.65%	Real Estate Inv. Trusts 3.17%	S&P 500 Index 37.58%	S&P 500/ BARRA Growth 23.97%	S&P 500 Index 33.36%	S&P 500 Index 28.58%	MSCI EAFE 26.96%	LB Agg 11.63%	LB Agg 8.44%	Real Estate Inv. Trusts 3.81%	Real Estate Inv. Trusts 37.15%	MSCI EAFE 20.25%	Real Estate Inv. Trusts 12.16%
3	Real Estate Inv. Trusts 19.16%	S&P 500 Index 5.25%	S&P 500/ BARRA Value 21.67%	S&P 500/ BARRA Value 26.13%	S&P 500 Index -3.10%	S&P 500/ BARRA Growth 38.37%	Real Estate Inv. Trusts 14.59%	Russell 2000 18.91%	S&P 500/ BARRA Growth 3.14%	S&P 500/ BARRA Value 37.00%	S&P 500 Index 22.96%	S&P 500/ BARRA Value 29.99%	MSCI EAFE 20.00%	Russell 2000 21.26%	S&P 500/ BARRA Value 6.08%	LB High Yield Bonds 5.28%	LB High Yield Bonds -1.41%	MSCI EAFE 38.59%	Russell 2000 18.33%	S&P 500/ BARRA Value 6.33%
4	S&P 500 Index 18.67%	LB High Yield Bonds 4.99%	S&P 500 Index 16.61%	Russell 2000 16.24%	S&P 500/ BARRA Value -6.85%	Real Estate Inv. Trusts 35.70%	S&P 500/ BARRA Value 10.53%	S&P 500/ BARRA Value 18.60%	S&P 500 Index 1.32%	Russell 2000 28.44%	S&P 500/ BARRA Value 21.99%	Russell 2000 22.36%	S&P 500/ BARRA Value 14.68%	S&P 500 Index 21.04%	Russell 2000 -3.02%	Russell 2000 2.49%	MSCI EAFE -15.94%	S&P 500/ BARRA Value 31.79%	S&P 500/ BARRA Value 15.71%	S&P 500 Index 4.91%
5	LB High Yield Bonds 17.45%	S&P 500/ BARRA Value 3.68%	Real Estate Inv. Trusts 13.49%	LB Agg 14.53%	LB High Yield Bonds -9.59%	S&P 500 Index 30.47%	S&P 500 Index 7.62%	LB High Yield Bonds 17.12%	S&P 500/ BARRA Value -0.64%	LB High Yield Bonds 19.17%	Russell 2000 16.49%	Real Estate Inv. Trusts 20.26%	LB Agg 8.69%	S&P 500/ BARRA Value 12.73%	LB High Yield Bonds -5.86%	S&P 500/ BARRA Value -11.71%	Russell 2000 -20.48%	LB High Yield Bonds 28.97%	LB High Yield Bonds 11.13%	Russell 2000 4.55%
6	LB Agg 15.26%	LB Agg 2.76%	LB High Yield Bonds 12.53%	MSCI EAFE 10.54%	Real Estate Inv. Trusts -15.35%	S&P 500/ BARRA Value 22.56%	LB Agg 7.40%	S&P 500 Index 10.08%	LB High Yield Bonds -1.03%	LB Agg 18.47%	LB High Yield Bonds 11.35%	LB High Yield Bonds 12.76%	LB High Yield Bonds 1.87%	LB High Yield Bonds 2.39%	S&P 500 Index -9.11%	S&P 500 Index -11.88%	S&P 500/ BARRA Value -20.86%	S&P 500 Index 28.69%	S&P 500 Index 10.88%	S&P 500/ BARRA Growth 3.46%
7	S&P 500/ BARRA Growth 14.50%	Real Estate Inv. Trusts -3.64%	S&P 500/ BARRA Growth 11.95%	Real Estate Inv. Trusts 8.84%	Russell 2000 -19.51%	LB Agg 16.00%	S&P 500/ BARRA Growth 5.07%	LB Agg 9.75%	Russell 2000 -1.82%	Real Estate Inv. Trusts 15.27%	MSCI EAFE 6.05%	LB Agg 9.65%	Russell 2000 -2.55%	LB Agg -0.82%	MSCI EAFE -14.17%	S&P 500/ BARRA Growth -12.73%	S&P 500 Index -22.10%	S&P 500/ BARRA Growth 25.66%	S&P 500/ BARRA Growth 6.13%	LB High Yield Bonds 2.74%
8	Russell 2000 5.68%	Russell 2000 -8.77%	LB Agg 7.89%	LB High Yield Bonds 0.83%	MSCI EAFE -23.45%	MSCI EAFE 12.13%	MSCI EAFE -12.17%	S&P 500/ BARRA Growth 1.68%	LB Agg -2.92%	MSCI EAFE 11.21%	LB Agg 3.63%	MSCI EAFE 1.78%	Real Estate Inv. Trusts -17.50%	Real Estate Inv. Trusts -4.62%	S&P 500/ BARRA Growth -22.08%	MSCI EAFE -21.44%	S&P 500/ BARRA Growth -23.59%	LB Agg 4.10%	LB Agg 4.34%	LB Agg 2.43%

Index returns are for illustrative purposes only and do not represent actual performance. Index performance returns do not reflect any management fees, transactions costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Performance information shown is historical and is no guarantee of future results. See below for a description of each index listed above.

## Description of the Indices

- S&P 500 Index** measures the performance of large capitalization U.S. stocks. It consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock prices times number of shares outstanding), with each stock's weight in the index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance.
- S&P 500/ Barra Growth Index** (Orange) and **S&P 500/ Value Index** (Purple) are designed to differentiate between fast growing companies and slower growing or undervalued companies. Standard & Poor's and BARRA cooperate to employ a price-to-book value calculation, whereby the market capitalization of an index is divided equally between growth and value. The growth and value definitions are only available on the U.S. indices. The indices are rebalanced twice per year.
- Russell 2000 Index** measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest companies in the Russell 3000 Index; these companies represent less than 10% of the total market capitalization of the Russell 3000.
- LB High Yield Bonds** is the Lehman Brothers High Yield Bond Index. This index includes over 1,300 individual corporate bond issues rated Not Investment Grade (Ba by Moody's or BB by Standard & Poor's or lower).
- Real Estate Investment Trusts** represents the NAREIT (National Association of Real Estate Investment Trusts) Equity REIT Index. The index contains over 150 companies representing over \$300 billion in market capitalization. The real estate markets included in the index include Industrial/Office, Retail, Residential, Lodging/Resorts, Self Storage, Health Care and Diversified properties.
- MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market-capitalization index that is designed to measure developed market equity performance (excluding the U.S. & Canada). The Index includes 21 developed-market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.
- LB Agg** is the Lehman Brothers Aggregate Bond Index. This index includes U.S. government, corporate, and mortgage-backed securities with maturities up to 30 years.

**In addition to normal risk involved with equity investing, investments in smaller companies, international companies or narrowly focused investments typically exhibit higher volatility. Diversification may not protect against market risk.**

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