MORETON FINANCIAL SOLUTIONS, LLC

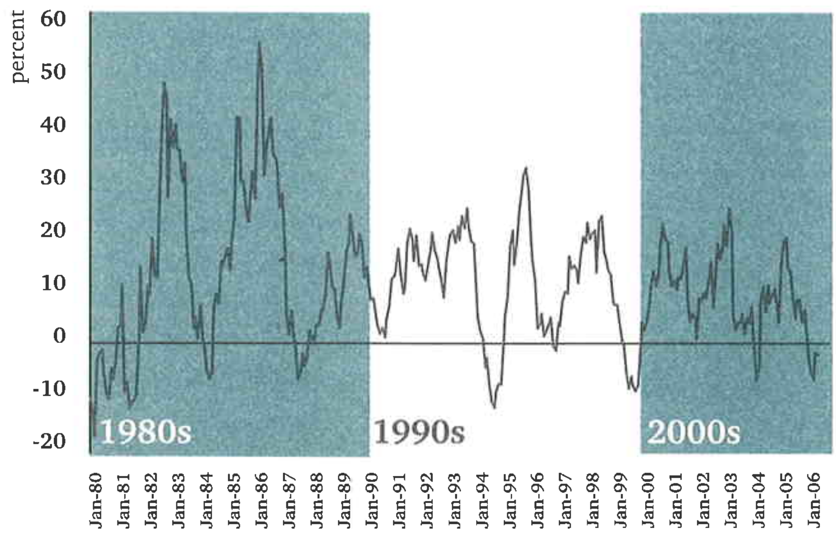
INVESTMENT UPDATE

OCTOBER 2006

HOORAH FOR LOWER RATES! ARE THEY REALLY HELPFUL?

Even more quickly than we expected, investors have adapted to a slowing economy and its reduced inflation pressures. Several softer inflation readings, combined with continued weakness in housing, convinced many that the Fed will be out of the picture for some time. There has been conjecture that the next move could be an easing, and could come sooner than expected. Whether this scenario pans out is highly uncertain, but the change in sentiment has caused interest rates to decline steeply. Since mid-June, the yield on the 30-year Treasury bond has declined from 5.25% to near 4.60%. As a holder of a large number of bonds, you might expect that we would welcome a move back to lower rates. You'd be partially correct, as the decline boosts the price of the existing bonds we hold for clients. Tempering our enthusiasm somewhat is the fact that new bonds must be purchased at these lower yields, and coupons for older bonds now may be reinvested at these lower rates. These two factors cause us, looking forward from the vantage point of today's low rates, to forecast lower bond returns. While interest rates conceivably could fall further – should economic growth slow significantly more than expected – the dynamic discussed above would be amplified if this were to happen. Without delving deeply into the math behind the concept of duration, another negative of lower rates is that a change in interest rates has a much greater impact on the return of a bond with a given maturity. An example will help to make this clear: in 1981, when long-term Treasuries were yielding near 14%, a 1% (100-basis-point) increase in rates would move the price only 6.5%. Today, because rates are so much lower, the same 100-basis-point move in rates would cause a price change of 15.3%!

VOLATILITY OF LONG-TERM GOVERNMENT BONDS
Rolling Annual Returns



Source: 1980-2005, Long-term Government Bonds, Ibbotson Associates;
2006 Lehman US Treasury Long, Baseline

While it has not felt like it – thanks to the recent retrenchment of rates – even as recently as June of this year, the experience for long bond owners was considerably less pleasant. At the end of June 2006, the 20-year Treasury's trailing 12-month total return was -7.26%. Surprisingly, this was one of the worst periods on record. According to Bianco Research, only eight other periods over the last 79 years were worse for investing in long-term Treasuries, with only two of those periods occurring in the last 25 years. Just a few months later, with the downdraft in yields, the 12-month return for the same 20-year maturity bond at the end of September was reduced by more than half what it had been in June.

Falling interest rates during most of the last 25 years show that it does not take big yield changes to cause significant changes in bond prices. Looking forward, we expect that returns will be much more volatile with a greater chance for negative returns than we have experienced in recent history. This greater sensitivity to rate changes is one of the prime reasons we are very cautious about our long-term bond purchases. We make them sparingly, and there are times when we might avoid them all together. Why buy them at all? At most times, to compensate for the greater riskiness, they offer a higher yield than shorter maturity bonds. Also, if rates fall, as they have done recently, these longer bonds pay the higher coupon for a longer period of time.

A REEDUCATION IN RISK

You likely have read or heard about the stunning September decline in the hedge fund Amaranth. One of the fund's managers had taken on massive exposure in various energy contracts, primarily natural gas, betting that prices would rise for contracts on months far in the future. Given our belief that many investors had been too complacent towards risks of all kinds, and our skepticism regarding the fervor some investors expressed towards many commodities during the later stages of the rally in late 2005, you might expect any comment from us on the subject to be moralistic and tinged by schadenfruede.

Actually our reaction has been somewhat different. It is hard to feel sorry for the trader who took these positions and who arguably understood their risks. After all, his daring exploits in the past are what allowed him to rise to prominence at the fund. But we do feel badly for the investors in the fund, which lost around 65% of its value in September alone. The fund was billed as multi-strategy and anyone who presumed that this diversified the fund's risk had a rude awakening.

September was not the first time that Amaranth exhibited significant volatility. Earlier this year, the fund had a smaller, but still significant decline, only to recoup the losses fairly quickly. We wonder where the folks were whose task it was to monitor the risk levels taken individually by each trader and collectively by the fund. Apparently some investors, alarmed by the previous fluctuations, discussed their concerns with the fund's managers and were told that the risk level of future trades had been reduced. To an investor in the fund, however, it would have been hard to gauge the degree to which this had been accomplished. The fund's management should have been able to determine this. How did the risk remain so great? Or is it possible that it even was increased rather than diminished? While these questions are sure to be answered after the fact, it only will be of academic interest to those investors who lost so much.

Responding to the debacle, the fund's management cited that these losing bets were made on events that they felt had only a "remote possibility" of occurrence. Unfortunately for their investors, the remote occurred. As natural gas prices declined by more than 50%, investors concluded that there was an ample supply of gas for the moment, which precipitated the price decline. It should not come as a surprise that some people may have ignored signs that supply was building, or that demand may have waned after the summer peak. As Maynard Keynes once observed, "Investors can remain irrational longer than you can remain solvent."

To us, the real moral of this story is that the very fact that an investment can increase by so much means that it can also fall by at least that magnitude. Unfortunately, like moths to a light, investors frequently are attracted after large returns are generated, while at the same time they imbue far more talent and mystique to the incumbent managers than is truly warranted. Upon reflection, mystique can sound perilously close to mistake.

The Amaranth story is only one of the reasons why we endeavor to monitor and control the level of risk exposure we have in our portfolios. Only for small amounts of a total portfolio might it be appropriate to expose oneself to risks such as the investors in Amaranth experienced. To the extent that Amaranth investors understood and were positioned appropriately for these risks, the sudden drop in value should not have been catastrophic. For investors lured by the prior high returns who did not heed the potential risks, we hope that they will be able to apply this painful lesson to future situations. The impact on the market will be minor, as sufficient liquidity exists for the positions taken by the fund. The same may not be the case for those who expose themselves (and possibly others) to undue levels of risk. Even when we think we understand the risks involved, markets have a way of humbling investors. There are times when a greater exposure to aggregate risk is worthwhile in some portfolios. This does not appear to us to be such a time.

Chris Sheldon

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