

MORETON FINANCIAL SOLUTIONS, LLC

INVESTMENT UPDATE



DECEMBER 2006

GOOD BUT NOT EASY

Barring turbulence this month, 2006 will go down on the books as a very good year for the markets. Most asset classes have generated surprisingly strong returns. At this writing in late November, the S&P 500 is up almost 14%. International stock returns have been strong, and collectibles such as fine art and wines also performed well.

Why have markets done so well? Often, we focus on what could go wrong and what could weigh on the markets. Sometimes, however, the question really should be, "what if everything goes right?" With a backdrop of reasonable valuations, economists and strategists are citing an impressive number of positive factors that contributed to greater-than-expected gains in 2006.

- The U.S. economy has been growing for 60 months since it troughed during November 2001. It now exceeds the 57-month average duration of the 10 expansions that occurred between 1945 and 2001.
- Household employment is up 9.6 million since it troughed during January 2002.
- The adult unemployment rate is only 3.9%, the lowest since May 2001. The jobless rate for workers with a college degree is 1.9%, near August's 5 1/2 year low of 1.8%.
- Productivity has increased 16% during the past five years.
- The record U.S. trade deficit continues to be offset by record capital inflows.
- The federal budget deficit is shrinking as tax revenues pour into the U.S. Treasury.

S&P 500 PRICE PERFORMANCE 2006



- The Fed has succeeded in taking the froth out of real estate.
- Globalization continues to advance as free trade proliferates. Russia soon will join the World Trade Organization. Support for reviving the WTO's Doha Round of trade liberalizations is growing around the world.
- Never before has the standard of living of so many people increased as quickly as during the current global economic boom. The wealth of nations continues to grow rapidly thanks to globalization.

Corporate earnings remained remarkably strong in the first three quarters of 2006. Despite a shift to a lower economic growth rate, third quarter business profits were up 20% from the prior year. This was the 18th consecutive quarter of double-digit growth, an unprecedented streak. Falling energy prices and slower economic growth reduced the threat of cyclical inflation and cooled inflation fears. These factors also allowed long-term interest rates to remain low, helping to boost stocks. A diminishing inflation threat forestalled further Fed tightening, which would have posed a risk to stocks in the form of reduced liquidity. Finally, the housing recession to date has not spilled over into consumption. The rapid disappearance of PlayStation 3s and flat screen TVs indicates that the holiday selling season may not be the fiasco some feared.

OUT WITH THE OLD, THEN THE NEW, THEN THE OLD...

Notwithstanding these strong market conditions, a great many investors had trouble realizing these returns. Some very big names encountered difficulty this year, including several with long track records of beating their benchmarks. Many investors were overly pessimistic about the prospects for 2006 and remained underinvested throughout



the year. Others experienced difficulty in stock selection when no clear trend or theme held sway for a long period. Indeed, volatility among the various stock sectors was more pronounced this year and left many by the wayside.

According to Birinyi Associates, the best performing stocks in the first half of the year were up 12% on average. During the third quarter, these same stocks lost an average of 15%. Conversely, the 50 stocks that fared the worst in the first half (-2.5% on average) were up 22% in the third quarter.

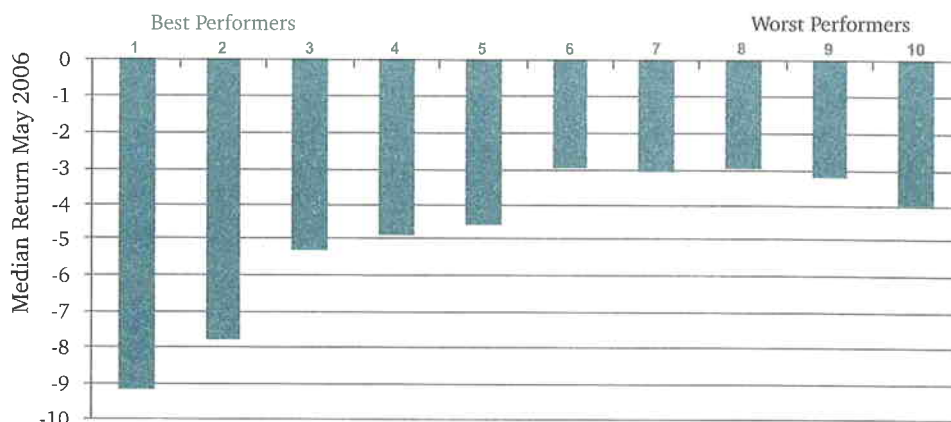
A report from The Leuthold Group showed this effect to be even more pronounced over shorter time periods. Leuthold took the largest 1000 stocks and sorted them by their prior 11-month performance (May-05 to Apr-06). It then ranked the stocks into deciles of 100 stocks and calculated each decile's median performance. As depicted in the chart above, Leuthold found that the prior leaders received the hardest blows.

Perhaps more interesting is the fact that, in carrying this test forward into July of 2006, The Leuthold Group found that the stocks that performed best in May and June were at the bottom of the stack in July, while the laggards of that period were July's best performers. Then, in August – no surprise by now – this trend once again reversed. No wonder investors looking to capitalize on short-term trends were frustrated. This rapid and consistent pattern of reversals certainly contributed to the underperformance of frequent traders such as hedge funds.

CAUTION HAS BEEN THE WATCHWORD

As demonstrated in our chart on page one, the markets, especially the S&P 500, were quite strong in the second half of the year. A notable difference in the environment compared to the late 1990s, however, has been ongoing investor skepticism. Then, ebullience was the prevailing sentiment toward equities.

TOP 1000 MARKET CAP U.S. STOCKS
Decile Performance (May 2005 – April 2006)



Source: The Leuthold Group

The universal expectation, whether by retail or professional investors, was for continued gains as far as the eye could see. Now, despite recent gains, investor sentiment is considerably more subdued. Flows by retail investors into equity mutual funds have been low. Hedge fund net equity exposure now is increasing, but remains far short of record highs. Institutional investor expectations for near-term equity returns have been modest and only very recently have begun to climb.

Many investors shifted to very low equity exposure levels early this year over concerns of too much inflation or too little economic growth. Investors of all stripes were caught off guard by the second-half rally and many remained underexposed to equities, perhaps expecting a seasonal pullback that frequently has occurred in September or October. Ironically, stocks often do better when the market is full of skeptics. The old saying is that “markets climb a wall of worry.” This year proved no exception.

WHAT LESSONS CAN BE LEARNED?

What can we learn from the experiences of 2006? The year offered an excellent reminder of the need for perspective and a proper time frame. Taking too short a view proved costly, as chasing recent winning stocks often meant buying the next month's losers. This year also illustrated how extreme shifts in asset allocation do not pay. At Mellon, we observed enough areas of concern coming into this year that we made modest shifts in the portfolio toward larger stocks and higher quality. We also advised reducing equity exposure slightly. In the case of moving toward larger stocks from smaller and from emerging market equities toward developed markets, these adjustments maintained relative returns, while lowering risk. In hindsight, we made our call to reduce equities back to a neutral long-term level too early, as equities performed better than our initial expectations. However, the recommended reduction in equities was modest and we maintained exposure to the areas of the markets that provided the best growth. Given the litany of concerns, it would have been very easy for an investor to succumb to fear and make an extreme portfolio move. History shows that this rarely is the right decision. For long-term investors, the better course of action is to set a portfolio mix to meet long-term goals, and attempt to ignore short-term market gyrations.

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