

Walden Capital Newsletter

Walden Capital Advisors

Fourth Quarter

It was an eventful year in 2006, with energy prices, the housing market, and Fed policy all impacting the investment landscape. Early in the year investors feared rising rates; however, once the Fed ended its string of rate hikes, the market climbed steadily higher.

Most asset classes had good returns for the year, with international stocks doing especially well, and domestic equities returning in the mid-to-high teens.

Despite rising stock prices, equity valuations remain attractive thanks to strong earnings, suggesting either that stocks are undervalued or that the market is discounting a material slowdown in the economy.

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Quarterly Investment Commentary

2006 was a very good year all around. The Dow broke through the 12,000 mark and returned to levels last seen seven years ago before the dot.com bubble burst. Most equity asset classes did well, with smaller-caps once again leading large-caps for the year, continuing their run of outperformance that began in 1999-2000. The small-cap Russell 2000 index was up 18.4%, while the large-cap S&P 500 was up 15.8%. The value indexes vastly outperformed their growth counterparts across all market caps. With a gain of almost 27%, international stocks did very well, once again outperforming domestic equities.

On the fixed-income side, domestic high-quality, intermediate-term bonds had a respectable year, with the Lehman Brothers Aggregate Bond Index gaining 4.3%.

A broad observation about returns in 2006 is that riskier asset classes generally did best. The riskier emerging-markets asset class gained close to 30%, outperforming developed foreign markets. High-yield bonds beat investment grade bonds with the lowest rated bonds performing best. And as noted above, smaller-caps once again outpaced larger-caps.

Investors' willingness to take on risk implies a lower risk premium. Interestingly, though, valuations for the S&P 500 reflect a different story: analysis suggests this index's valuation is either too low or investors are pricing in an economic slowdown, which wouldn't be good for risky assets. Meanwhile, real interest rates are very low, which usually means bond investors are worried about recession (suggesting risk aversion). We don't know who will turn out to be right. Valuation analysis is complicated by the participation of foreign investors and hedge funds, which have their own agendas that may have little or nothing to do with the aforementioned observations—for example, interest rates might not be low because of recession fears, but rather because foreign investors currently prefer our bonds to their own.

Investment Review

Recapping 2006, it was an eventful and at times tumultuous year. The ongoing difficulties in Iraq and the related shift in power in Washington D.C. were two big stories, but not as interesting from an investment standpoint as the stories on inflation, oil prices, the housing market, and Fed policy.

Inflationary pressures increased a bit in 2006. As interest rates rose, the cost of borrowing money increased. Additionally, unemployment decreased to its lowest point in five years, putting pressure on employers to increase wages.

After beginning the year around \$60 per barrel, oil peaked near \$80 per barrel and fostered the belief among some industry watchers that higher oil prices would continue indefinitely (pundits were talking about \$100 per barrel of oil). Many of the managers and strategists we follow believed that oil prices would come down, which turned out to be true, and oil ended the year at roughly the same place at which it began.

The big question on the housing market was when, or if, the housing bubble would burst, and what the fallout would be. While some regions were hit hard, a broader analysis suggested that while the risk of a housing decline was very high, the magnitude and spill-over into the broader economy was not sufficiently high to dampen the very good stock market returns for the year. While the housing market has already cooled off considerably, it's still too soon to say how much further it might have to go and what its effect on consumer spending and unemployment might be.

Fed policy was a big driver of the markets in 2006. Early in the year, investors were growing concerned about an interest rate overshoot causing a recession. By summer, the Fed had

hiked rates by another 125 basis points, and stocks suffered. Once the Fed announced that it was on hold for future hikes, the market spent the rest of the year bouncing higher. Today, there is growing talk of the possibility of a recession that would lead the Fed to begin cutting rates again. This illustrates the fickle nature of short-term sentiment. In less than six months, the market went from concerns about rising rates damaging the economy, to relief that the rate hikes were over, to fears of a cyclical recession (which would lead to falling rates). In the real world, underlying fundamentals seldom change that quickly. We think the message is that objective analysis that focuses on the long-term is an advantage. Being in "reactive mode" is an almost sure-fire way to get whipsawed, since the market reflects investors' sentiments instantaneously. Short-term investor sentiment though rarely impacts long-term fundamentals.

Equity Market Outlook

With the S&P 500 putting up good numbers in 2006, and some market indexes reaching record levels, stocks may "seem" like they should be getting expensive. In truth, though, the valuation picture has actually changed very little. This is because earnings have gone up along with stock prices, leaving the relationship between prices and earnings at about the same place. Additionally, market volatility is at a five year low and has dropped almost in half since June 2006. It's worth remembering that the new highs reached by some indexes are only now eclipsing levels that were first seen nearly seven years ago.

Where does this all leave us? Attractive valuations tell us the market is either cheap—meaning returns going forward are likely to be better than average—or that the market is discounting a meaningful decline in the fundamentals. We've seen signs of slowing

earnings growth and a deceleration in the economy. Part of this is normal cyclical behavior, and some may be in response to the slowdown in the housing market, but in either case it is clear that we're coming off of a spectacular period of earnings growth, and things are likely to cool off. At current valuation levels, however, some margin of safety is already factored into the market.

Overall equity allocation in our models is at a neutral weighting; however, as the extended period of small-cap outperformance has created a valuation disparity relative to large-caps, we have a slight shift in the models from small-caps to mid and large caps. Looking overseas, valuations of foreign stocks are roughly in line with their historical average relative to the U.S. Our portfolios remain at a neutral weighting to foreign stocks, and as always we prefer to let the geographical allocation be determined on a stock-by-stock basis by our managers.

In Summary

As a reminder, we seek to add value both through asset allocation and fund selection. According to Ibbotson Associates research, over 90% of a portfolio's long term return is a result of asset allocation, with security selection and market timing accounting for less than 5% each. The target returns for our models over the long term are in line with historical market returns for those risk levels. We can't predict the timing of those returns, except that it is highly unlikely that they will be smooth from year to year. Our goal as your advisor is to remain aware of overall portfolio risk and set allocations accordingly, make tactical allocation shifts only when highly compelling opportunities exist, and use funds we believe are high quality. Remember that investment success requires discipline, rationality and a focus on the long term.

News

Walden Capital Approved for use of DFA Funds

Dimensional Fund Advisors ("DFA") is an investment firm based in Santa Monica, California which offers institutional funds to individual investors only through a select group of approved investment advisors. These funds are not available to retail investors. DFA's funds are passively managed asset class funds, rather than strict index funds, giving them more trading and portfolio composition flexibility than traditional index funds. As opportunities arise, we will look to add some of these funds to the portfolios.

Change in Taxation of Custodial Account Income

Prior to 2006, children under the age of 14 paid taxes at their parents' marginal tax rate for any income over \$1,700. Once the child reached age 14, taxes were paid at the child's rate which is presumably lower than that of the parent. The government increased this age to 18 thereby increasing the taxes on these accounts in certain circumstances.

Billing

Your first bill is included in this package. Billing is done in advance of each quarter so this bill is for the period January 1 through March 31, 2007. Please review the bill carefully and make sure that the following was done correctly: any consolidating of accounts for purposes of calculating the fee and listing of accounts from which fees will be deducted (or indication that fee should be paid by check.)

2006 Realized Capital Gains Reports IMPORTANT FOR FORMER PMA CLIENTS

For those of you who transferred from PMA and have taxable accounts, you will be receiving a 2006 Realized Capital Gains Report for each account from PMA once your assets have transferred out. Some of you have already received this. There is a letter accompanying the report noting that the PMA system is unable to code the transfer out as a transfer and therefore codes it as a sale. The result is that all of the transfers out are shown as actual sales on this report with corresponding capital gains reported. **YOUR REALIZED CAPITAL GAINS ARE THEREFORE OVERSTATED.** Please send me this report as soon as possible, and I will correct it for you and mail it back to you with a copy to your accountant if you would like.

2006 Performance Calculations IMPORTANT FOR FORMER PMA CLIENTS

For those of you whose assets transferred before year end, you will not be receiving a final 2006 performance figure from PMA. I will be happy to calculate the performance for you but I will need some information to do so, all of which I do not currently have. I am waiting for year end transaction summaries from PMA. If you have your 9/30/06 market values and performance reports that you could mail, fax, email or call in to me, I would appreciate receiving that information. Once I have that information from you and the transaction summary from PMA, I will be able to calculate the performance for you.

Cost Basis Reporting for Statements IMPORTANT FOR FORMER PMA CLIENTS

As I receive the transaction summaries from PMA, I will input cost basis into our system so that you will see that information on your reports. The reports you are receiving today do not yet contain that information.

Tips for the New Year

As the new year begins, it is a good time to think about a few ideas that will help you achieve your financial goals. If you want to discuss any of them, please feel free to call me.

- **GOALS:** Think about and write down your financial goals. You are more likely to achieve goals you have written down. Also, goals change over time so now is as good a time as any to revisit old goals and create new ones.
- **WILLS:** If you have not reviewed your will in the past five years, call your attorney to have he or she review it with you to determine if it still reflects your current wishes. Also, make sure that your assets are titled correctly to reflect the intentions of your will. Estate tax exemption levels are increasing as are your assets. It is important that your estate is set up to take advantage of the exemption levels as estate taxes run about 50%.
- **SAVING FOR RETIREMENT:** Maximize your contributions to retirement plans, either through work or through IRAs.
- **ROTH IRAS:** If you are eligible to make contributions to a Roth IRA or do a conversion of a regular IRA to a Roth IRA, consider doing so.
- **CATCH UP PROVISIONS:** If you are over 50 years old, you can contribute an extra \$5,000 in 2007 to a 401k and an extra \$1,000 to an IRA.
- **AUTOMATIC MONTHLY SAVINGS:** Pay yourself before you pay others – if you can save on a monthly basis and have it taken directly from your bank account to your investment account, this money will add up over time.