ADDING VALUE

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SUMMARY:

Sometimes it is worthwhile to compare where we've been and where we're going. The New Year presents such an opportunity, especially when it heralds the long-awaited BBB – "Boomer Birthday Bash."

Fourth Quarter Investment Review and Outlook

Happy Birthday, Boomers

Everyone looks forward to a new year with excitement and some trepidation. We view it as a chance to take a long-awaited vacation, to make a resolution for improving our health and diet, or to enhance our educational interests. 2006 is important for another reason; it will be the first year of a huge and ongoing birthday party. In 2006, the first members of the Baby Boom generation turn 60. We can expect to send birthday cards to President and Mrs. Bush, Donald Trump, Cher, Sally Field, Diane Keaton, Candice Bergen, Steven Spielberg, Bill Clinton, among many others. These Boomers are vital, visible, assured, veterans of failure, beneficiaries of their parent's financial prudence, and seekers of wisdom. From the time that they started their life's work at age 30 in the 1970's, some things have changed and others haven't. Here's what was happening then:

- Nixon visited China, hoping to build a "generation of peace."
- Nixon accepted responsibility for Watergate and resigned rather than being impeached.
- The oil-embargo formed by the Middle East oil-producing companies (OPEC) harshly hit the world. In the U.S., gas rations were set at 8 gallons per week and crude oil was priced at $1/barrel.
- Cher divorced Sonny Bono.
- Steven Spielberg produced Jaws.
- Wheel of Fortune debuted on NBC.
- Chrysler Corporation offered the 1st car rebates.
- President Ford declared an end to the Vietnam Era after 46,000 Americans died from combat, 11,000 died from non-combat, and 303,000 were wounded.
- James Rupers killed his family for the inheritance.
- Ice thickness at Wilkes Land, Antarctica was 4776 meters (15,669 feet).
- First televised kidney transplant was seen.
- One-day admission to the Magic Kingdom (including seven rides) when Walt Disney World opened in 1971 was $4.75.
- Steelers beat Minnesota with a score of 16 to 6 in Superbowl IX.
- Black September guerillas hit the Munich Olympics killing 11 Israeli athletes.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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Science tells us that the brain changes continually as a result of our life experiences. Experiences are the reason that all individuals are unique. There are no individuals with exactly the same upbringing, nutrition, education, social stamping, physical, social, and cultural setting. For the vast majority of American and European men and women today, the 60's will be a stage where the maximum of freedom of choice co-exists with a minimum of physical limitations. A great many of these Boomers will live to their 90's, in other words, they are at the cusp of their Second Adulthood, the second 30 years. Governed as they are by the experiences of the first 30 years, we use this newsletter to ponder how they will resolve some of the financial problems lurking on the sidelines.

Financially, we think some of the challenges that have been incubating and will now play out over the next 30 years are:

- Collectively, China and India represent about 40% of the world's population and 19% of world's Gross Domestic Product as measured by the International Monetary Fund's purchasing-power-parity metrics. Together they also account for about 25% of all scientists and engineers in the world today. The population of China and India are younger than the rest of the world by a wide margin. The low-wage workers of these countries enjoy the functional equivalent of real-time connectivity to distribution systems and computers around the world. Further these workers are hardworking, industrious, and hungry for success. An extrapolation of the recent accomplishments of these countries poses a profound question for the rich nations of the developed world: If India and China can both improve the balance and sustainability of their already powerful growth models, what does the future hold for us? Thank you, Richard Nixon, for awakening this giant economy 30 years ago.
- America's massive external deficit, on track to account for 70% of all the world's deficits this year, seems set to get even worse in the years ahead. And, U.S. consumption remains at a record 71% of GDP, well in excess of shares in Europe (58%), Japan (55%) and China (42%). How much bigger can houses get and how much more stuff can we accumulate?
- Suffering its greatest shortfall of domestic savings in modern history (a net national saving rate that has averaged just 1.5% of GDP since early 2002 as calculated by Morgan Stanley), the U.S. lacks the internal wherewithal to support investment in public goods such as infrastructure, homeland security, and a safety net for the underclass. When saving short America needs funding, it turns to the rest of the world to provide capital. Global lenders have been delighted to lend the U.S. money at extremely generous financing terms. What will happen when global lenders stop the flow of capital to the U.S.?
- We have seen a lot of bankruptcies in corporate America, but the recent Delphi bankruptcy seems to us to be a big deal. (Delphi is the auto parts supplier that was spun out of GM in 1999.) It is emblematic of a new set of powerful structural pressures bearing down on the U.S. For the first time in history, 2006 may mark a year in which the U.S. loses dominance in a prime manufacturing industry-automobiles. Interestingly enough, the first inkling of the decline began 30 years ago when foreign auto sales first rounded to a 1% penetration of the total automobile market. Now some 30 years later, it is projected to be 30%. That is truly an insidious and inexorable increase.

- A further question of this bankruptcy gives rise to the potential ripple effect of systemic risk and the funding of legacy costs. As part of the 1999 spin-off, GM agreed to guarantee pensions, post-retirement healthcare, and life insurance for certain Delphi UAW workers-guarantees that Morgan Stanley's fixed income team believe amounts to around $3.8 billion. Systemic risk never enters the mindset of liquidity driven markets until it is too late. Systemic risk is analogous to rush hour traffic when everyone leaves the city by the same route at the same time. Pandemonium results. Is this systemic risk lurking in other areas of our financial system and if so, what is it and what will be the consequences?
- Just as Baby Boomers get ready to use the "fruits of their labors," companies in record numbers announce the termination of their defined benefit (DB) plans. (The first announcement of 2006 was IBM's announcement to discontinue its DB Plan.) The Pension Benefit Guaranty Corporation puts the funding gap (the difference between assets and the amount to be paid out) at $450 billion for single-employer plans, another $150 billion for multi-employer plans and approximately $1.5 trillion for state and local governments. These claims were always viewed by America as a problem with a very distant future. Just as the Baby Boomers retire, that very distant future may be now. Again using Delphi as an example, we don't think Delphi is similar to the failures of WorldCom and Enron, instead it reflects the pressures of global competition, bloated labor costs, and the enormous legacy of increasingly onerous corporate retirement benefits.

As we ponder these questions as Baby Boomers ourselves, we come to some conclusions that we incorporate into the investment portfolios that we manage for you:

- Corporate pension funds are a prize tool of financial engineering. In 1981, when long-term U.S. Treasury bonds yielded 13.0%, the projected plan return was 7%. Currently, with bond yields at 4.7%, the projected return averages about 8.5%. The numbers just don't work. As we analyze portfolios, we are very aware of those companies who have contingent pension liabilities that are problematical; and, if possible, stay away from investing in them.
- We have never had the U.S.-centric approach to asset allocation as many of our competitors. Generally, our portfolios have at least double the international allocation, and sometimes even triple the allocation of our competitors. In addition, we believe that indexing international portfolios is sub-optimal and that active international management does make a difference. Every one of our significant international holdings has exceeded its benchmark over the 5-year period. By the way, most of these managers have closed their funds to new investors.
- We think about America's unquestioned supremacy in the global restructuring sweepstakes. The U.S. penchant for shredding social contracts and forcing bad companies out of business was an aspect of "flexibility" that other countries were reluctant to adopt (think Japan and Germany). Today, after more than a decade of restructuring, Japan may be on the cusp of producing better results. Germany has at last grasped the problem and seems to be taking the necessary action to improve their economic position. Our international positions in Japan are increasing annually. On average, our broadly mandated inter-

national managers now hold over 15% of their assets in Japan.
- Real estate investments have performed admirably over the past 5 years. (Our largest position has had an average annual return of approximately 20% per annum for this period.) We haven't added to our real estate positions in 2005 nor do we expect to in 2006, primarily because the capitalization rate is so high. For instance, investors are now buying second homes in California at purchase prices of $1,200,000 to receive $24,000 in rental income. Wow, we hope the prices continue to climb, because that is the only thing that will make the investment acceptable.

A quote from Silas Marner, a popular high school English book read by the Boomers, states: "The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent."

So here we are with the first Baby Boomers celebrating their 60th birthdays and what have we learned in 30 years:

- Nixon awoke the sleeping dragon 30 years ago.
- The price of a limited resource (oil) will fluctuate, but the price will always end at a higher level.
- GM used rebates first introduced 30 years ago to such a degree in 2005 that it has virtually no showroom traffic in 2006.
- One-day admission to Walt Disney World now costs $59.75.
- Steven Spielberg produces Munich based on traumatic events of his 30th birthday.
- The Steelers are headed for the AFC finals in Superbowl XL contention.
- The Apprentice, by Donald Trump, is a hit show.
- It takes a long time to melt 15,669 feet of ice in Antarctica, but it is melting.
- Financial engineering only postpones the impact of bad decisions.
- President Bush declares a winding down of war in Iraq after casualties reach 2,000 Americans.
- Terrorism reaches new levels of angst.

Yes, as the Baby Boomers celebrate their birthdays and seek wisdom to approach their next and last 30 years, they will face the challenges of rebalancing an increasingly unbalanced world. We have had a 30-year lapse of time, when our financial fears have not been realized and America stands as the greatest nation on earth. Let's hope that these wise boomers at 60 have the wherewithal to adapt and thrive in a globally challenging environment. The problem is not that they don't see the potential issues, but rather their avoidance of the issue until it becomes a catastrophe. We come to work every day seeking to avoid catastrophes. Happy Birthday, Boomers! Happy Birthday, to ourselves!

Sincerely,

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