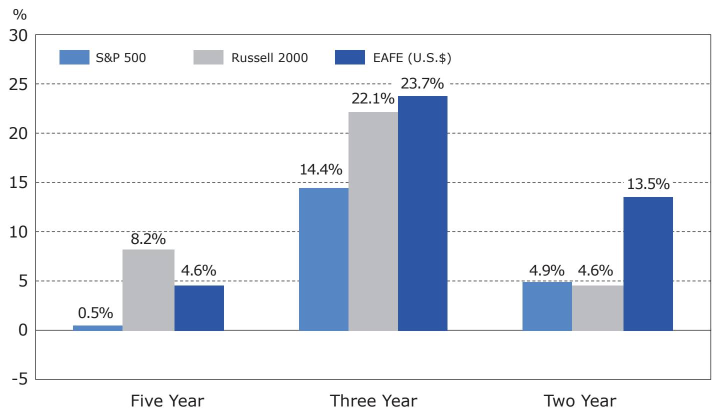
For the year 2005, U.S. stock markets appreciated modestly, as shown in Exhibit 1 to the right. Within sectors, energy was the star performer, up 32%, followed by utilities, up 16%. Otherwise, it was hard to find broad areas of support. Other sectors provided lackluster to down results, as market leadership was narrow. Discretionary consumer goods brought up the rear, down 6%, which includes the very poor performing auto and related companies.

Foreign stocks had an outstanding year in local terms, up 29%. The dollar appreciated over 14% against both the Euro and Yen, but the year was still quite good for foreign securities in U.S. dollar terms, with developed markets up 14%.

Bond markets had a dull year, increasing 2%-3% on a total return basis, indistinguishable from cash. Among alternatives, hedged strategies posted positive but modest results, while both real estate and private equity provided very good returns.

Exhibit 1: Historic Performance - Annualized



Overview

The world remains a frustrating place for professional investors. Our dilemma is that the fundamental economic condition continues positive, while the risk/reward equation for investment markets remains uninspiring.

On the economic front, global economic conditions continue in a positive trend. While economic growth in the U.S. is expected to moderate, as consumer spending slows due to higher short-term interest rates, a less buoyant housing market and higher oil prices, the rest of the world seems to be strengthening. Europe and Japan show improving signs and emerging markets continue to boom. The likely result should be more balanced and diversified economic growth around the world. The U.S. and China have been the primary engines of growth carrying the world.

Some prominent economists now see an extended era of continuing global growth and low inflation fueled by the industrialization of China and other emerging markets in Asia, Eastern Europe, and Latin America, and restructuring and rationalization in Europe and Japan. The primary force in this scenario continues to be China and other emerging countries whose drive to industrialize their societies combines low wage costs with modern manufacturing technology. This combination continues to push unit production costs lower, thus containing inflationary tendencies of sustained high growth.

As an example of the scale of these efforts, over 60% of China's population remains in rural poverty and it is China's announced intention under its form of "totalitarianism capitalism" to move 400 million of its population into a more industrialized society over the next ten years. In order to accommodate this, the world's manufacturing base would continue migrating to the developing world, while mature societies would continue restructuring to accommodate this trend, migrating to higher value and more services-orientated roles. The U.S. has been in the forefront of this trend. Europe and Japan have lagged, creating the potential for significant restructuring in those societies going forward.

These trends are textbook cases of the law of comparative advantage and, if sustained over a long period of time, would likely benefit the worldwide community. This assumes that this trend can be tolerated from a political standpoint and is not derailed by some financial accident or geopolitical upheaval.

Within the corporate world, conditions are also benign. Profit margins remain near historic highs. Balance sheets for most companies remain in good shape, despite deterioration in lower-quality credits. These conditions are worldwide, as Japanese and European companies have moved ahead with restructuring and rationalization without much help from their governments. The improving trend overseas has largely escaped the media, but not foreign stock markets, as their recent performance bears out.

While some moderation in economic and corporate performance is expected, the current positive trend is well established. Moreover, such trends have a tendency to be self-reinforcing, with improving performance ultimately leading to new job creation and corporate and consumer spending, which produces higher profits and so on. The risks to this rosy outlook fall into three camps: imbalances within the world economy, terrorist and other geopolitical issues, and pandemic.

- The imbalances stem from the fact that the world economy is not in equilibrium and has not been so for quite some time. The imbalances include the record U.S. trade and current account deficits, inflation in housing prices, and the fact that corporate profit margins are far above long-term trends and have a long-standing, mean reverting tendency. Nearly every economist will tell you that these conditions are not indefinitely sustainable and must come back into greater balance. But they will also tell you that they can remain in place well into the future. How and over what period of time the imbalances are resolved may or may not result in economic decline and disruption of investment and currency markets. As a result, these imbalances contain risk for worldwide economic conditions, and especially investment markets.

- Geopolitical events entail too many possibilities to mention. However, protectionism is a much discussed threat, importantly in the U.S. Given the U.S.'s vibrant economy and a relatively low unemployment rate, we seem to be weathering the transformation that the globalization of trade is causing, but those who are temporarily or permanently disadvantaged are very vocal and their plight can be heartbreaking. An outbreak of protectionism in the U.S. would do major damage to worldwide trade conditions, as the U.S. has been the world's leader in encouraging trade for the worldwide community.

- A terrorist threat is likely to be a more transitory issue despite its fearsome character. A major terrorist event would undoubtedly create shock and immediate decline in investment markets, but the decline is likely to be temporary. The world has usually lived with some form of major threat. The Cold War lasted for over 50 years and at times was quite dangerous. We suspect that the world has learned to live with the terrorist threat. The effects of the recent events in Spain and London would seem to indicate this, although much worse events are certainly possible and could have a greater effect.

- A true pandemic is the greatest threat, but hopefully the least likely. If consumers in many countries were to become afraid to gather for work, shopping, or other purposes the worldwide economy could be badly damaged.

In a general sense, most investment markets remain priced at levels that, by historical standards, would present a poor risk/reward tradeoff, caused by a world awash in liquidity in every asset class and a relatively high state of investor complacency. Investor complacency is reflected in low credit spreads in fixed income markets, full stock market valuation, and low volatility in all investment markets. Historically, a significantly higher risk premium or lower valuations would have been required by investors.

This does not mean that investment markets have to decline. In fact, if the expectation of continued good worldwide economic growth with low inflation were to persist without a financial accident or other disruption, it is quite possible that investors will become still more complacent and will further "re-rate" historical valuations upward. The rationale would be that the world has entered a "new era" of greater stability, higher growth potential, and very modest inflation, which justifies reducing the risk premia historically afforded assets in less attractive times. Especially in a world awash in liquidity, this would justify investing for significantly lower returns and at lower valuations. In the adjustment process, strong investment market performance, and possibly additional bubbles, could ensue.

Some professional investors have described the current scenario as a global game of chicken. If you do not participate, you could face a sustained period of poor returns for your clients if markets do not fall or they simply "muddle" through without providing a buying opportunity. If you buy into the "new era" scenario and one or more of the major risks come home to roost, you risk major losses for your clients.

It is important to note that the changes of the type discussed above often require years to unfold and the risks and imbalances we are discussing may persist for prolonged periods of time. While these uncertainties persist, markets will remain vulnerable and such periods are likely to lead to sub-par return potential going forward. We are hopeful that these risks and the imbalances which have created them will be slowly mitigated over time as we "muddle through" the period ahead. There is a risk that they could be resolved more violently and with greater damage to the worldwide economy and financial markets.

This is the world we live in and we cannot change it. So let's look at the investment markets themselves and how to best navigate the current conditions.

Domestic Equities

For 2005, securities analysts believe operating earnings for the S&P 500 increased 13%. For 2006, an additional 12% increase is currently expected. The long-term average is about 8%.

The S&P 500 is trading at about 17x projected 2005 earnings and about 15x projected 2006 earnings. The long-term average for the P/E ratio on forward earnings is about 15x, although these data mix reporting and operating results. In more recent years, when operating data were used, the forward average is about 12x.

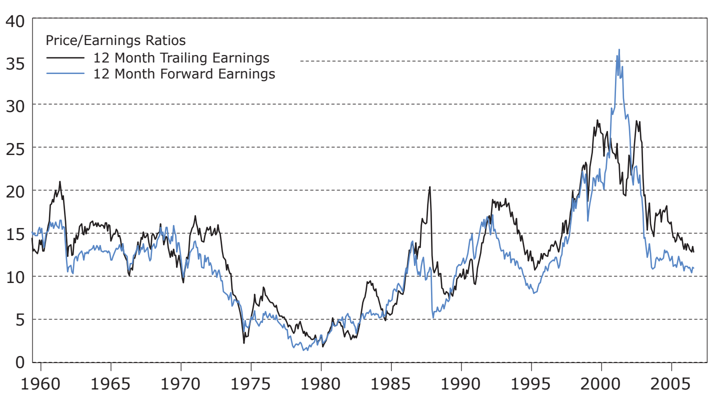
Earnings data have become cloudier in recent times for two reasons:

- Energy companies have been an extraordinary contributor that may diminish greatly in 2006 and beyond. Exxon alone accounted for over 5% of the S&P 500 earnings in the fourth quarter.

- While stock buybacks are good for investors, they boost reported per share earnings increases. For example, one analyst noted that the third-quarter year-over-year earnings increase for the S&P 500 was 11% as reported, but only 8% if you back out the effects of the buybacks.

It is certainly fair to say that the combination of increasing corporate earnings and stagnant stock markets have improved the valuation of U.S. stocks and, with price earnings ratios now at their lowest point since the late 1990s, the subject of fair valuation can be expected to be hotly debated. (See **Exhibit 2** below)

Exhibit 2: The Standard & Poor's 500 Stock Index



The P/E Ratios are calculated using Reported Earnings prior to 1988 and Operating Earnings from 1988 to the present.
Last Observations December 2005

Source: Standard & Poor's

While the P/E ratio of the S&P 500 is not low by historic standards, those who support fair valuation note low levels of interest rates and inflation, apparent economic stability as GDP marches upward, continuing high corporate profit margins, low levels of volatility, and a high degree of liquidity available to corporations and investors.

All of these factors tend to make investors very "comfortable." One of our managers has recently done a study indicating that high P/E ratios are often associated with these periods of investor "comfort." With the Federal Reserve expected to end its long series of short-term interest rate hikes, the possibility of the Iraq War winding down, and other factors, some investors believe the stock market could sell at substantially higher levels in the near-term. They also point out that valuation levels in the U.S. are much more competitive with foreign counterparts after the substantial out-performance by foreign stocks in recent times.

The potential problem with this argument is that some of the factors supporting investor comfort and complacency are mean reverting, for example, high corporate profit margin levels. U.S. profit margins are in the top five percent of historical experience. If both profit margins and P/E ratios decline to historical norms, the S&P 500 could decline from about 1200 to 800. Other vulnerabilities include the existing imbalances in the worldwide financial system and other risks discussed above that could disrupt financial markets.

As mentioned in prior reports, larger, higher-quality companies have become relatively cheap in today's stock market. The largest 25 companies in the S&P 500 were recently at a 20-year low in terms of their valuation relative to the index. The last time we neared this level was in 1991, after which large caps outperformed significantly. This suggests greater investment in larger, higher-quality companies, and even indexing.

However, there may be other factors at play. First, some of these companies face societal constraints on their growth, such as Wal-Mart and Microsoft. In addition, the major drug companies face difficult regulatory and pricing problems. Second, a number of very large financial institutions contain a leveraged and a trading-oriented posture that may be deserving of lower valuation. Finally, these larger and higher-quality companies tend to out-perform in less buoyant times. If the world is going to provide relatively high growth, low inflation, lots of liquidity and a resulting tendency toward riskier assets, then this may not yet be the moment for large, higher-quality companies. As a result, for now we will leave the question of greater investment in such companies in the better-qualified hands of our active managers who will select them on a company-by-company basis when they are attractive, and some are doing so.

International Equities

Developed foreign stock markets appreciated 14% in 2005 in dollar terms and 29% in local currency. In local currency, the Pacific (+38%) outperformed Europe (+25%). Emerging markets were up 35% for the year in U.S. dollars. Currency effects significantly reduced returns to U.S. investors. For example, the U.S. dollar appreciated by over 14% against both the Euro and the Yen.

While we continue to believe foreign stocks offer better opportunities than U.S. stocks, our view is based less on valuation now. For example, while European markets continue to sell at a 15%-20% discount to U.S. companies, their long-term growth rate in earnings is expected to be slower, which justifies a lower P/E ratio. What a purely valuation analysis misses, however, is the potential for restructuring and rationalization to improve corporate profitability, which has lagged that of the U.S. While both European and Japanese companies have lagged the U.S. significantly in acclimating to the new imperatives of trade globalization, the process is underway and contains the ability for a "catch-up" to the U.S. through measures that have already taken place in the U.S. to improve profitability. The current wave of activism sweeping over major stock markets and less inhibition to such influences through reduced corporate cross-ownership and governmental interference is likely to encourage such changes over the next few years. As a result, we believe it is possible that European and Japanese profits could diverge positively from the slower growing economic trends in those countries.

Japan and China deserve a special note in our discussion, given their potential importance going forward. In all the developed world, Japan likely has the greatest potential for a revival in economic and corporate performance. This has not gone unrecognized, as Japan's stock market increased 40% in local terms in 2005 and has doubled from its bottom in 2003. Given this extraordinary rise, some correction in Japanese markets seems quite plausible in the near-term, but the long-term is potentially attractive for investors in Japanese companies, particularly those below the top level.

While Japan has a number of ongoing problems (e.g., high government debt as a percent of GDP, aging population, etc.) the rationalization of much of the banking system, the elimination of most of the large cross-holdings of securities that insulated management and a more optimistic view by corporate management have moved Japan a long way toward a more enlightened view of their obligations to shareholders. At the same time, many mid- to smaller-sized companies in Japan retain very inefficient balance sheets (e.g., too much cash), are overly diversified and have unfocused product lines.

These conditions cry out for rationalization and lend themselves to the wave of activism and better corporate governance which is sweeping through developed markets around the world. Also, the surge in the Japanese market has largely been driven by foreign investors. Japanese institutions and individuals remain underexposed to equities. Should they join in, markets would be further supported. While markets in Japan will face increasing interest rates and other headwinds over time, Japan's symbiosis with the boom in China, better political leadership, and improving consumer and corporate leadership provide the potential for unusual change.

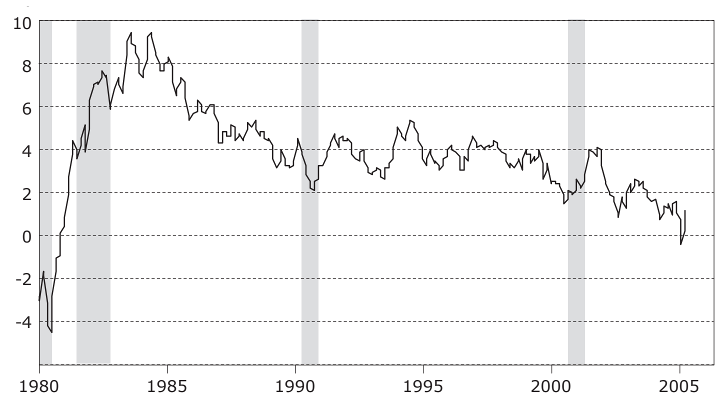
We earlier noted the economic potential of China as it industrializes. While China has been intriguing for some time, direct investment in China was largely out of the question for all but the most risk-tolerant investors. In the last year or so, however, it appears that China may have become "investable," as the Chinese government has made strides in rationalizing its ownership of inefficient state-controlled companies and the large backlog of bad loans in its banking system. At this point, such opportunities still create high risks, are importantly illiquid and must be considered more like private equity investing. However, the Chinese government seems to be putting forces in motion which will allow a level of potential profitability which justifies the risks of investing there.

Fixed Income

Bond markets provided sub-par returns to investors in 2005, but this is actually a somewhat positive outcome given the negative views of investors (including ourselves) at the outset of the year. Most investors had expected significant increases in interest rates and inflation over 2004-2005, which would have created a much worse result for the bond market. For 2005, 10-year U.S. Treasuries and intermediate municipals returned nearly 2%, and intermediate corporates returned about 1%. The U.S high-yield market returned about 3%, while emerging country debt returned about 12%.

Like many investors, we have been negative on the bond market for some time. We believe the 20-year bull market in bonds likely ran its course in 2003. At current rates of inflation, real short- and long-term rates remain well below historical norms. (See **Exhibit 3**). However, the deflationary force of continuing trade globalization may result in flat trends in inflation and interest rates for some time, despite a healthy worldwide economic growth rate.

Exhibit 3: Real Interest Rates - 10 Year Governments - CPI (YTY%)



Source: Federal Reserve Board © 2006 Crandall, Pierce & Company

We should also comment on the shape of the yield curve as the U.S. Treasury curve flattened, and briefly inverted, during the fourth quarter. While an inverted yield curve is not rare, its occurrence historically presaged an economic downturn. Historically, long-term interest rates rise to some degree in sympathy with increasing short-term rates. However, in our increasingly interconnected global bond market, the relatively lower interest rates in other developed countries acted as a weight on U.S. rates, prohibiting the creation of a substantial yield gap between these instruments. For these reasons, we downplay the significance of the inverted yield curve and its portent of recession in the U.S. economy. Interestingly, many observers view the demand created by relatively high U.S. interest rates as one of the contributing factors to the strong performance of the U.S. dollar in 2005.

We would be remiss if we did not mention the risks of this expectation. U.S. fiscal policy remains remarkable for its lack of restraint. On top of the Iraq War, the costs of Hurricanes Katrina and Rita are likely to keep federal deficits at a substantial level despite increasing tax receipts. Typically, this would call for a combination of spending restraint and tax increases. While efforts have been made, little has been accomplished in the current divisive political environment. Moreover, if the trade and fiscal deficits of the U.S. are to be moderated at some point in the future, many believe a decline in the value of the U.S. dollar will be required, which is also likely to increase inflation and interest rates in the U.S.

While we have become more sanguine concerning interest rate trends, we remain concerned about credit issues. Complacency in bond markets has been especially evident in historically low credit spreads and deteriorating credit analysis.

- We are in transition from an era of bondfriendly transactions, as corporations improved balance sheets and increased cash positions, to an era focused more on actions friendly to equity holders, as more aggressive use of balance sheets by corporations is sought through such measures as stock buybacks and acquisitions. The recent spate of leveraged buyouts has the potential to force much more aggressive use of balance sheets, in some cases reducing investment grade debt to junk overnight.

- The enormous issuance of high yield debt in recent years has completely changed the quality of the corporate bond sector. Today, two thirds of corporate bond debt is rated as "junk" versus 3% in 1980. While some of this change has been caused by the downgrade of some very large companies, such as GM and Ford, the high yield corporate bond market now accounts for $3 trillion, not much less than the Treasury market at $4 trillion.

- Price based risk modeling concepts have importantly replaced experienced credit analysis. Such models and the tranche structuring on Wall Street combine to produce derivative instruments of great complexity that are very difficult to analyze. These models are untried. Moreover, the decoupling of ownership and accountability for risk assessment created through the growth of conduit asset backed financing, as loan originators no longer retain loans, is unhealthy for the quality of risk analysis. Not long ago, Warren Buffet described certain derivatives as "financial weapons of mass destruction." We hope time does not prove him right.

- The explosive growth of credit default swaps may have anesthetized the buyers of high yield debt as they may hedge the credit risk they buy and accept the higher interest rates of high yield debt. The credit default swap carries not only the risk of untried derivatives generally, but many of the contracts are custom arrangements that are difficult to track and settle in the rapid trading environment of these markets. This settlement issue has yet to be resolved and the Federal Reserve is clearly now focused on it. Currently, exactly who bears what risk may not be clearly defined.

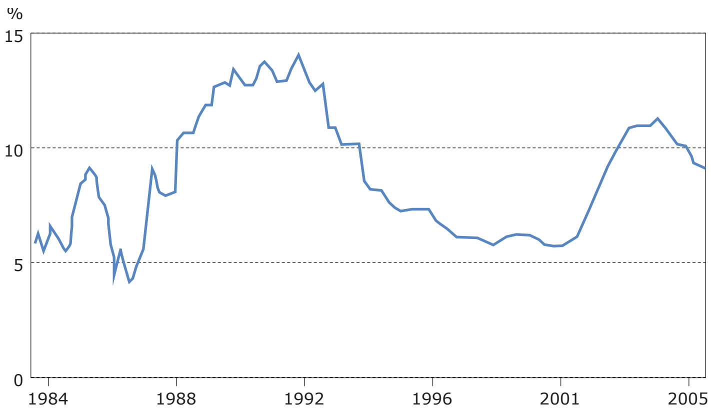
At some point, the extraordinary issuance of high yield debt is likely to lead to investment opportunity and we are alert to that. It is interesting to note that U.S. high yield corporate debt carries an interest rate significantly higher than emerging market debt now. However, if we are in an era of good economic growth and continuing low interest rates, we may have to wait a while. Typically, major opportunities in distressed debt are caused by an economic downturn or a period of heightened lending requirements and interest rates.

Real Estate

As of September 30, returns for privately held, unlevered, core U.S. real estate properties were estimated at 14% in the first nine months of 2005 and 19% year over year. The year over year return is the highest in 20 years. These are the most recently published data and reflect real estate's substantial current yield plus appreciation. REITs increased about 14% for 2005.

Operating trends in the U.S. are improving, especially on the coasts. Real estate is highly correlated to growth and economic activity, with a lag. As a result, recent growth trends are bullish for real estate operations. Gross rents are beginning to increase and vacancy rates continue to decline, although they still remain high, especially in office markets (13% vacancy). (See **Exhibit 4**). New development is relatively quiescent, except in retail.

Exhibit 4: NCRIEF Vacancy



On the other hand, operating costs have increased with higher fuel and construction costs. While these increased costs are eventually recovered, the lag can be significant in office, industrial, and hotels.

Retail continues to represent a potential problem. Strong consumer spending over the last several years has caused a significant increase in the pipeline of new development. If growth in consumer spending does decline over the new year or so, the retail sector could be faced with a combination of increased supply and declining demand.

Capital markets continue to love real estate and valuation levels remain quite high. At this point, some of our real estate managers believe that valuations have overshot fair value. However, they also expect that current valuations are not likely to fall much, absent a recession.

Real estate's popularity reflects the fact that it is currently very competitive with other asset classes in today's low-return environment. The perceived stability of contractual rent with built in inflation in rates, its ability to grow in value along with economic activity and its relatively high current return are the foundations of real estate's attraction. The low interest rate environment and easy lending conditions are also helpful to real estate, as they allow positive leverage to be applied to enhance both the current and the capital return of real estate.

Real estate is also in a positive secular trend as it moves from a marginal asset class into greater acceptance as a mainstream investment area. In part, this simply reflects its recent appreciation, which has attracted attention. It is also supported by increasing transparency as well as more active and liquid markets, although the asset remains inherently illiquid.

The attraction of real estate is not limited to the U.S., as greater understanding of the legal and political framework in which real estate assets are acquired and owned around the world has led to greater cross-border real estate investing. By expanding our range of activity into the international arena, we benefit from a larger set of opportunities in areas where real estate investing is potentially less competitive and advanced. There are also interesting diversification benefits, as real estate investment cycles are not as synchronized across borders as are bond and stock markets.

With interest rates expected to remain flat or to rise slowly, and given our expectation for a continuing low-return world, real estate pricing could remain elevated for some time. Given the inefficient and property specific nature of real estate investing, this presents the opportunity to find underdeveloped or unrecognized opportunities that can be improved and properly marketed in this attractive market for sale, almost as a kind of arbitrage. For this reason, we are relatively positive on real estate investing in the intermediate term. In the long-term, an expanding economy is likely to lead to increasing rents and operating income, and we expect real estate to continue to gain traction as a mainstream asset class, both in the U.S. and overseas.

Public markets for REITs have been one of the best performing sectors of U.S. equity markets over the last several years. We prefer private markets for real estate investing currently, however, given the much greater size of the non-securitized real estate market and the pricing and operational inefficiencies that are more prevalent there.

Hedged Strategies

Although hedge fund indices are seriously flawed and must be viewed as more anecdotal than factual, they indicate hedged strategies returned about 5% for 2005.

While investor expectations as to the benefits of hedge funds remain exaggerated, they are beginning to become more realistic given modest returns in recent years. In great part, this reflects the increasingly crowded field and the fact that a number of hedged strategies cannot accommodate large amounts of capital. To give you an idea of the scale of the competitive issue, consider the fact that while hedge funds have grown enormously, now with assets under management of over $1 trillion, the proprietary trading desks of financial institutions have grown even faster and now account for over $4 trillion of assets invested in many of the same strategies. The investor's predicament is further compromised by the fact that many of the best managers have reached very large size and have closed to new investors, or even additional capital from existing investors.

To accommodate this highly competitive environment, a number of the larger and better managed hedge funds have diversified their approach and moved further afield. Many have moved from a single strategy to multiple strategies. Some have move into leveraged buyouts or other forms of private equity and even into direct high-yield lending. Some resemble a merchant bank.

Our expectation for hedged strategies remains for returns below historical levels. The large flow of money to hedged strategies is likely to lower returns for a sustained period. While our managers have exceeded their benchmark for hedged strategies of Treasury bills plus 5% by a comfortable margin in the last ten years, they may be hard pressed to reach that benchmark in the next several years due to the amount of competitive capital at work in the field.

Despite the muted outlook, we remain interested in the area because we believe it attracts the most talented managers and that the long/short strategy is a powerful and potentially positive investment tool in the hands of the right manager. The challenge is to be sure one has a talented manager who has the understanding and ability to deal productively with the hedge fund format, including the risks of leverage and the unlimited loss

Private Equity

Although private equity indices are flawed, Venture Economics reported a 20% increase for venture capital funds for the twelve months ended September 30, and a 26% increase for buyout funds. This data is the latest available.

Recent conditions for buyout funds have been unusually good. U.S. companies are still trying to rationalize their businesses and de-lever by selling off lagging operations. Lending conditions have been extraordinarily easy and the junk bond market is very accepting of low-grade credits. The range of market capitalization susceptible to a buyout has increased at the upper end, as some buyout funds have become very large and are amenable to club deals in which several funds, and even hedge funds, pool their resources to buy a company.

The result has been extraordinarily high short-term returns and a surge in the volume of large leverage buyouts in the U.S. and overseas. Current conditions have allowed larger LBOs to purchase an asset, install relatively short term improvements and to then refinance at much higher leverage, or tap the IPO market, to achieve extraordinarily high short-term returns. The increasing standards of corporate governance and the prevalence of activist investing are likely to continue to provide fairly fertile ground for buyout investing, especially overseas where the need for restructuring is greatest. The primary issue for buyout funds is likely to be price given large increases in the amount of investable capital in this field, as the number and size of buyout funds increase and as they are joined by some of the larger hedge funds.

Venture capital remains in an improving phase, as the level of underlying investment continues to increase. As venture capital markets have stabilized, investment levels have moved further into the seed and early stage investing areas and realizations have improved as the IPO market has been more open. Unfortunately, fundraising has run even faster. The shake-out from the bubble did not effectively reduce the number of players in any significant degree and the overhang of un-invested money is large and is not diminishing as the rate of additional fundraising is about equal to the amount invested by venture funds.

Summary

The good news is that the fundamentals of the global economy appear to be in reasonable shape and moving in a good trend. Most economists expect this condition to continue, although the trend may flatten if the U.S. slows very much.

The bad news is that investment markets are awash in liquidity, most are priced at or above historical valuation levels and investors appear very complacent as they migrate to riskier assets in search of return.

For "risk-conscious" investors such as ourselves and our clients, this is an uncomfortable situation, as it is difficult to find returns that justify risks we perceive. While we would prefer a more conducive world in which to deploy our client's capital, we cannot change the facts we face. We must simply determine how best to profit for the current environment while remaining very conscious of the risks we take in doing so.

Currently, we are focused as follows:

- Given the fact that all asset classes are over funded, we are in an unusual period of convergence in pricing trends across asset classes. One might say that market efficiency has come to asset allocation. As a result, we believe that asset allocation will be a less useful tool and that implementation within asset classes will be at a premium.

- Cash seems more inviting, with short-term rates at about 4%, but we are certain that attempts to move in and out of cash will provide poor results. As a result, despite the risk levels we have discussed above, we will remain fully invested, relying on broad diversity and fundamentally sound and experienced management to mitigate the risks we face.

- Continue to seek out the best investment talent we can recruit to work for our clients and be sure they are fundamentally focused on the absolute value they pay for assets. Simply buying something well is a primary risk reducing factor. Although assets may decline from the level at which one buys them, a fundamentally fair purchase price should eventually yield a reasonable return and avoid permanent loss of capital.

- Within stock markets, put greater emphasis on activist managers who can benefit from the trend toward better corporate governance and accountability to shareholders in unlocking values in companies who have not rationalized their businesses for the benefit of its shareholders. This is especially attractive in markets overseas where restructuring and rationalization have lagged that of the U.S.

- Maintain the current emphasis on foreign stocks. Given the recent out-performance of foreign stocks, the U.S. could be due for a period of out-performance. However, foreign companies have an opportunity to grow their profits at a rate disproportionate to the U.S. as they restructure and accommodate to the increasing globalization of trade.

- Within foreign stock markets, focus especially on the potential of activist strategies in Japan and on China in its transition to a risky but investable market. These measures are likely to require a higher tolerance for less liquidity and higher risk, supported by higher potential return.

- Maintain reduced bond exposure given relatively modest return potential, diminished credit quality, and tight spreads.

- To the degree possible, build real estate exposure, both in the U.S. and internationally. Operating fundamentals are in an improving phase and real estate continues to be a highly inefficient market, allowing our managers to find discreet opportunities that can provide attractive returns. As the institutional appeal of real estate investing grows, we seek to work with managers who will feed institutional appetites by creating assets that institutional capital desires.

- Maintain hedged strategies exposure, but migrate towards managers who have restrained their assets under management so that they can focus their investments on a relatively small number of top hedged strategies managers.

- Expand the traditional concept of "private equity" to include a broader range of nonmarketable investment strategies beyond the classic venture and buyout fund areas, as we and others have to dig harder to find opportunity in today's world, we are more frequently finding investment opportunities in the often less liquid "seams" between the converging worlds of traditional investment management, hedged strategies, and private equity.

Given our emphasis on investing based on fundamentally sound valuation, it is quite possible that the performance of our clients will lag popular indices in a world of investor complacency, higher tolerance for riskier assets and historically high valuation, as was the case in the late 1990s. While we do not believe we will approach anything like the "silliness" of the late 1990s, it is quite possible that the investment experience which will unfold in the next few years could once again reward those investors who are comfortable with a higher level of risk in the pursuit of high return as opposed to our more risk-conscious approach. We also believe that our clients may have to endure somewhat higher illiquidity as opportunities we currently perceive to be attractive tend to be in less liquid areas.