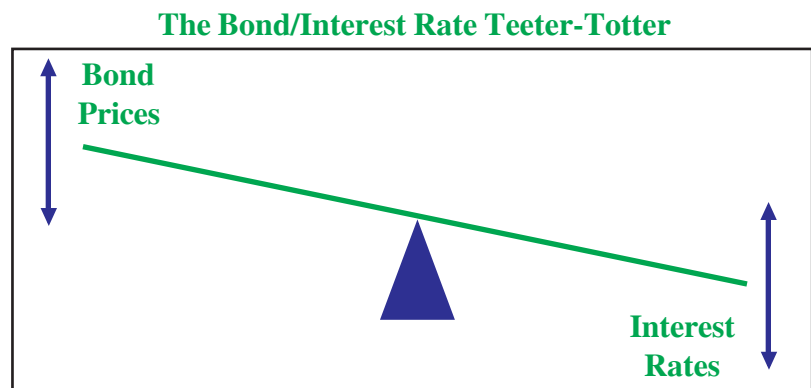


IT'S ALL ABOUT INTEREST RATES

Stock prices moved higher this past quarter pushing your portfolio to yet another benchmark high *despite* continuing economic concerns over rising oil prices and steadily increasing interest rates. Prudent portfolio management is a continual process of risk control, and we are using recent stock market strength to prune back portfolios and take more of an overall defensive investment stance. Over the next quarter we will continue to focus on protecting your recent stock gains and, as interest rates work their way to attractively higher levels, begin adding fixed income investments (bonds and notes) to portfolios. ***We believe one of the keys to success over the remainder of 2006 is adjusting to an increasingly harsh environment for stocks and more favorable one for bonds.*** Our plans call for making gradual portfolio shifts away from stocks and into the safety of bonds, currently sporting their highest yields in four years.

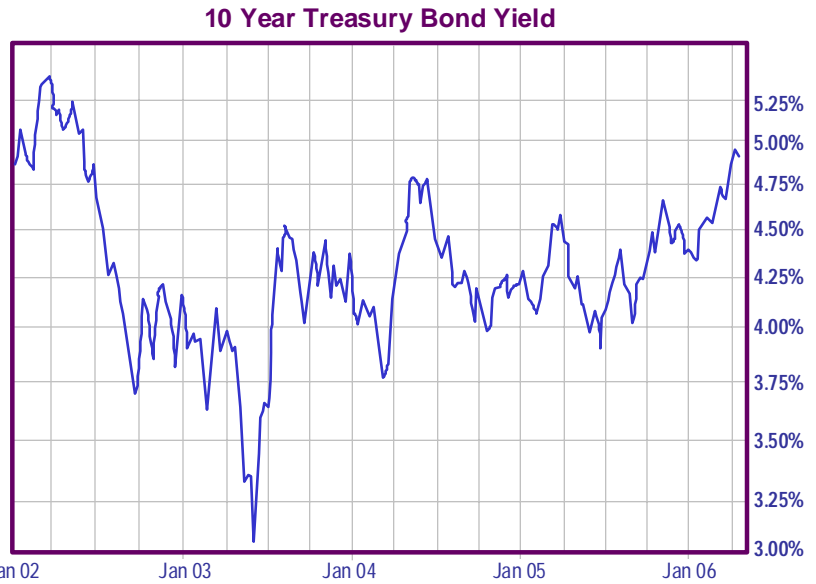
Bond price movements can confuse even relatively sophisticated investors, so we would like to briefly use recent history as an example to explain how bonds behave as interest rates change. ***The key to understanding bonds is to picture a teeter-totter with interest rates on one-side and bond prices on the other. Bond prices move in the opposite direction of***

interest rates. Our example will help illustrate their behavior. Please bear with us as we run through the math for you, but pay close attention because we do have a quiz for you at the end of the letter!



Just two years ago, money market funds were paying less than 1% and bond rates hit 50-year lows. The 10-year maturity US Treasury bond yield sank to a measly 3.1%. At the time, frantic investors scrambled to find extra return and were willing to accept only \$310/year of income (locked in for 10 years) on a \$10,000 bond investment. Today, the 10-year bond yields 5% or \$500/year of income — roughly 60% more earning power than two years ago. What would that 3.1% bond be valued at today? With current rates at 5% for 10-year bonds, the 3.1% bonds from two years ago have to be discounted in price to be sold in today's environment. In fact, that \$10,000 bond is now worth only about \$8,802. Even after including income received of \$620 (\$310/year times 2 years) the total return on the original \$10,000 investment amounts to only \$9,422 – a nearly 6%

loss! Impatient investors who did not understand the risks in bonds fell into a “yield trap” and experienced a costly and painful lesson. We avoided falling into the yield trap, and you now have more money to invest at higher rates. ***Recent history serves as a good bond market lesson; just because bonds are thought to be safe investments does not mean an investor can’t suffer a loss.*** When interest rates are low, bonds offer limited opportunity and carry above average risk.



Bond Yields Becoming Attractive

Now, however, the tables have turned full circle for bond investors.

The Federal Reserve is on a mission to cool off inflationary pressures and reign in an overheating economy (especially in real estate). We believe, by raising interest rates 15 consecutive times since June 2004, the Fed has almost accomplished their goal of slowing the economy down. When interest rates eventually peak for this cycle and move lower, bonds will appreciate in value. Using our previous example of the 10-year US Treasury bond, today’s investors not only receive higher income, but will also benefit from bond price appreciation as they become more valuable in a lower rate world. For example, over the next 12 months, should rates move from 5% today to say 4%; a \$10,000 bond will appreciate in value to \$10,744. Adding in \$500 in interest payments brings the total return to \$11,244 or **12.44%** (see table for details). You can see why we are getting excited about the potential for bonds to deliver excellent total returns (income + growth) over the next few years.

The next big investment opportunity for investors is taking advantage of this year’s higher interest rates by locking in yields and riding bond prices higher. (You can relax now; the math part of the newsletter is over!)

THE REWARD FOR LOWER INTEREST RATES

10 Year Treasury Bond - 5% Rate

If Rates Decline to	<i>*Total Return</i>		
	<u>1st year</u>	<u>2nd year</u>	<u>3rd year</u>
4.5%	+8.63%	+13.32%	+17.95%
4.0%	+12.44%	+16.73%	+21.00%
3.5%	+16.41%	+20.31%	+24.17%

**Total Return: Capital Appreciation plus Interest Income*

We intentionally avoided exposing portfolios to fixed rate bonds for the past few years because our business cycle research warned yields were too low and the price risks not worth the relatively paltry income. Instead, we correctly emphasized stocks,

especially higher dividend paying ones, for their income and growth opportunities. As stocks have moved higher over the last few years, and bond prices moved lower (remember the teeter-totter, when interest rates rise, bond prices decline) their relative attractiveness has begun to come more into balance.

While steadily increasing interest rates present good opportunities for bond investors, they unfortunately also increase the risk for the stock market. We are somewhat bothered by the media's notion, which is only wishful thinking, that somehow stocks can painlessly adjust to continued Fed tightening. Some suggest once the Fed stops raising rates, it will signal "all-clear" for stocks. That is highly unlikely and historically inaccurate. ***More typically, late in the tightening cycle stocks undergo a significant correction and only begin to do really well after the Fed begins to lower interest rates once again.*** We expect that new Fed Chairman Bernanke and his board of governors at the Federal Reserve will soon begin to see clear evidence that the economy is indeed slowing significantly — only then will the Fed stop raising rates. ***Our professional opinion is they could begin lowering rates again by the end of 2006, setting up the next business cycle expansion and bountiful rewards for both bond and stock investors.***

We continue to evaluate market conditions, search for low-risk opportunities, and gradually make appropriate adjustments to your portfolio as the business cycle evolves. We are ever mindful of your foremost goal, to protect your hard earned capital and grow it steadily and prudently. Thank you for your continued confidence. Please feel free to contact us should you have any questions regarding your portfolio.

Now for that quiz we promised! What happens to bond prices when interest rates go down? (See bottom of page for answer).

Quiz Answer: Bond prices go up when interest rates go down. If you missed the question your homework assignment is to reread the newsletter again!