



Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON

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SEPTEMBER 2006 COMMENTS

PLANNING FOR THE FUTURE OF PARK PIEDMONT ADVISORS:

As time passes, many of you have expressed an interest in how we are planning for the future continuity and growth of our business, and how this will benefit you. We therefore want you to know that we have a number of initiatives underway:

- Nick is now working jointly with Victor for a number of Victor's clients;
- We are actively looking to hire an additional investment professional to work with Victor's clients in the east, and a second person to work with Nick's clients in the west;
- Victor intends to continue working on a full time basis into the indefinite future; and
- We are interested in associating with currently practicing accountants who also have an interest in providing investment advice to their clients using the PPA methodology of setting an appropriate asset allocation and implementing with indexed investments. We have established three such associations to date. If you can refer an accountant who might be interested, please do so.

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Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

COMMENTS: INDEX RESULTS for period ending SEPTEMBER, 2006

<u>STOCKS</u>	<u>YEAR</u> <u>1999</u>	<u>YEAR</u> <u>2000</u>	<u>YEAR</u> <u>2001</u>	<u>YEAR</u> <u>2002</u>	<u>YEAR</u> <u>2003</u>	<u>YEAR</u> <u>2004</u>	<u>YEAR</u> <u>2005</u>	<u>YTD</u> <u>2006</u>	<u>CURR.</u> <u>MONTH</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6%)	(11.0%)	(21.0%)	28.4%	12.5%	6.0%	7.9%	2.4%
Standard & Poors 500 Index (2)	19.6%	(10.1%)	(13.0%)	(23.4%)	26.4%	9.0%	3.0%	7.0%	2.5%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2%)	(13.0%)	(23.7%)	25.9%	7.2%	5.1%	3.0%	2.9%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0%)	(20.9%)	32.2%	15.3%	7.1%	13.3%	2.3%
Dow Jones Industrial Average Index (2)	25.2%	(6.2%)	(7.1%)	(16.8%)	25.3%	3.2%	(0.6)%	9.0%	2.8%
NASDAQ Composite Index (2)	85.6%	(39.3%)	(21.0%)	(31.5%)	50.0%	8.6%	1.4%	2.4%	3.4%
Vanguard Midcap US Index Fund (1)	25.0%	2.6%	(4.8%)	(16.3%)	34.1%	20.4%	13.9%	5.8%	1.7%
Vanguard Smallcap US Index Fund (1)	19.6%	(4.2%)	1.0%	(21.6%)	45.6%	19.9%	7.4%	6.6%	0.9%
Vanguard International Index Fund (EAFE) (1)	25.3%	(15.2%)	(22.6%)	(17.5%)	40.3%	20.8%	15.6%	13.9%	0.3%
Vanguard Emerging Markets Index Fund (1)	61.6%	(21.6%)	(2.9%)	(7.4%)	57.7%	26.1%	32.1%	10.4%	0.9%
Vanguard Real Estate Invest. Trust Fund (1)	(0.4%)	26.4%	12.4%	3.8%	35.7%	30.8%	11.9%	23.8%	2.3%
<u>BONDS</u>									
Vanguard Total Bond Market Index (1)	(0.8%)	11.3%	8.3%	8.2%	4.0%	4.2%	2.4%	2.9%	0.9%
Vanguard Interm. Tax-Exempt Index Fund (1)	(2.9%)	9.2%	5.0%	7.9%	4.4%	3.2%	2.4%	3.3%	0.6%
Vanguard Short-term Bond Index (1)	2.1%	8.9%	8.9%	6.1%	3.4%	1.7%	1.3%	3.0%	0.6%
Vanguard Short Tax-Exempt Index Fund (1)	2.6%	4.9%	4.8%	3.5%	1.6%	1.1%	1.8%	2.4%	0.3%
Vanguard High-Yield Bond Fund (1)	NA	NA	NA	1.7%	17.2%	8.5%	2.8%	4.6%	1.3%
Vanguard Inflation-Pro- -tected Bond Fund (1)	NA	NA	7.6%	16.6%	8.0%	8.3%	2.6%	1.8%	0.2%

- 1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
- 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
		<u>1999</u>					<u>2000</u>					<u>2001</u>			
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
BONDS	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0			
Interm. Tax.															
		<u>2002</u>					<u>2003</u>					<u>2004</u>			
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
BONDS	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0			
Interm. Tax.															
		<u>2005</u>					<u>2006</u>					<u>2007</u>			
S&P 500	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2%								
NASDAQ	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9%								
BONDS	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8%								
Interm. Tax.															

SEPTEMBER 2006 COMMENTS

STOCK index prices were uniformly higher in September, for the second consecutive month. The headline news was that the Dow Industrials had almost reached their previous highs reached in 2000 (while the S&P 500 is still down 12% from its highs, and the NASDAQ down 55% from its highs, figures which are reported each month on page 4 of these Comments). For the month, the S&P 500, the Dow Industrials, the NASDAQ, and the Total Stock Market (TSM), which includes Midcap and Smallcap stocks, were up 2.5%, 2.8%, 3.4%, and 2.4%, respectively. Midcap and Smallcap gained less, at 1.7% and 0.9% respectively, while International and Emerging Market indexes gained even less, at 0.3% and 0.9%, respectively. The REIT index gained (for it) a modest 2.3%, but is up a remarkable 23.8% YTD. Largecap Value trailed Largecap Growth for the month, but continued its longer-term outperformance. See page 2 for figures for the month, YTD, and since 1999.

BOND returns (price change plus interest) had their third consecutive month of gains. The benchmark 10-year US Treasury yield closed at 4.64%, below the previous month's close of 4.74%, and more than a half point (50 basis points, or "bps") below the current 5.25% short-term overnight rate set by the Federal Reserve. The fact the Fed paused, for the second consecutive month, in its two plus year campaign of raising the short-term rates it controls, was a major factor in the decline in rates and continuing rise in bond prices. The Fed's view is that inflation is likely to moderate, given the housing slowdown and decline in oil prices (the impacts of declining prices for housing and oil are discussed in detail on pages 7 and 8). However, 10-year yields are not likely to continue below short-term yields, since the normal relationship (also known as the "yield curve") of 10-year yields to short-term yields is positive 200 bps or more, and not negative 60 bps. Therefore, we are likely to see either rising longer-term rates, or declining shorter-term rates, in the coming months. YTD bond returns range from +2.4% to +3.3% for both short and intermediate maturities, and have caught up with the returns from money markets, which benefit most directly from increases in short-term interest rates. See page 2 for results for the month, YTD, and since 1999.

The stock market rally that began decisively in March 2003 has raised the S&P 500 index 72% from its October 2002 low, but it is still 191 points from its all-time high of 1,527 (this is 12% from its all-time high, but 24% from its 2002 low. This result occurs because after a 50% price decline, prices must increase by 100% to reach their previous high levels). By contrast, the Dow Jones Industrials are **less than 1%** below their all-time high, while the NASDAQ remains a stunning 55% below its all-time high. Although the longer-term results of these three averages are quite similar (see next paragraph and chart below), the differences in the magnitude of both the gains and declines since 1994 are strikingly large.

In order to keep the current recovery in perspective, we continue to show the chart below, which sets out the extent of the declines measured from the highs of Q1 2000. The chart also puts these declines in the context of results since the end of 1994 (also see the figures on page 10). Note that the three indexes have positive average annual returns ranging from 9.5% to 9.9% for the 11.75 year period from the end of 1994 through September 2006, very much in line with long-term stock returns going back to 1926. Further, as these returns converge more and more, the idea of “regression to the mean,” described by Swensen as “one of the most powerful influences in the world of finance” (pg. 154), comes clearly into focus.

The long-term investor therefore has a very different view of the stock market's returns than those measuring returns from the highest levels.

	<u>S&P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
Year End 2004	1,212	(21)%	10,783	(8)%	2,175	(57)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year 2006 thru Sept 30, 2006	1,336	(12)%	11,679	(1)%	2,258	(55)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999

	<u>S&P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. % Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
September 2006	1,336	11,679	2,258
Gain	877	7,845	1,506
Avg. Ann. % Gain: '95-9/06; 11.75 yrs	9.5 %	9.9 %	9.8 %

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

I. UPDATE OF KEY ECONOMIC INDICATORS

The strength of the overall US and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. We, along with many market observers and academics who write about the markets, believe stock and bond prices already reflect consensus expectations of economic growth. Further, we believe that even if you could accurately predict any number of actual economic figures, the market's reaction to those figures is essentially unpredictable. In any event, an understanding of the direction of current economic trends may at times be useful as a context to help understand market conditions. This section of the Comments provides an update of key economic indicators.

- (1) Gross Domestic Product (GDP) is the broadest measure of goods and services produced in the US economy (GDP figures are inflation-adjusted, annualized growth rates). There has been no reporting as yet of Q3 GDP, but GDP for Q2, which was initially reported at 2.5%, then revised upward to 2.9%, was revised downward to 2.6%, "less than half the robust 5.6% growth seen in Q1. Sluggishness in the housing market was identified as a primary contributing factor in the downward revision" (Vanguard Economic Week in Review [VEWR], 9/25-29/06)
- (2) Employment growth for September will be reported Friday, October 6th. August's employment growth was 128,000, and the June and July figures were revised slightly upward, "but the pace of job creation trailed the 146,000 average for the first half of the year" (Wall Street Journal [WSJ], 9/2-3/06).
- (3) Interest Rates on longer-term bonds declined in September for the third consecutive month, with the benchmark 10-year US Treasury interest rate, which is set by buyers and sellers in the bond market, closing at 4.64%, well below the recent high of 5.25% reached in June. For the second consecutive month, the Federal Reserve held the short-term rates it controls at 5.25%, so that "what started out as a pause in rate increases last month began to look more like a full halt yesterday... In explaining its decision, the Fed cited the quickening decline in housing activity and easing inflation pressure from energy" (WSJ, 9/21/06, front page). The fact the yield curve is now sharply inverted, with overnight rates more than of 1% higher than the 10-year Treasury, is discussed in the BOND section on page 3 of these Comments.
- (4) Inflation rates declined in August. The "core" Consumer Price Index (CPI), which excludes the volatile food and energy sectors, increased 0.2%, the same rate of increase as July, after four consecutive months of 0.3% increases, and up 2.8% from a year earlier. With food and energy included, the monthly rate was up 0.2%, well below July's 0.4%. The most recent twelve-month increase was 3.8%, down from July's 4.1% (WSJ 9/16-17/06, A2). The Producer Price Index (PPI) core rate declined for a second consecutive month, by 0.4%, following July's decline of 0.3%. With food and energy included, the monthly increase was 0.1% for the second consecutive month. The year over year increases for the PPI with food and energy included was 3.7%, "the slowest growth rate since March" (VEWR, 9/18-22/06). (Note: The CPI measures prices of goods and services; the PPI, only goods.)

(5) Sector Economic Activity Continued Mixed, But with Signs of a Slowdown

- (a) Durable goods orders (industrial and consumer) fell 0.5%, following July's decline of 2.7%, with declines "in almost every product category" (VEWR, 9/25-29/06).
 - (b) Industrial production also declined, by 0.1%, "the first decline since January. Capacity utilization showed a small decrease to 82.4%, still above its 1972-2005 average" (VEWR, 9/11-15/06).
 - (c) Retail Sales rose 0.2%, following a surprising 1.4% gain in July (mostly from the volatile auto sector). Excluding sales of gasoline, for which there was a sharp price decline from early August highs, the sales increase would have been 0.4% (WSJ, 9/15/06, A2). (Retail sales are not adjusted for inflation, and include such disparate categories as gasoline, autos, and the Internet.)
 - (d) Housing sales for existing homes "continued to decline in August, and the nation's median home price dropped for the first time in more than a decade. The decline in sales was 0.5% from July, and was 12.6% lower from a year earlier (WSJ, 9/26/06, A2) New home sales rose in August by 4.1%, but July's sales were revised downward, and the year over year decline reached 17.4% (VEWR, 9/25-29/06) In a further sign of slowdown, "construction starts on new homes plunged last month as builders curtailed production in response to mounting inventory and slowing sales" (WSJ, 9/20/06, A2)
 - (e) Personal Income increased 0.3% in August, following a 0.5% gain in July. The August gain was "the weakest in nine months, reflecting sluggish wage growth, when job creation was modest." Personal spending "rose 0.1%, the lowest rate of growth since November, and much slower than July's 0.8% gain" (WSJ, 9/30-10/1/06, A3).
- (6) Consumer Confidence, as measured by the Conference Board's Index, rose to 104.5 from 100.2, "responding favorably to a decline in gas prices, and more optimism about the job market" (WSJ, 9/27/04, A4).
- (7) Corporate Profits for Q3 will begin to be reported in October. "Profits have grown at double digit rates for 17 consecutive quarters, helping equity markets overcome the twin poisons of rising interest rates and high energy prices" (NY Times [NYT], Sunday Financial section, 10/1/06, pg 6; the article discusses the likelihood of these favorable profits continuing into the future) .

Overall, the economic news reported during September pointed to a moderately slowing economy. Slower GDP growth, modest declines in the industrial sector, a slight increase in retail sales, and the continued weakness in housing, all pointed to a slower economy. With the slowdown came lower inflation rates and lower interest rates, both of which provided good news for stock and bond prices. How the reality of slower growth plays out in the future price movements of stocks and bonds remains to be seen, and much depends on whether the slowdown continues to be moderate, or accelerates into a more serious slowdown.

II. IMPACTS OF DECLINING PRICES FOR HOUSING AND OIL

Last month's Comments presented a detailed discussion of the current leveling, and even moderately downward, trend in housing prices, including the negative impacts from such a trend. During this same time frame, oil prices have declined from an early summer high of \$77 per barrel to as low as \$60 per barrel during the last week of September. This section of the Comments will examine why declining housing prices are viewed with alarm, while declining oil prices are welcomed by almost everyone except the oil industry itself.

The NYT article quoted extensively last month (8/27/06, "News of the Week in Review," front page; page 7-9 of the Comments), sets out the adverse consequences of a decline in housing prices, including "families in a financial bind unable to rescue themselves by refinancing their mortgage. Foreclosures would then rise, damaging banks and increasing the number of homes for sale. Even homeowners not in danger of losing their home – an overwhelming majority certainly – might respond to falling prices by cutting spending, particularly if they had been counting on their home's value to serve as a retirement account. That could force job cuts in a wide range of industries. Already the housing slowdown has begun damaging the job market. Builders, mortgage lenders, and real estate agencies have stopped adding to payrolls. Defined broadly, the real estate sector has accounted for 44% of jobs created since 2000 and employs more than 1 in 10 American workers, according to Moody's Economy.com." A WSJ article (9/30-10/1, A7) titled "Taking the Temperature of the U.S. Economy" states that "While lower home prices are good for the buyer, they can be bad news for the economy. Homeowners may begin to feel less wealthy when the value of their homes falls. That in turn causes them to spend less, further slowing the economy. It will leave many homeowners with less capacity to take out equity on their homes, a key driver of continued strong consumer spending."

However, when it comes to declining oil prices, the conventional wisdom is that these declines provide an overall benefit to the economy, and certainly to the prices of liquid stocks and bonds. In a front page article (WSJ, 9/13/06) discussing oil prices, the authors begin: "The recent drop in oil prices could provide a welcome and surprising boost to consumer pocketbooks this fall, cushioning the economy from a falloff in home prices while venting an important source of inflation pressure. The easing of energy prices is an unexpected – and little-noted – positive amid economic anxiety over falling housing activity, previous energy price increases, and the possibility of recession. Crude oil was at \$77 a barrel as recently as early August, and closed yesterday (Oct 12th), at \$63.76, a near six-month low... , which helped spur stock prices to a four month high... and reduced retail gasoline prices to \$2.67 a gallon, from a high of \$3.08."

The WSJ article continues by quoting a Wall Street economist that "lower gasoline prices should boost the annual growth rate of consumer spending a full percentage point and could lift fourth quarter economic growth from a forecast 3% annual rate to as high as 3.7%." The article then discusses the fact that the sharp increase in oil prices since 2004 "squeezed wages, in particular for less affluent families... which in turn crimped spending," and that the more recent decline in oil prices could "lead to a pickup in consumer demand, that could also boost business confidence."

It is fairly clear from these articles that a decline in housing prices is not good for the economy, while a decline in oil prices is good for the economy. Our inquiry for this section of the Comments is why this should be so. To focus in on the issue, why isn't a decline in housing prices as welcome news for the economy, and for inflationary pressures, as the decline in oil prices?

Higher prices, whether for housing or for oil, reduce the consumer's ability to purchase other goods and services. Further, higher prices, whether for housing or oil, add to inflationary pressures. So what other factors are involved that differentiate the impacts of falling housing prices from the impacts of falling oil prices?

One significant difference is that housing is viewed as an asset, so that rising prices benefit the owners of the houses by providing an increasing store of wealth over time. Refer back to the quoted section of the NYT article that spoke of people "counting on their home's value to serve as a retirement account." While higher home prices take money from the buyer's pockets, that money in turn is available to the seller. By contrast, the money spent on higher oil prices goes to a very narrow group of suppliers, including the major oil companies and the nations that have vast supplies of oil within their national boundaries.

An additional feature of housing as an asset allows homeowners to borrow money against the value of their homes. The willingness of banks and other financial institutions to lend money against the collateral value of homes has the effect of putting huge sums of purchasing power into people's hands, based on the rise in the value of their homes over time, even at a rate of increase only modestly above the rate of inflation. As an example, a home purchased for \$100,000 28 years ago, with a mortgage of \$50,000, could be refinanced 28 years later, when the home is worth \$400,000 (at an assumed annual rate of increase in value of 5%), with the owner borrowing an additional \$300,000, or more (assuming the initial mortgage had been paid off). And this money is available while the owner continues to live in the home, at the cost of an annual interest figure that is often tax deductible from other income. So when interest rates on these loans are low, as they have been for several years, the refinancing of homes provides a powerful boost to the economy. There is no such corresponding favorable impact associated with the rising price of oil.

Another significant difference is that housing generates a great deal of related economic activity, from the builders who build the houses, to the realtors who earn commissions from the purchase and sale of houses, to the furniture and appliance and home improvement industries that provide goods and services to homeowners on an ongoing basis (refer again to the quoted NYT article). By contrast, oil, once consumed, is gone, and the economic activity involved in additional exploration is more narrow than the activity generated by the housing sector.

We think the discussion in this section should prove helpful in sorting out and understanding the divergent impacts of rising and falling prices in two basic sectors of our economy, which in turn should help in understanding the varied consequences that flow from the changing prices of housing and energy.

III. NEW HEDGE FUND PROBLEMS

We have written about hedge funds in a number of previous Monthly Comments, mostly pointing out the problems that arise from investing in these funds. New problems have surfaced in the news this month, which are reported below. We would summarize the negatives associated with these investments as follows:

- 1) high fees erode the real investment return;
- 2) reported investment returns for the industry are unreliable; poorly performing funds drop out and their results are not reported; even continuing funds can choose to not report results;
- 3) investment strategies successful in one time frame are copied by other managers, and the opportunities for profits in the future narrow substantially;
- 4) many fund managers are free to invest in any investment (stocks, bonds, currencies, commodities), using a variety of strategies (long, short, highly leveraged with options), which means the investor has no clear idea of what is being done in the pursuit of profit. This adds to investor risk;
- 5) the industry is extremely competitive for investor dollars. Success is rewarded with more money under management and more fees; failure means the fund is out of business. This encourages managers to take greater risks to justify their high fees and to retain the money invested with them; and
- 6) the truly successful funds take money only from the largest of private and institutional investors. (This is Swensen's point that even wealthy individuals do not have access to the best hedge funds).

In a recent article (WSJ, 9/20/06, D1), Jonathan Clements writes about some of these problems:

- 1) he cites a study by Ibbotson and Chen that after adjusting for the overstatement of their investment results, hedge funds have actually underperformed the S&P 500 index from the period 1995 through April 2006. The two key sources of overstatement are that hedge funds "backfill" their data, with reporting only by funds that post stellar returns, and that when poor performing funds go out of business, their dismal results are ignored; and
- 2) he discusses hedge funds that have modest return goals in exchange for adding diversification to a portfolio and investing with lower risk. But he says that hedge funds with these objectives have too much cost associated with them, and that using regular mutual funds can provide similar results at much lower costs.

The news that came out this month illustrates some number of the negatives set out above. The major story involved a fund called Amaranth, and its head energy trader. As reported in the WSJ (9/19/06, front page), this hedge fund, "at the end of August, trading natural gas, was up approximately \$2 billion for the year. Then Mr. Hunter lost roughly \$5 billion in about a week... dragging the fund's asset under management down to \$4.5 billion from \$9 billion at the start of September." In our view, the most significant aspect of this story is the fact that the head of the fund, as recently as the end of August, maintained that the fund had its risk under control. The WSJ cites an August 29th interview (9/20/06, pg. C1), given by the fund's Chief Executive, Nick Maounis, in which he said the fund's "bets were meant to minimize risk and maximize reward." He is quoted as saying that "spreads and options are of their very nature instruments for positions which are designed to allow the user to capture upside with a much clearer understanding with respect to downside exposure." This interview took place a few short weeks before the fund lost half its money in a week of trading. So either Mr. Maounis did not understand what was going on, or he wanted his listeners to believe risk was under control when it clearly was not. If the losses are limited to those who invested in Amaranth, that is one thing; but we believe the real issue here is how much unknown risk (to the fund's executives, and most surely to the fund's investors) is being taken in the pursuit of the kind of outsized profits that make certain hedge funds spectacularly rich and successful, but consign many others to underperformance and obscurity. In an unrelated article discussing how small hedge funds try and raise money from investors, the WSJ (9/29/06, C1) notes that "though there are nearly 7,000 hedge funds, about 80% of the industry's assets are controlled by 125 firms." This points to how narrow are the number of truly successful funds; most of the remainder are in the category of "wannabes."

But Amaranth was not the only negative hedge fund story that emerged during the month of September. Another fund, Pirate Capital, made the news when it was announced that the "SEC is investigating whether Pirate ran afoul of securities law by failing to timely disclose it had sold stocks... Pirate says the regulatory matter was a misunderstanding that it has sought to rectify. Pirate's stumble reflects a growing problem faced by hedge funds these days. Many of these funds, private pools of money catering to wealthy investors and institutions, are jam-packed into stocks with other hedge funds pursuing similar investment strategies. When the strategy falters, fast money traders rush for the exits, dragging the stocks down further and faster than they would have had the hedge funds not plowed in" (WSJ, 9/27, C1). The article also discusses the fact that Pirate's assets have grown so fast in the past year that "finding enough promising 'activist' investments in which to deploy such a large amount of capital is difficult," and that "some of the stocks targeted by Pirate are small, thinly traded shares, which fall even harder when the selling starts, based on their lack of 'liquidity.'" So the problems that Pirate has encountered recently fall into the problem areas of too many investors chasing the same strategy, and perhaps taking on too much risk in terms of their inability to make orderly sales when the strategy calls for selling.

The month of September also brought up the fundamental issue of whether the performance of even some of the more successful hedge funds is likely to persist into the future. The WSJ reported (9/13/06, pg. C1) that "some of the most hallowed names in the hedge fund world are producing very human returns this year." The article cites Convexity Capital, which raised \$6 billion based on the record of its manager Jack Meyer, former investment manager of Harvard's endowment, with having a 1% return after fees so far this year, and TPG-Axon, another \$6 billion fund managed by Dinakar Singh, who previously ran Goldman Sachs' in-house trading, as being up 3% after fees. Other well known funds are cited in the article as delivering similar sub-par returns. And in a separate article on the same page, it was reported that "Global Alpha, an elite \$10 billion hedge fund offered by Goldman Sachs to its wealthiest clients, as well as its own partners, had a rocky August, losing nearly 10% of its value... The loss is notable because it occurred across many different trading strategies. It is unusual for a hedge fund trading in diverse markets to have so many misplaced bets at the same time."

If the well known funds have been underperforming, what of the indexed hedge fund investments that have recently become available to investors with modest sums to invest. The WSJ (9/7/06, pg. C1) reports that investors have begun pulling money out of these funds, citing a number of reasons for their declining popularity. First, many of the largest funds either do not provide the data needed to be included in the indexes, or do not accept new investments, so that "many investable index hedge funds do not reflect some of the industry's highest fliers... therefore, these investable indexes tend to get the second tier funds, as the best funds are closed to new cash." (This is one of the key points stressed by Swensen in his advice to individual investors to avoid hedge funds.) The next problem mentioned is that there is an extra layer of fees that means the investor's return will most likely be less than the index by the amount of those fees. "Investable indexes also add extra fees, typically an annual fee of 1% to 2% of assets, on top of the hefty fees paid to the underlying hedge funds. The net effect is that many of these vehicles have failed to keep track of the indexes they are meant to mirror." Two examples are presented: One index up 6.6% YTD, but the investable index up less than 5%; and another index up 5.1%, with the investable index up only 2.9%. Remember the Clements article cited above, in which he advises using regular mutual funds to achieve normal investment returns, thereby avoiding the high costs associated with these hedge fund investments.

IV. A GLIMPSE OF AN ACTIVE MONEY MANAGER AT WORK

This section is devoted to a front page article that appeared in the September 29th WSJ, describing the activities of one highlighted professional money manager, under the headline "As Stocks Near a High, Pressure Builds for a Professional Investor." Based on the descriptions provided by the WSJ writer, and quotes from the manager himself, we think you will come away quite pleased that your money is invested with us, and not with the management style described in the article. Remember, there is no asset allocation issue here; the manager invests in stocks only, so what follows describes an active stock picker.

The article features Jon Brorson, “a Chicago money manager with \$2.3 billion under his supervision, one of many doubters who stayed on the sidelines as the (stock) market marched ahead this summer... Investors like Mr. Brorson figure others are driving it (the Dow Jones average) too high, setting it up for a fall. They’ve been expecting a slowing economy to shrink corporate profits and lead to a pullback... So far these skeptics have been outvoted. As stocks have risen, they’ve seen their holdings suffer, slowly prompting more and more to throw in the towel and buy the kind of stocks that benefit from a resilient economy.”

“Mr. Brorson’s worries served him well in May. Then, he shifted toward “defensive” companies whose sales tend to hold up in all kinds of economies... The Dow got to within 81 points (less than 1%) of its record and then fell 8% into July. Now, as it (the Dow) rises, he’s fighting the trend again. Doing so keeps him up at night and, his wife says, makes him irritable.”

The article describes Mr. Brorson’s switch from Northern Trust to Neuberger Berman in late 2002. “The main goal in his old job had been to protect assets. But Neuberger Berman, now part of Lehman Brothers, is determined to outdo the competition. It had fired his predecessor just before Christmas that year for being behind the curve. ‘The mindset is 180 degrees different’, he says... Mr. Brorson sets the direction for a variety of investment accounts including three mutual funds, letting portfolio managers pick most of the individual stocks. For three years, his team rode what proved to be a resurgent market, mostly staying ahead of the pack. But early this year he got worried. A string of Fed interest rate boosts was putting a drag on the economy, as were high oil prices... Mortgage rates rose, and consumers showed signs of restraining their borrowing and spending. Pulling out of a winning bet is one of the hardest things for investment pros to do. It means selling your strongest positions while others are buying and prices are high. Yet if you wait for stock prices to weaken, it may be too late. Mr. Brorson’s stomach churned as he cut back on stocks tied to economic strength... When the market cracked in May, he was exultant, as his move to caution put him ahead of the more bullish competition.” But of course the story does not end here.

The article further describes how Mr. Brorson works. “To do his job, he immerses himself in the market, the data, the commentary, the moves of various stocks and indexes. One computer screen is on his desk in front of him, and two others, for email and for charts, on a credenza behind him. Most days he skips breakfast and lunch, munching on nuts, raisins and bananas, and drinking coffee and water... Every morning he goes to the Morningstar web site, a mutual fund research firm that compares funds to each other and to indexes. Thanks to his May move, in late August most of the funds still were ahead of the competition, but slipping.” He is quoted, “You don’t want to bleed to death at the side of the road from getting nicked, but I am not going to change anything. What I am worried about is a more sustained move that goes up 15%-20% into December. We would have to react to that.” Notice his concern is if stocks continue to rise. As for how he would react, read on.

The article continues by setting out the events of September. “He believed the upturn wouldn’t last. Meanwhile, he had bet that demand would keep energy stocks rising, and had hung onto them. Now, softer oil prices were pulling energy stocks down. Other pros were selling energy stocks, taking profits, and putting money in beaten-down tech and retailing shares.” He says, ‘very rarely does a sector lead for three consecutive years. I know that. And this would be year three for energy, but I am maintaining my position.’ Mr. Brorson “figured any gains in tech stocks would be a chance to cut holdings in them even more.” Another quote ‘I hate these things. If they show any sign of life, shoot ‘em between the eyes and throw ‘em overboard.’

“Over the next weeks, the market kept moving against Mr. Brorson. Economic reports reinforced hope the Fed was managing to cool the economy smoothly. Tech continued to rise, but he was unwilling to buy more tech or retail stocks... One thing buoying the market was that investment pros who were still trailing the indexes they were measured against felt pressure to buy currently hot stocks before the quarter’s end... Mr. Brorson re-checked which sectors were leading, something he’s been doing almost every hour.”

More time passes, and the article continues: “Yet within days, he had shifted his bet. He told associates he had made a classic mistake of staying too long with a winner: energy stocks.” He is quoted, ‘I should have sold out when (two of his associates) wanted me to. So let’s close the barn door when there is still part of the horse left.’

The article concludes: “Mr. Brorson knows that if the market keeps defying his expectations, he will at some point be forced to start buying the winners, or risk falling behind... The goal, he repeatedly reminds himself, isn’t to be right, it’s to own winning stocks. His final quote: ‘It is not a moral thing, about who is right and who is wrong. It is just money and we are paid to make it grow.’

For us, this article points to a number of problems associated with active stock picking:

- 1) the manager is constantly making judgments (i.e., guessing) about unknown future events;
- 2) if the market goes against his judgments, he will eventually have to buy in at higher prices, so as not to under-perform his peers by too large a margin;
- 3) being right in one time frame has no bearing on being right in a subsequent time frame;
- 4) why should we expect any particular manager’s judgment to be better than that of all the other managers, and investors, professional or not, who make up the ongoing pricing of the markets?; and
- 5) note the costs associated with this management are not mentioned in the article. They are certain to be higher with active management than with our approach, summarized below.

As all of you who work with us know, we believe the better way to invest is to use low-cost, tax efficient, indexed investments that match the results of broadly diversified market segments. As we mentioned at the outset, Mr. Brorson manages only stocks, and therefore is not involved in the asset allocation mix between stocks and income-oriented investments, which is a crucial part of our work on behalf of our clients. Our indexed investments are designed to implement asset allocations, which are set up meet our client’s objectives with as low a risk exposure as those objectives permit.

S&P 500 (1)

DOW JONES (1)

NASDAQ (1)

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

I. Figures From Period Starting 2000 (% Figures Are Cumulative Declines From 1/01/00)

Start of 2000	1,470		11,500		4,070	
End of 2000	1,320	(10.1)%	10,785	(6.2)%	2,470	(39.3)%
Sept. 21, 2001 <u>Low</u>	965	(34.3)%	8,235	(28.4)%	1,425	(65.0)%
End of 2001	1,148	(21.9)%	10,020	(12.9)%	1,950	(52.0)%
Oct. 9, 2002 <u>Low</u>	777	(47.1)%	7,286	(36.6)%	1,114	(72.6)%
End of 2002	880	(40.1)%	8,342	(27.5)%	1,336	(67.2)%
End of 2003	1,112	(24.3)%	10,454	(9.1)%	2,003	(50.8)%
End of 2004	1,212	(17.5)%	10,783	(6.2)%	2,175	(46.5)%
End of 2005	1,248	(15.1)%	10,718	(6.8)%	2,205	(45.8)%
Through Sept 30, 2006	1,336	(9.1)%	11,679	+1.5%	2,258	(44.5)%

II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)

Start of 1995	459		3,834		752	
End of 1999	<u>1,470</u>		<u>11,500</u>		<u>4,070</u>	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	<u>1,148</u>		<u>10,020</u>		<u>1,950</u>	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	<u>880</u>		<u>8,342</u>		<u>1,336</u>	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
End of 2003	<u>1,112</u>		<u>10,454</u>		<u>2,003</u>	
9 Year Gain; Annualized %	653	10.3%	6,620	11.8%	1,251	11.5%
End of 2004	<u>1,212</u>		<u>10,783</u>		<u>2,175</u>	
10 Year Gain; Annualized %	753	10.2%	6,949	10.9%	1,423	11.2%
End of 2005	<u>1,248</u>		<u>10,718</u>		<u>2,205</u>	
11 Yr Gain; Annualized %	789	9.5%	6,884	9.8%	1,453	10.3%
Through Sept 30, 2006	<u>1,336</u>		<u>11,679</u>		<u>2,258</u>	
11.75 Yr Gain; Annualized %	877	9.5%	7,845	9.9%	1,506	9.8%



Victor Levinson



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