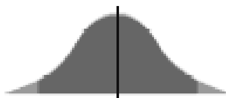

Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON **NICK LEVINSON**

OCTOBER 2005 COMMENTS

IMPORTANT NOTICES:

TRIP to INDIA: Victor and his wife are panning a trip to India with friends, leaving Wednesday evening, November 16th, and returning the first weekend in December. Given the time differences and other communications difficulties, please direct all phone calls and emails during this time period either to Lynette, at 212-391-2323 or lynettec@parkpiedmont.com, or Nick, at 510-601-6662 or nickl@parkpiedmont.com. (Remember, Nick is based in California). Victor will be in contact with both Lynette and Nick every day, so any issues that arise will be dealt with in a timely way.

THOUGHT for the MONTH: From the Preface of "Unconventional Success: A Fundamental Approach to Personal Investment," by David Swensen, the Chief Investment Officer of Yale University's highly successful endowment fund, a new book directed at individual investors that we will be writing about for a number of months: "Instead of pursuing ephemeral promises of market-beating strategies, individuals benefit from adopting the ironclad reality of market-mimicking portfolios managed by not-for-profit investment organizations."

YEAR END TAX MATTERS: Between now and year end, we will be working on:

1) Required Minimum Distributions from IRA accounts. Clients affected will be receiving letters from NFS, and we will be following up to assure timely compliance.
2) Cost Basis information for all securities sold during 2005.
3) Cost Basis Reports for all unsold security positions in taxable accounts.

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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.

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COMMENTS: INDEX RESULTS for period ending OCTOBER, 2005

STOCKS	**YEAR 1999**	**YEAR 2000**	**YEAR 2001**	**YEAR 2002**	**YEAR 2003**	**YEAR 2004**	**YTD 2005**	**CURR. MONTH**
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6%)	(11.0%)	(21.0%)	28.4%	12.5%	1.8%	(1.9)%
Standard & Poors 500 Index (2)	19.6%	(10.1%)	(13.0%)	(23.4%)	26.4%	9.0%	(0.4)%	(1.8)%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2%)	(13.0%)	(23.7%)	25.9%	7.2%	1.2%	(0.8)%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0%)	(20.9%)	32.2%	15.3%	2.7%	(2.7)%
Dow Jones Industrial Average Index (2)	25.2%	(6.2%)	(7.1%)	(16.8%)	25.3%	3.2%	(3.2)%	(1.2)%
NASDAQ Composite Index (2)	85.6%	(39.3%)	(21.0%)	(31.5%)	50.0%	8.6%	(2.5)%	(1.4)%
Vanguard Midcap US Index Fund (1)	25.0%	2.6%	(4.8%)	(16.3%)	34.1%	20.4%	7.0%	(3.5)%
Vanguard Smallcap US Index Fund (1)	19.6%	(4.2%)	1.0%	(21.6%)	45.6%	19.9%	2.7 %	(3.4)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(15.2%)	(22.6%)	(17.5%)	40.3%	20.8%	7.1%	(3.7)%
Vanguard Real Estate Invest. Trust Fund (1)	(0.4%)	26.4%	12.4%	3.8%	35.7%	30.8%	7.4%	(2.6)%
BONDS								
Vanguard Total Bond Market Index (1)	(0.8%)	11.3%	8.3%	8.2%	4.0%	4.2%	0.9%	(0.9)%
Vanguard Interm. Tax-Exempt Index Fund (1)	(2.9%)	9.2%	5.0%	7.9%	4.4%	3.2%	1.0%	(0.7)%
Vanguard Short-term Bond Index (1)	2.1%	8.9%	8.9%	6.1%	3.4%	1.7%	0.6%	(0.2)%
Vanguard Short Tax-Exempt Index Fund (1)	2.6%	4.9%	4.8%	3.5%	1.6%	1.1%	1.2%	(0.1)%
Vanguard High-Yield	NA	NA	NA	1.7%	17.2%	8.5%	0.9%	(0.7)%

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.

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%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
		1999				**2000**				**2001**		
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.												
		2002				**2003**				**2004**		
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.												
		2005				**2006**				**2007**		
S&P 500	(2.6)	0.9%	3.1%									
NASDAQ	(8.1)	2.6%	4.4%									
BONDS	(0.5)	3.0%	(0.7%)									
Interm. Tax.												

OCTOBER 2005 COMMENTS

STOCK index prices declined in October, but a strong finish to the month reduced the extent of the declines. The S&P 500, Dow Industrials, and NASDAQ all were lower by between 1.2% and 1.8%. The Midcap, Smallcap, REIT and International indexes, which have been outperforming the Large Cap indexes all year, were down even more, with declines ranging from 2.6% to 3.7%. For 2005 year-to-date (YTD), the S&P 500 is down (0.4)%, the Dow down (3.2)%, and the NASDAQ down (2.5)%. By contrast, the Midcap, Smallcap, REIT and international indexes remain up between 2.7% and 7.4%, continuing to outperform the Largecap indexes. The Total Stock Market index is up 1.8%, benefiting from the Midcap and Smallcap performance. See page 2 for the monthly and YTD figures.

BOND returns (price change plus interest) declined significantly during October, for the second consecutive month. Concern over inflation was the main reason cited for the continuing rise in interest rates and decline in bond prices. (Pages 7-9 of this month's Comments addresses the subject of Inflation in detail). The benchmark 10-year US Treasury yield closed the month at 4.56%, well above September's level of 4.33% and far above August's close of 4.02 %. Given the two consecutive monthly price declines, YTD figures for most intermediate- and short-term bond funds are now around 1%, and therefore below the returns achieved on money markets, which benefit most directly from increases in short-term interest rates. Bond results for the month and YTD are reported on page 2.

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The stock market rally that began decisively in March 2003 has raised the S&P 500 by 55% from the October 2002 low. While these gains have made investors believe again that stocks do not go down in perpetuity (a widely-held view during the depths of the 2000-02 bear market), the question of whether this recovery will continue is, as always, dependent on unknown, unpredictable future events. Indeed, over the first ten months of this year, Largecap stock indexes are now all modestly negative. (Note also that after a 50% price decline, it takes a 100% gain to return to the previous level. Since the S&P 500 reached its high of 1,527 in Q1 2000, and then declined by almost half to 777 during Q4 2002, the current level of 1,207 is 55% higher than the low but still another 320 points, or 41%, from the prior high).

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 15). Note that the three indexes have positive average annual returns ranging from 9.3% to 10.0% for the ten-year, ten-month period from the end of 1994 through October 2005, 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" seems quite applicable.

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

	S&P 500 (1)		**DOW (1)**		**NASDAQ (1)**	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
April 10, 2001 Low	1,103	(28)%	9,390	(20)%	1,684	(67)%
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)%
October 31, 2005	1,207	(21)%	10,440	(11)%	2,120	(58)%

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

	S&P 500 (1)	**DOW (1)**	**NASDAQ (1)**
End 1994	459	3,834	752
End 1999	1,470	11,500	4,070
Gain	1,011	7,666	3,318
Avg.Ann.%Gain:'95-'99; 5 years	26.2%	24.6%	40.2%
October 2005	1,207	10,440	2,120
Gain	748	6,606	1,368
Avg.Ann.%Gain:'95-10/05; 10.83 yrs	9.3%	9.7%	10.0%

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

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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. See the August 2005 Comments for reference to a NY Times (NYT) article "Economic View" (7/31/05, Financial section, pg. 4), listing the major components of GDP). The initial estimate of GDP growth for the third quarter was favorable. "Hurricanes and high gas prices notwithstanding, the economy grew at a healthy 3.8% annualized pace, beating most analysts' expectations and improving on the second quarter's 3.3% growth rate (Vanguard Economic Week in Review [VEWR], 10/24-28/05)."Increased consumer and federal government spending contributed heavily to the increase, while residential and non-residential construction slowed and inventories declined. Exports also decelerated, while imports remained unchanged" (Wall Street Journal [WSJ], 10/29-30/05, pg. A2).

(2) Employment for September declined by 35,000, "the first decline since May 2003, but far less than the 175,000 drop expected by economists….The employment report suggested the economy is likely to recover from Katrina's buffeting with little trouble despite the higher energy prices of recent months" (WSJ, 10/8-9/05, pg. A2).

(3) Interest Rates increased sharply in October. The benchmark 10-year US Treasury interest rate, which is set by buyers and sellers in the bond market, closed at 4.56%, significantly above September's close of 4.33%, which in turn was far above August's level of 4.02%. Additional information on interest rates is included in the discussion of inflation on pages 7-9 of these Comments.

(4) Inflation, as measured by the Consumer Price Index (CPI) "core" rate, which excludes the volatile food and energy sectors, increased a modest 0.1% in September, but overall CPI was up a much higher 1.2%, "the fastest acceleration in more than 25 years" (WSJ, 10/15-16, pg. A2). Rising energy costs were the reason for the sharp increase. The Producer Price Index (PPI) core rate was up 0.3% in September, and up 1.9% with food and energy included, its largest increase since January 1990 (NYT, 10/19/05, pg. C2). (Note: the CPI measures prices of goods and services; the PPI, only goods). An in-depth discussion of inflation and its impact on market prices is included in pages 7-9 of these Comments.

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(5) Sector Economic Activity was Mixed

(a) Durable goods orders (industrial and consumer) fell 2.1% in September, adversely affected by "a strike at Boeing and the after-effects of Hurricanes Katrina and Rita" (WSJ, 10/28/05, pg. A2).

(b) Industrial production declined 1.3% in September, a decline attributed to the impacts of the hurricanes (VEWR, 10/10-14/05).

(c) Retail Sales increased 0.2% in September, and were up 1.1% after excluding declines in auto sales. Gasoline spending contributed to the gains (VEWR, 10/10-14/05). (Retail sales are not adjusted for inflation, and include disparate categories such as gasoline sales, auto sales, and non-store retailers such as the Internet.)

(d) Housing sales for existing homes were unchanged in September, while new home sales gained "a smaller than expected" 2.1% (VEWR, 10/24-28/05). Sales prices for existing homes fell, "providing further indication that the housing boom is starting to cool" (NYT 10/26/05, pg. C3).

(e) Personal Income "rose more than expected in September…at a seasonably adjusted annual rate of 1.7%, after easing a revised 0.9% in August, which initially was reported as a 0.1% decline" (WSJ, 11/1/05, pg. A2).

(6) Consumer Confidence, as measured by the Conference Board's Index, fell in October to "its lowest level in two years and a drop of more than 19% since January. Most forecasters had expected as slight rebound this month, but high energy prices and the lingering effects of Hurricanes Katrina and Rita continued to weigh on consumers' minds"(VEWR, 10/24-28/05).

(7) Corporate Profits for the S&P 500 stocks increased 14% in the first quarter and 12% in the second quarter, both figures significantly higher than analysts' expectations (see cite below). Consensus forecasts for the third quarter, not yet completed, are for gains above 15%, but many forecasts are being reduced because of the hurricanes and high energy costs. One reason for the higher profits is "because energy sector profits are expected to shoot through the roof" (NYT, Sunday Financial section, 10/2/05, pg. 7). While corporate profits are a major driver of stock prices, it is important to note that over extended periods of time the rate of profit growth is closely related to the rate of overall economic growth.

It is interesting to note how many of these economic reports vary significantly from the reported "analysts' expectations." For this period, positive reports appear to have occurred "in spite of" the hurricanes and rising energy prices, and negative reports occurred "because of" the hurricanes and rising energy prices. Makes you wonder about the sense of the reporting. Overall, the economic news reported in October was mixed, and the broadly diversified liquid investment markets for both US stocks and bonds for the full year 2005 have produced meager, if not modestly negative, returns. As for the future, market prices will, as always, be determined by unpredictable, unknowable future events.

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II. INFLATION AS A CURRENT ISSUE, AND ITS IMPACT ON MARKETS

During October, when both stock and bond prices moved significantly lower, the major economic story of the month was inflation, or, more precisely, the fear that inflation was on the rise. Therefore, we think it timely to review once again the role that inflation plays on market prices.

Inflation refers to the idea that over time, the purchasing power of a currency tends to decline. Put another way, prices of the same items tend to increase over time, and the rate of inflation attempts to measure these price increases. Notice that when prices increase for the same item, the purchasing power of a fixed amount of money is reduced. Price increases can be caused by increased demand for goods and services, by a reduced supply of goods and services, or by an increased amount of currency available to purchase the same amount of goods and services, or by some combination of all three factors. When economic growth is strong, demand for goods and services tends to rise. If supply cannot meet the demand, prices will rise. If an economy makes more currency available and the supply of goods and services does not increase accordingly, prices will rise because there is more currency seeking to purchase the available goods and services.

An increase in prices causes hardship because many people's incomes and financial assets do not increase fast enough to offset the increase in prices. In such circumstances, the standard of living of this group of people will decline, as their money buys fewer goods and services. Inflation also "hurts economic growth by distorting investment decisions" (WSJ, 10/31/05, pg A2). The US economy for years has benefited from low rates of inflation, but over the past few years there has been a spectacular rise in the price of oil and other energy related products, which can play a significant role in increasing inflationary pressures. In order to head off unwanted higher rates of inflation, the US Federal Reserve has been increasing the interest rates it controls (since June 2004, and including November 1, 2005, there have been twelve quarter point rate increases, from 1% to 4%). The economic theory here is that higher interest rates will slow economic growth, which in turn reduces demand for goods and services, thereby moderating some of the upward pressure in prices.

Higher interest rates typically result in lower bond prices, although in this cycle, while shorter-term bond prices have declined in line with higher shorter-term interest rates, longer-term bond prices have not declined as expected because longer-term interest rates have not increased, much to the surprise of even Fed Chairman Greenspan. The impact of higher inflation on stock prices is more complex. While rising interest rates and higher prices in general tend to reduce demand and also add to the cost of doing business, the other side of the coin is that rising prices can benefit businesses if their sales grow faster than their costs.

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With this as background, we turn to October's media reporting on the current situation of rising inflation and its impact on stock and bond prices. A front page article headlined "Inflation Worries Send Shivers Through Markets," (WSJ, 10/7/05), begins: "A whiff of inflation has blown fear through the stock market this week, knocking the Dow Jones Industrial Average (DJIA) to a three month low and stirring anxiety that a much awaited year end rally may not materialize. In recent weeks, even as hurricanes drove up oil prices, stock investors had shrugged off inflation fears on the grounds that "core" inflation – the rate of price increases on products excluding volatile energy and food costs – was tame. But this week, while oil prices have fallen sharply, signs have emerged that inflation may be working itself into the economy. That would be bad news for stocks, notably because it likely would prompt the Federal Reserve to cool the economy by pushing interest rates higher, raising borrowing costs for businesses and consumers alike."

In a more recent article (WSJ, 10/24/05, pg. C1), headlined "Specter of Inflation Haunts Dow," the same writer observes that "Inflation is important to stocks because it influences just about every element that moves the stock market up and down. The biggest impact is on interest rates, as rising inflation forces the Federal Reserve to push interest rates higher. Higher prices and higher interest rates boost costs for businesses and consumers alike, holding back sales and profits. Inflation also hurts the financial underpinnings of stocks, making them less attractive, since a big piece of stock gains is eaten up by the rising cost of living. When inflation hits, investors tend to flee to alternatives such as real estate, gold, other commodities and money market accounts."

The NYT (10/25/05, pg. C1), in an article headlined "Echoes of 1987: First on Bernanke's To-Do List: Tame Inflation" discussing the nomination of Ben Bernanke to succeed Alan Greenspan as Chairman of the Federal Reserve, states that "Mr. Bernanke's first task is likely to be the one that temporarily tripped up Mr. Greenspan shortly after he became chairman in 1987: bringing down inflation without causing too much damage to the economy or the stock market along the way. Over the last year, inflation has reached 4.7%, the highest level since 1991, as energy prices have soared. Core inflation, which excludes food and energy and is closely watched at the Fed, has hit 2%, the upper limit of what Mr. Bernanke has called his 'comfort zone'." (In a sarcastic response to the "dueling numbers" of core versus overall inflation, the same NYT, in an article in its Sunday Business section (10/23/05, pg. 3), ran this headline: "If You Don't Eat or Drive, Inflation's No Problem.")

Another front page WSJ article (10/13/05), headlined "Era of Low Rates around the Globe May Soon Be Over," discusses the relationship between inflation and interest rates throughout the world. "As signs of inflation, spurred in part by soaring energy prices, surface around the world, central banks are signaling that the era of unusually cheap credit is coming to an end. The implications for markets and the world economy are significant: Investors may retreat from risky assets and air could leak out of the global housing boom….The mere expectation that central banks will tighten has prompted investors to trim their appetites for risk…. Low interest rates helped corporations reduce their debt burdens and interest costs, encouraged consumers to buy home and cars, and boosted house and stock prices, making consumers wealthier and more willing to spend. But leaving rates low as economies return to full strength raises the risk that buoyant demand will outstrip the capacity of business to crank out goods and services. The result would be bottlenecks and higher prices. Thus central banks want to get rates back to normal levels."

With regard to inflation, interest rates and bond prices, one WSJ article (10/15/05, pg. B5) states that "inflation fears remain bad news for bondholders," but there is also the view that "the steady interest rate increases will soon catch up with the economy at large…so that the economic data will begin to reveal evidence of an economic slowdown" (WSJ, 10/29/05, pg. B4). Such a slowdown, if it occurs, would relieve inflationary pressures, so that the interest rate increases that cause bond prices to fall could then be halted.

David Swensen's book (reported on in detail in these Comments, pp. 10-14) discusses the impacts of inflation on stock prices (pp. 40-42): "Stocks tend to provide long term protection against generalized price inflation….In spite of the clear theoretical link between stock prices and inflation, the stock market presents a mixed record on incorporating inflation into equity prices…. Jeremy Siegel (author of "Stocks for the Long Run") observes that stock prices "provide excellent long-term hedges against inflation" and weak short-term protection against rising prices….While capital markets history supports Siegel's observation, the difference in short-run and long-run responses by equity prices to inflation creates a paradox. Because the long run consists of a series of short runs, no theory explains both the poor short term record and the strong long term record of stock price protection against price increases….Investors seeking shelter from inflation need to look beyond holdings of marketable securities."

With regard to inflation and bond prices, Swensen writes (pg. 51) that "investors in traditional US Treasury bonds deal with information only on nominal returns….Nominally denominated investments, like Treasury bonds, match nominal liabilities (like fixed debt obligations) nicely. If, on the other hand, a retiree hopes to maintain a certain standard of living, the retiree needs funds sufficient to keep pace with changes induced by inflation. Inflation-sensitive investments fulfill inflation-sensitive requirements….Investors price fixed income instruments to generate positive inflation-adjusted rates of return…..When inflation rates exceed expectations, the unexpected inflation erodes the purchasing power of the promised stream of fixed payments, causing investors to receive disappointing after-inflation returns….Unanticipated inflation crushes bonds, while ultimately benefiting equities."

III. SWENSEN, ON "SOURCES OF RETURN"

For this month's as well as future Comments, we will be reporting on the recently published book, "Unconventional Success: A Fundamental Approach to Personal Investment," written by David Swensen, the Chief Investment Officer of Yale University's highly successful endowment fund. This book is directed towards individual, rather than institutional, investors. (Yale is of course an institutional investor).

We believe this book will take its place as one of the truly important books for individual investors, along with Burton Malkiel's "A Random Walk Down Wall Street" and the various books written by John Bogle and Peter Bernstein. For any of our clients who would like to read Swensen's book, let us know and we will send you a copy at our cost. If, however, you want to rely on our reporting of the book, please feel free to do so. While we do not mean to discourage anyone from reading the book, given the significance of its key points, be advised that, in our opinion, the book has a number of redundant portions, and the organization of some of its subject matter is questionable. We have attempted to better organize our summary of this material, even if some of the references to the book are out of order.

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It is also worth noting at the beginning of our reporting on this book that, while we agree with its basic principles, there are a number of particulars with which we have a different point of view. We will of course note all differences with an "Our View" discussion, after setting forth Swensen's ideas as expressed in the book.

This month's report will cover the first section of the book, headed "Sources of Return," (pp. 11-30), and a closely related topic, "Portfolio Construction," (pp. 81-91). Swensen begins (pp. 11-12) by stating that there are "three tools to employ in generating investment returns: Asset allocation, market timing and security selection… Asset allocation refers to the long-term decision regarding the proportion of assets that an investor chooses to place in particular classes of investments… Market timing refers to deviations from long-term asset allocation targets. Active market timing represents a purposeful attempt to generate short-term, superior returns based on insights regarding relative assert class valuations….Passive market timing consists of the inadvertent deviations from long-term targets caused by the action of market forces on the value of a portfolio's various asset classes… Security selection refers to the method of construction of portfolios for each of the individual asset classes, beginning with the choice of passive and active management. Passive management, the baseline against which other options must be measured, involves replication of the underlying market. In the case of domestic equities, the S&P 500, the S&P 1500, the Russell 3000 and the Wilshire 5000 represent broad-based indices that provide reasonable definitions of the market and sensible alternatives for investors pursuing passive management. Active management involves making bets against the market, with the investor attempting to overweight attractively-priced stocks and underweight expensively-priced stocks. The returns resulting from the active manager's deviations relative to the benchmark represent security selection returns."

Of these three basic tools that can be used to generate investment returns, "asset-allocation decisions play a central role in determining investor results. A number of well-regarded studies of institutional portfolios conclude that approximately 90% of the variability of returns stems from asset allocation, leaving approximately 10% of the variability to be determined by security selection and market timing" (pg. 12). In continuing with a discussion of asset allocation, the author writes that "three basic investment principles inform asset-allocation decisions in well-constructed portfolios. First, long term investors build portfolios with a pronounced equity bias. Second, careful investors fashion portfolios with substantial diversification. Third, sensible investors create portfolios with concern for tax considerations. "The essence of the process that leads to creation of viable portfolio targets involves: knowledge of basic investment principles; definition of specific investment goals; and understanding of individual risk tolerances" (pp. 13-14).

The first point of emphasizing equities relates to the basic principle that "equity investors rightly expect returns superior to those expected by holders of less risky financial assets, albeit at the cost of higher levels of risk….In the case of marketable securities returns, over reasonably long periods of time, stock returns exceed those of bonds and cash….A superficial examination of the data might lead to the conclusion that investors should put all of their eggs in the equity market basket. However, a closer look at history illustrates the dangers of a single-asset-class concentration" (pp. 14-16).

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This leads to Swensen's second point about the benefits of diversification. The author cites the stock market crash of 1929, and the bear market in stocks and stagflation of the 1970s, as two extended periods during which inflation-adjusted equity losses exceeded 70%. Swensen writes that "from a strictly financial perspective, diversification improves portfolio characteristics by allowing investors to achieve higher returns for a given level of risk (or lower risk for a given level of returns)….Ultimately, the behavioral benefits of diversification loom larger than the financial benefits. Investors with undiversified portfolios face enormous pressures, both internal and external, to change course when the concentrated strategy produces poor results….When only a portion of the portfolio suffers from dramatically adverse price moves, investors face a higher likelihood of riding out the storm….The act of diversification provides a free lunch of enhanced returns and reduced risk, increasing the likelihood that an investor will stay the course in difficult market environments" (pg. 17).

Swensen's third point about tax sensitivity focuses on investors' ability to defer capital gains taxes, which "creates enormous economic value to investors….The fact that unrealized gains incur no tax provides powerful incentive to hold winning positions, deferring the tax liability to some future date" (pg. 25 and 28). The author raises a variety of tax related questions (pg. 27), one of which is whether taxable bonds with a high current-income component should be held in a tax-deferred account. The question goes unanswered, but our view is that the answer is absolutely yes, since all distributions from retirement accounts are taxed as ordinary income and bonds typically earn little if any capital gain. Stocks, on the other hand, are best held in taxable accounts to get the advantage of long-term capital gain treatment, since holding stocks in a retirement account converts potentially advantageous capital gain treatment into ordinary income taxation. The closing paragraph in the tax section states that "tax treatment of investment income adds enormous complexity to the portfolio management process. On top of the intrinsic difficulty in understanding the existing tax code, investors operate in a constantly changing framework. Rational investors respond to the complex, ever-changing tax environment by taking care to minimize the tax burden carried by the investment portfolio" (pg. 29).

The Chapter Summary section states that "instead of concentrating on the central issue of creating sensible long-term asset-allocation targets, investors too frequently focus on the unproductive diversions of security selection and market timing (pg. 29).

Security selection "plays a minor role in (institutional) investment returns, because they tend to hold broadly diversified portfolios that correlate reasonably strongly with the overall market….An active investor can overweight a stock only if other market players take offsetting underweight positions. By definition, the sum of overweight positions must equal the sum of underweight positions, allowing the market weight to remain the market weight. Based on subsequent performance, the overweighters and underweighters turn into winners and losers….Before considering transaction costs, active management appears to be a zero-sum game, a contest in which the winners' gains exactly offset the losers' losses….The leakage of fees from the system causes active management to turn into a negative-sum game in which the aggregate returns for active investors fall short of the aggregate returns for the market as a whole. Security selection may provide substantial excess returns to skilled investors, but those excess returns come directly from the pockets of other players who suffer poor relative returns" (pp. 21-23).

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Swensen observes that institutional investors avoid market timing, perhaps because they "recognize the futility of consistently making the relative asset class valuation assessments necessary for market-timing success, particularly when such assessments rely on a bewildering collection of unknowable economic and financial variables" (pg. 20). Then he turns to individual investors, stating that "the available evidence points to a pattern of excessive allocation to recent strong performers offset by inadequate allocation to recent weak performers….Strong evidence exists that markets exhibit mean-reverting behavior, a tendency for good performance to follow bad and bad to follow good. In markets characterized by mean reversion, investors who fail to rebalance portfolios to long-term targets end up with outsized exposure to recently appreciated assets that prove most vulnerable to poor future results" (pg 21).

Finally, Swensen maintains that investors ultimately reap rewards only if they maintain positions in the face of market woes. Individuals who prove unable to withstand the inevitable market traumas end up whipsawed, abandoning sensible strategies just as the out-of-favor moves into the limelight. The history of capital markets provides important support for the notions of owning equities and of creating diversified portfolios….The volatility of risky asset classes occasionally proves too great for investors to stomach, arguing for moderation in exposure to ay individual class of securities" (pg. 29).

The next sections of the book discuss core (pp. 33-80) and non-core asset classes (pp. 92-147), interspersed with a section titled "Portfolio Construction' (pp. 81-91). Because we believe "portfolio construction" is most closely related to the author's critical asset allocation principles of equity orientation and diversification, we will discuss portfolio construction here, and hold the discussion of core and non-core asset classes for next month's Comments.

The section on portfolio construction begins with the notion that both "science" and "art" are involved. (**Our note: We at PPA believe our primary role as advisors is to apply the science and the art described in this paragraph, and the paragraphs that follow, on behalf of our clients**). "The science encompasses the application of basic investment principles to the problem of combining core asset classes in an efficient, cost-effective manner. The art concerns the use of common-sense judgment in the challenge of incorporating individual characteristics into the asset allocation process." The goal is to "increase the likelihood that investors will develop the conviction necessary to maintain a steady long-term course amid the turbulent crosscurrents endemic to security markets" (pg. 81). The text continues (pg. 81): "Diversification and equity orientation represent important objective principles for long-term investors….Personal preferences play a critical subjective role in portfolio decision making….**By adopting asset allocation targets that dovetail with personal risk tolerances, investors vastly increase the odds of investment success**."

Swensen then brings up individual circumstances as introducing "important considerations to the portfolio structuring process," referring to such matters as non-financial assets (homes and businesses) and liabilities, concluding that "sensible investors consider financial asset allocations in a context that encompasses the broadest possible picture of individual assets and liabilities" (pp. 81-82). In a further reference to taking the broadest view of their financial circumstances, Swensen makes the suggestion that investors consider potential future inheritances, and their sources, which could range from equity-oriented portfolios to insurance proceeds (more in the nature of a fixed income portfolio) (pg. 87).

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He next discusses the possibility that individuals have "unusual personal expertise holding the potential to generate superior returns by applying their skills in market-beating active management," but then concludes this paragraph by observing that "unfortunately, genuine investment skill proves so rare a commodity among individual investors that the incidence of extraordinary-expertise-justified overexposure to an asset class approaches zero" (pg. 82). In a further reference to the likelihood of individual investors possessing special market-beating skills, the author poses the following question: "If highly compensated, specially trained, handsomely supported investment professionals fail to produce even market-matching results, what leads part time, financially untutored, resource-deficient individuals to believe they can succeed" (pg. 86)?

The next factor discussed is Time Horizon, which refers to when investors will need to use some or all of their money, rather than simply allowing the investments to earn on-going returns. "Time horizon constitutes one of the most influential variables in structuring investment portfolios. …As time horizon shortens, investors reduce long term portfolio holdings in favor of cash positions. Investors address changes in time horizon by altering the mix between the risky, long term portfolio and the riskless, money market portfolio" (pg. 82). While we agree with the fundamental point here that as time horizon shortens exposure to riskier asset classes should be reduced, it is our view that additional choices other than money market funds should be considered in the investment mix, particularly high-quality short-term bond funds, which provide a higher yield than money markets, with some modest short-term price risk.

The text then returns briefly to the science of portfolio structure, recommending that "a preponderance of assets be invested in the high expected return asset classes of domestic equity, foreign developed equity, emerging market equity and real estate," which provides diversification within the stock portion of the portfolio. Swensen also recommends US Treasury Inflation Protected Bonds and US government bonds for the bond portion of the portfolio (pg. 83). As mentioned above, we will review Swensen's detailed discussion of these core stock and bond positions in next month's Comments.

The next section provides additional observations on the art of personalizing portfolio construction (again it is on this subject that we believe PPA adds significant value for its clients). "Incorporating personal preferences in portfolio decisions guards investors from counterproductive actions to adverse developments **after the fact** by limiting exposure to poorly loved asset classes **before the fact**….Lack of conviction and absence of comfort cause investors to buy high and sell low, damaging portfolio returns" (pg. 85).

Finally, the text returns to the subject of the importance of the investor's time horizon on allocation decisions. "Most investors seek to satisfy a multitude of goals with invested funds….The appropriate degree of investment risk depends on the time available until funds are needed. For periods of one to two years or less, investors ought to favor bank deposits, money market funds or short term bond funds" (pg. 88). (Our note: Here Swensen does mention short term bond funds, as we suggested earlier). For time frames of eight years or more, "equity oriented, diversified asset allocation provides the most likely framework for long-term success,…and for those investors with intermediate horizons, a combination of risky long-term assets and less risky short term investments" is recommended (pp. 88-89).

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As is appropriate in reporting on a book written by a highly respected expert in the field, we have used extensive quotes. To conclude this month's reporting, we would like to put some of the key ideas into our own words, ones that our clients have heard more than once.

1) Asset allocation is the most important part of the investment process. Market timing and stock picking are not beneficial. Implementing your asset allocation with low cost indexed investments is the best approach. (Vanguard is an example of the non-profit investment firm applauded by Swensen for its low cost approach).

2) While stocks may show the highest long-term investment returns, they may not generate these returns in a time frame relevant to you. Further, the potential for extreme ups and downs in prices (referred to as volatility by the financial press) can make you so uncomfortable that you sell stock positions during periods of market declines. This tendency to sell when prices are going down is not a good way to handle investments, particularly for those people who also follow the tendency to buy as prices are going up.

3) Being comfortable with your asset allocation is the key to staying the course. Further, for those fortunate enough to have already accumulated substantial amounts of capital, preserving this capital and generating a reasonable income-oriented return is preferable to exposing the capital to risk that is unnecessary to achieve your objectives.

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	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)

	S&P 500	%	DOW JONES	%	NASDAQ	%
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 Low	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 Low	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)%
October 31, 2005	1,207	(17.9)%	10,440	(9.2)%	2,120	(47.9)%

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

	S&P 500	%	DOW JONES	%	NASDAQ	%
Start of 1995	459		3,834		752	
End of 1999	1,470		11,500		4,070	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	1,148		10,020		1,950	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	880		8,342		1,336	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
End of 2003	1,112		10,454		2,003	
9 Year Gain; Annualized %	653	10.3%	6,620	11.8%	1,251	11.5.%
End of 2004	1,212		10,783		2,175	
10 Year Gain; Annualized %	753	10.2%	6,949	10.9%	1,423	11.2%
October 31, 2005	1,207		10,440		2,120	
10.83 Yr Gain; Annualized %	748	9.3%	6,606	9.7%	1,368	10.0%

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