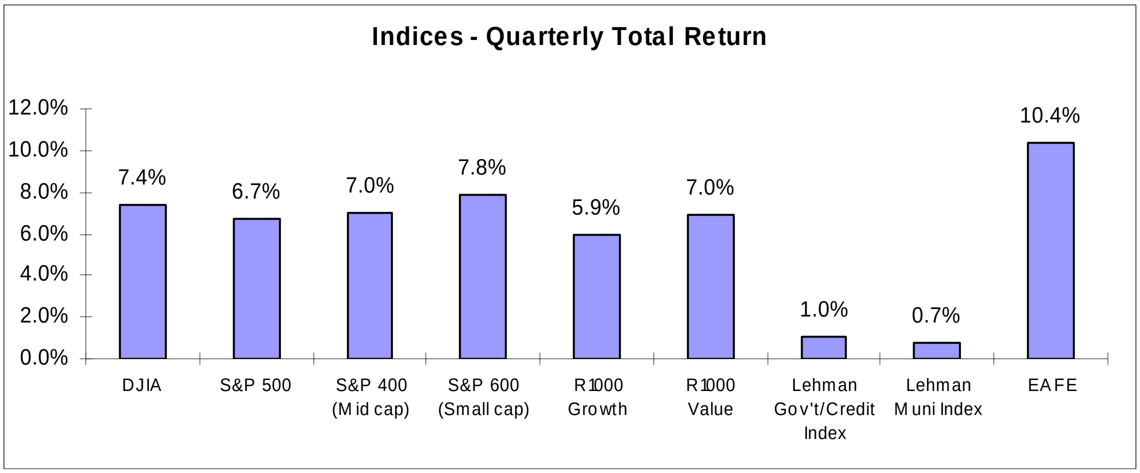


The year was 1974. Newly installed President Gerald R. Ford was facing a multitude of thorny issues: a politically unpopular and financially costly war on foreign soil; a distinct lack of confidence in the Executive branch of government brought on by the Watergate scandal; and sky-high energy costs that were squeezing both corporate profits and consumer spending. The accessory of choice among his Administration was the "WIN" button ("Whip Inflation Now," for those of you too young to remember) as the rate of inflation had soared to 12.2% and become, in President Ford's words, "public enemy number one." Stocks were trading at single-digit price-earnings multiples and U.S. government bonds were yielding 7.60%. Fast forward to today, as we mourn the passing of President Ford, and there are certain eerie political and economic parallels. Despite the similarities, however, the financial markets and corporate profit margins are in immeasurably better condition. The crucial difference: "WIN" today might stand for "What Inflation Now?" Notwithstanding a surge in crude oil to $77/bbl in July and comparable advances in other commodities, consumer prices had risen only 2.5% year-over-year, down from 3.5% a year earlier. Reflecting the lack of inflation, the bellwether 10-year Treasury note closed 2006 yielding 4.70%, and the forward 12-month P/E on the S&P 500 was a shade under 15.

REVIEW

The year 2006 was extremely kind to most financial assets as a world of investors awash in cash competed to bid up prices. While U.S. large-cap stocks, as represented by the S&P 500 index, performed admirably with a total return of 15.8%, various other asset classes also dispensed double digit returns. The MSCI EAFE index, for example, a broad measure of foreign stock returns, crested 26.3% during the year, while the MSCI Emerging Markets index surpassed that with a 32.6% gain. Risk premiums continued to contract, testing the fortitude of professional money managers, who almost universally underperformed their respective benchmarks.

Fixed income markets traded in a narrow range during 2006, with the bellwether 10-year Treasury note beginning the year yielding 4.39% before rising as high as 5.24% mid-year and settling down to close at 4.70%. Lower quality bonds fared better; the Merrill Lynch High Yield index closed the year yielding barely more than 3% above the 10-year Treasury, down from a spread of almost 4% just 12 months earlier (and from over 10% in 2002).

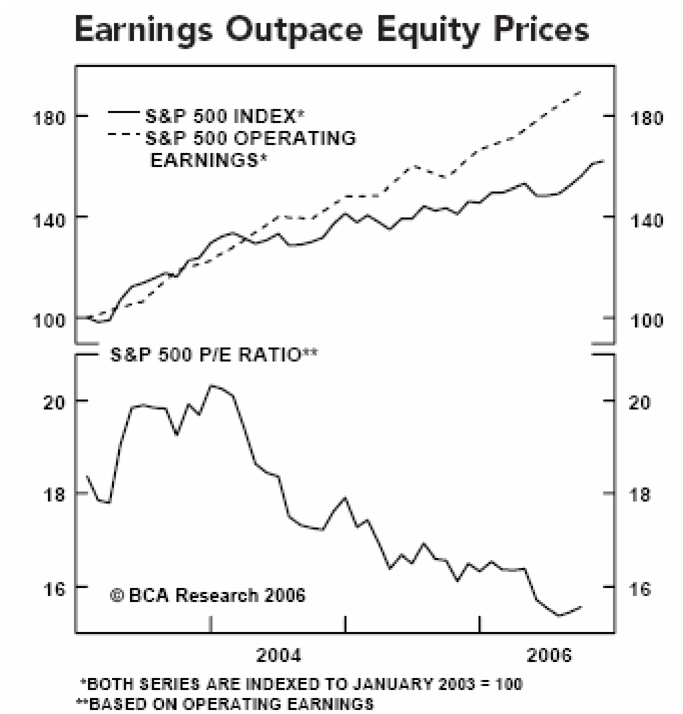
Crude oil surged 26% before peaking in mid-July and retreating to finish flat for the year at $61/bbl. Gold followed a similar trajectory, soaring 39% into May and then receding, but it still ended up 23% on the year at $638/oz. It was the base metal complex, however, that evinced the most froth during the period; the CRB base metal index more than doubled in 2006 on sustained Asian demand and dwindling inventories.

A healthy appetite for risk and yield, in tandem with high levels of liquidity, facilitated the heaviest year of merger and acquisition (M&A) activity on record: $3.8 trillion in deals, eclipsing 2000's previous high-water mark of $3.4 trillion. Moreover, 60% of deals were done for cash, in contrast to 2000, when 71% of deals were paid for with (largely inflated) stock.

The tidal wave of M&A action contributed to the aforementioned frustration of active equity managers, as it narrowed the valuation and performance range of individual stocks. If a company failed to execute, its stock often found an artificial floor from buyout speculation, redirecting investment dollars that might otherwise have flowed into stocks with superior operating characteristics. The main cause, however, in our opinion, of the marked inability of active managers to surpass the S&P 500 in 2006 was the tortuous and segmented path of stock prices. The January to April period was essentially an extension of 2005's themes of the twin booms in global infrastructure and commodities. In May, attention abruptly turned to the specter of Ford-era stagflation, as the slump in residential housing and consumer inflation simultaneously accelerated. A sharp correction in all but the biggest stocks lasted until August, when the Fed finally ended its stair-step 0.25% interest rate increases that began back in 2004 under then-Chairman Alan Greenspan. Stocks have advanced unabated since, and the foremost sectors are those that were hit hardest during the corrective phase: consumer discretionary and information technology. In short, it was a very difficult period in which to set and adhere to a cogent portfolio management strategy.

OUTLOOK

As we peer through the (admittedly cloudy) crystal periscope into 2007, we see a vista dominated by a vast sea of liquidity. While some treacherous shoals lurk below the surface, it will take an enormous ebb tide to expose the dangers beneath. The sponge of higher interest rates has yet to expand enough to sop up the surplus cash circling the globe in search of investment opportunities, and the deceleration in inflation that followed on the heels of the recent downshift in the domestic economy leaves us optimistic that stocks and bonds will stay afloat this year. In fact, after last year's stellar showing by foreign stock markets, U.S. stocks, particularly large-cap issues, are arguably among the cheapest worldwide. Given a benign inflation backdrop, which is our base case, it would be unsurprising to see a combination of modest (albeit decelerating) profit growth and valuation expansion carry stocks to higher ground. While this has been the second-longest running bull market since 1928, its magnitude is dwarfed by its duration: the 17% average annual return ranks dead last. The reason for the disparity is multiple contraction; typically P/E ratios expand during bull runs, but over the past four years, growth in operating profits of the S&P 500 has exceeded the growth of the index itself, compressing the P/E ratio from over 20 to below 16 (*see chart – source: BCA Research*).



During the same period, the year-over-year rate of change in the Consumer Price Index has actually fallen, considerably reducing the stress on new Fed Chairman Ben Bernanke to extend the rate hike campaign. We are in something of a counterintuitive stretch, in which "bad" news is likely to be good news for the longer-term health of the bull market: slowing economic growth (but not recession) keeps bond yields and inflation low without crushing earnings, and a weakening (but not free-falling) dollar boosts export competitiveness and overseas profits and eases pressure on foreign central banks to raise interest rates. There are explicit risks to the clear-sailing story, but a global economy featuring excess labor and excess capital is likely to support further financial gains.

We are less sanguine, but not negative, on the outlook for fixed income. Capital appreciation is limited by the low absolute level of yields, and spreads on riskier paper are historically quite narrow, leaving little room for error if default rates pick up from current depths. Tepid domestic economic growth and contained inflation readings, on the other hand, should keep rates from climbing considerably higher. We appear to be in the early stages of a releveraging of corporate balance sheets, facilitated by billions of dollars in private equity funds. With real, after-tax borrowing costs well below the available return on equity capital, the deluge of buyout activity is predictable. Ultimately, corporate bondholders will demand a higher return (yield) in exchange for the higher leverage, but the flood of liquidity is for now engulfing such concerns.

A key swing factor in both the equity and fixed income markets will be the reaction of the Fed to the prevailing economic data. We are assuming that Chairman Bernanke is merely talking tough at this point in order to establish his inflation-fighting credentials, but if inflation unexpectedly re-emerges and the Fed tightens policy anew, it could lead to a profit-crunching overshoot. Similarly, if Chairman Bernanke reacts too late in easing policy following evidence of recession, profits and stocks would likely decline. At this point, however, inflation has been a demand-based phenomenon that has quickly retreated upon economic weakness (see, e.g., gasoline prices), allowing bonds and the dollar to act as a relief valve for equities. In the longer-term, the significant fountainheads of global savings – emerging Asian economies, Latin America (now a net lender after years on the brink), and oil-producing nations – may begin to dry up or be absorbed by internal uses, threatening the virtuous circle of capital flows, but there is no current incentive for any of the participants to encourage such an outcome.

Best wishes for a healthy and prosperous 2007,

The Colony Group