

Aureus Asset Management, LLC
Investment Perspectives
January 3, 2006

I. Review of 2005

The past year showed the wisdom of global diversification. In the equity markets, the US lagged, with the Standard & Poor's "500" providing a return of 3% (4.9% including dividends). Within the US market, there were a few areas of strength, such as energy, utilities, industrial materials and large capitalization biotech leaders. These groups produced gains of from 20-40% or more. Yet most industries were either stagnant or under pressure. Concentration was the right strategy, provided of course that one knew where to concentrate.

Abroad, the remaining 50% of the world's equity market capitalization sprinted ahead, with the MSCI EAFE Index up 12% (translated into US dollars). Within that index (which measures all the major stock markets of the world apart from North America), Japan had its best year since the late 1980s, with a gain of over 40% as measured in yen. In local currencies, Europe posted a return the mid teens, and China and Hong Kong lagged with gains of about 5%. These figures were reduced by the surprising strength of the dollar relative to the yen, the pound sterling and the euro. However, even after currency translation, it was clear that the US market was the weak spot globally.

Stock picking easily justified itself last year, as the majority of actively managed US equity funds were able to surpass the S&P "500". Of the three market capitalization groups, mid cap was the clear winner, with small cap second and large cap bringing up the rear.

High quality bonds, such as US Treasuries, did not quite earn their coupon, ending with total returns in the 2-3% range. More risky bonds, in the emerging markets or in low quality corporate issues, did better as investors went for yield over safety, although the dollar's strength reduced returns from all non-US bonds.

US investors who owned nothing but large cap stocks and high quality bonds showed, on average, a return in the low single digits, enough to offset inflation by a little. On the other hand, investors with a broad focus—around the world and throughout the market capitalization ranges—earned a double digit rate of return.

II. Outlook for the World's Economies in 2006

As investors, we face many imponderables this year. Will the Iraq war wind down? Will terrorism shock us with horrific events? While no one can answer these questions, we can examine the key economic fundamentals of inflation, profits, and growth in an effort to project how markets may behave under all but extreme circumstances.

Outlook for the World's Economies in 2006 - Continued

Globally, inflation is well under control, apart from a few countries with relaxed fiscal discipline. International trade, with countries jockeying to improve their exports especially to the US, helps to keep prices down. Equally as important, large and long-lasting gains in productivity from investment in high tech and other forms of capital equipment enable manufacturers to maintain stable price levels for many consumer goods, except those highly dependent on energy as a raw material. For the US, another year of inflation of around 2½-3% in the Consumer Price Index seems likely.

The price of crude oil rose 40% last year. Fortunately, the dependence of the US economy on energy is considerably less than in the 1980s. This is not to say that high energy prices can or should be dismissed; many middle or lower income consumers in this country are feeling considerable pressure, especially from heating costs. Yet the world adjusted better than expected to the abrupt rise in both oil and natural gas prices. We will have to contend, in our judgment, with these higher price levels for years to come, as the supply of new sources of energy is rising slower than demand.

Corporate profit margins in the US are now back to levels not seen in decades. Since 1950, profit margins have been through three distinct eras. The first, which includes most of the 1950s and 1960s (excluding recession years), had high margins, as corporations were not challenged by global competition. The second, which lasted from the early 1970s through the late 1980s, was a period of relatively low margins, under the impact of high inflation and sluggish growth. Finally, the third period, from around 1990 to date, marks a return to high margins, as many corporations have taken full advantage of big gains in productivity to offset the impact of markets now open to foreign competitors.

Will margins be maintained or not? The present Chairman of the Federal Reserve, Alan Greenspan, who retires at the end of January, was among the first observers to comment on the substantial and continuing gains in productivity in this country, in a speech of about six years ago. As long as productivity is rising over 3% a year, as it has from 1998 on, and as long as real GDP grows in the range of 3-4%, we believe that profit margins should remain robust. For 2006, an increase of about 8-10% in overall corporate earnings seems realistic.

Global growth is highly dependent on the free functioning of financial markets, the debt market in particular. Currently, the world's economies are not in balance. The US, for instance, has very large trade and Federal budget deficits. The rest of the world has a surplus of savings, brought about both by large export earnings from developing countries and by oil earnings from the Middle East, Russia and parts of Latin America. The imbalances of the US, for the time being, are matched by the imbalances of the remainder of the globe, and are financed by a debt market in which our deficits provide a savings vehicle for the earnings of other countries. The new Chairman of the Federal Reserve, Ben Bernanke, who assumes the role this February, remarked in a speech last March that "over the past decade a combination of diverse forces has created a significant increase in the global supply of saving—a global savings glut—which helps to explain both the increase in the US current account deficit and the relatively low level of

Outlook for the World's Economies in 2006 - Continued

long-term real interest rates in the world today". Self-interest, on both our part as well as in foreign countries with large surpluses, should maintain low cost debt for financing the world's financial imbalances, at least for the near future.

Thus, the best economic forecast for 2006 is likely a status quo. That is, growth in the US will be faster than in Europe, but Asian economies and certain other emerging countries will report the best growth rates. Long-term interest rates should rise only modestly. Earnings for industries with high levels of productivity and with important new products or services should rise quite strongly. In the absence of an unanticipated global economic shock, the world should post a satisfactory year.

III. Outlook for the World's Markets in 2006

Growth, inflation, valuation and investor psychology all affect financial markets. We have reviewed the first two items—growth and inflation—and have concluded that they should remain favorable. What about valuation and psychology?

In the US, equity valuations have declined, as earnings have risen faster than stock prices. Today, the S&P "500" stands at about 17-18 times profits to be reported for the full year 2005, and only about 15-16 times estimated 2006 earnings. Since the 1950s, the average price-earnings multiple of the S&P "500" has been 15x. However, over that same time frame, the average real interest rate, whether short or long-term, has been somewhat higher than at present. Therefore, equities seem a better relative value than bonds. Provided that the Federal Reserve's move to raise short-term rates is close to an end, the US equity market might well rise in line with earnings this year, or at a little faster rate than in 2005.

In Europe, where the equity markets had strong gains over the last twelve months, the prospects for 2006 are moderately positive because valuations still remain slightly lower than historical averages. In Asia and in emerging markets selling strongly into the US, the outlook appears very favorable, despite the superb performance of many of these markets since their lows of 1998. In these markets, local currency debt as well as equities may continue to benefit from high levels of investor confidence.

Psychology is favorable and should remain so, barring unforeseen events. That depends on international coordination, in economic as well as political terms. Whether international markets continue to open, and whether trade barriers continue to decline, will help to determine the vital parameters of future global growth. With valuations reasonable, although not cheap, and with psychology positive, we believe that there are attractive opportunities for globally focused investors in 2006.

In this environment, we remain convinced that a comprehensive asset allocation strategy, featuring global diversification and access to premium investment managers, will best position investors for successful long-term results.

IV. Returns for 2005*

Asset Class	Return (In dollars)
Equities (principal change only):	
US (Standard & Poor's 500)	+3.0%
Mid cap index	11.3
Small cap index	6.7
World ex US	+14.4%
European region	+10.2%
France	9.1
Germany	8.5
UK	5.0
Pacific region	+19.5%
Japan	27.7
Emerging markets	+40.7%
Bonds (total return including income):	
US intermediate Treasuries	+1.6%
US municipals	3.5
Non-US	-8.9
Currencies (vs. the dollar):	
Pound sterling	-10.2%
Euro	-12.6
Yen	-12.8
Commodities:	
Dow Jones AIG index	+17.5%
Gold	18.5
Crude oil	40.5

*Source: *Barron's*; *Wall Street Journal*