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Quarterly Market Overview

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While many investors have sought safe havens at home others have embraced risk abroad

In July 2005, we dedicated our entire newsletter to shaping an argument for why investors should favor foreign equities over foreign debt moving forward. We identified a trend via mutual fund performance returns (1-, 3- & 5-yr.) that clearly showed how the momentum was shifting away from emerging markets and developed foreign markets debt funds to their equity counterparts. The only period in which foreign debt funds were outperforming foreign equity funds was the rolling 5-yr. average as of June 30, 2005.

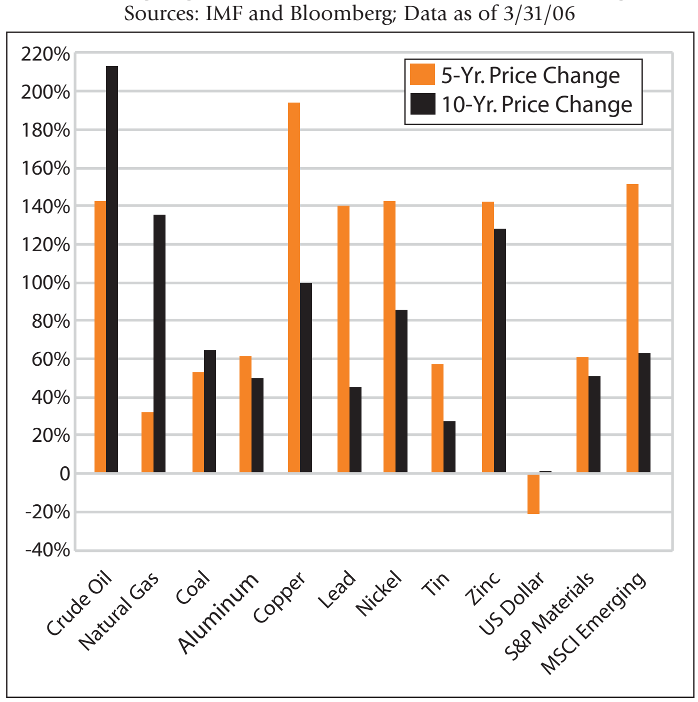
Today, both emerging markets and developed foreign markets equity funds are outperforming their debt counterparts for all three time periods, with emerging markets equities leading the way by a country mile. The indices confirm this as well. The MSCI Emerging Markets Index from Morgan Stanley posted the following returns through March 31, 2006: **47.1%** (1-yr.); **207.2%** (3-yr.); and **151.6%** (5-yr.). Here are the returns for the MSCI World (ex U.S.) Index over the same periods: **25.71%** (1-yr.); **130.3%** (3-yr.); and **45.7%** (5-yr.). Notice the surge in the 3-yr. return for emerging markets equities? The flow of capital has a lot to do with that.

From 2000 through 2002, the period covering the most recent bear market in stocks, emerging markets equity funds experienced net redemptions totaling $2.3 billion, according to AMG Data Services. From 2003 through 2005, however, investors poured **$26.4 billion** back into those same emerging markets equity funds. In 2005, the $15.9 billion of inflows was more than triple the inflows in 2003, which indicates they are accelerating. Now in our newsletter last July, we encouraged investors to consider diversifying into large-cap foreign stocks from developed countries based on valuation and an improving economic situation, particularly in the Euro zone. We stand by that assessment. We would like, however, to take this opportunity to briefly assess the overall climate in some of the most popular emerging markets, such as Brazil, Russia, India and China (BRICs).

Why are these four so popular? It may have something to do with the fact that they were responsible for 30% of the overall growth in global demand in 2005 – more than double their contribution five years ago, according to data from the International Monetary Fund (IMF).

The global economic recovery commencing in late 2001 ignited a major rally in commodities, which has been a boon for such emerging countries as Russia (oil) and Brazil (materials). The chart below shows the surge in the demand for commodities over the past five and ten years. The bull market has been fueled to a degree by speculators on Wall Street, according to C. Harry Falk, president of the New York Board of Trade. Historically, raw materials producers and consumers account for 85% of futures activity. They use futures to lock in the prices of raw materials to protect themselves against spikes. Today, due to increased interest from hedge funds and other money managers, investors now account for 40% of the exchange activity. As the chart shows, an investor owning just basic materials companies would not have exploited the bull market in commodities to the degree emerging markets investors were able to.

Emerging Markets & Commodities Up Big
Sources: IMF and Bloomberg; Data as of 3/31/06



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Investors have been hitting the BRICs hard

Brazil

Brazil is Latin America's largest economy. China has been investing aggressively in Brazil. It has also been buying much needed commodities from them. Brazil is becoming an agricultural power. It is presently only farming 19% of its 790 million cultivable acres, according to the OECD. Its percentage of non-performing loans declined from 5.6% in 2001 to 4.1% in Q2'05, according to the IMF.

Russia

Russia is essentially an energy play. It is clearly benefiting from the instability in the Middle East. Russia is taking in around $500 million a day from the sale of oil, according to Sky News. Thanks to the high price of oil, Russia was a major exporter of capital in 2005, according to the IMF. Its percentage of non-performing loans declined from 6.2% in 2001 to 3.4% in Q3'05, according to the IMF.

India

India is growing in the 7-8% range and is the only large economy expected to grow faster in the next five years than the last five years, according to *Forbes*. Prime Minister Manmohan Singh said recently that they will be loosening restrictions on the flow of capital into India, according to *BusinessWeek*. Its percentage of non-performing loans declined from 11.4% in 2001 to 5.2% in Q3'05, according to the IMF.

China

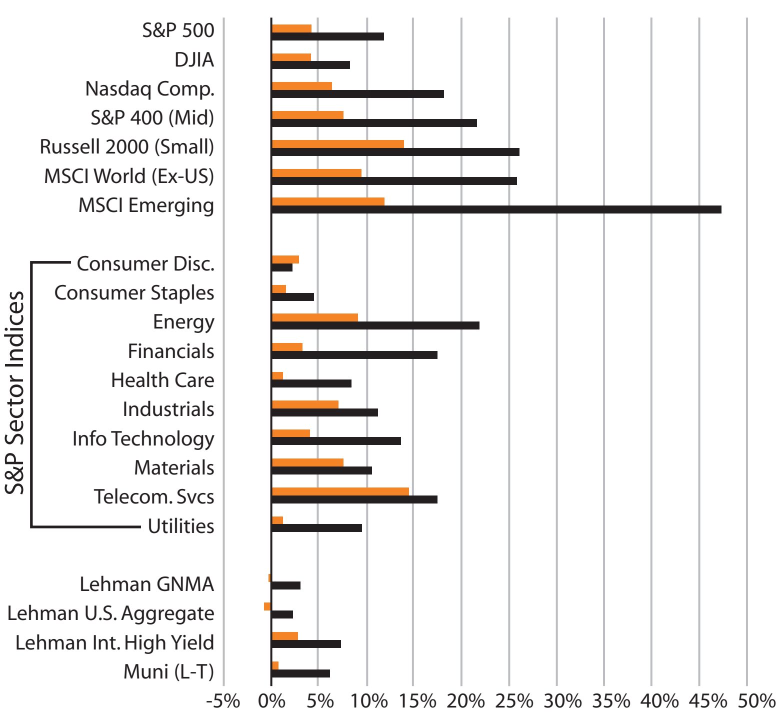
China has grown its economy at close to a 10% annual clip over the past three years. The government has made it clear it is uncomfortable with such robust growth and would prefer to see it slow to closer to 7%. China has become a major exporter, but is also focused on growing its domestic economy. Its percentage of non-performing loans declined from 29.8% in 2001to 10.5% in 2005, according to the IMF.

	Bovespa (USD)	RTS (USD)	BSE Sensex 30 (USD)	Hang Seng (USD)
03'06	21.3%	27.5%	21.3%	7.0%
2005	45.9%	86.8%	39.5%	8.7%
2004	28.8%	8.9%	21.1%	17.0%
2003	140.7%	62.6%	86.0%	41.8%
2002	-45.7%	38.7%	7.4%	-15.6%

Source: Bloomberg

Why the strong interest in emerging markets equities? One theory that has been floated has to do with corporate governance. Historically, one of the biggest concerns with investing in emerging markets securities has been a lack of trust in their financials – that their accounting standards aren't on par with the U.S. and other developed countries. It appears, however, that the sheer number and magnitude of the scandals that hit Wall Street and Corporate America a few years ago may have rendered this objection obsolete in the minds of investors. Capital flows into developing nations in Latin America, Asia and Central Europe are expected to hit a record $345.2 billion in 2006, surpassing the previous record set in 1996, according to the Institute of International Finance. Such inflows would constitute a 62% increase over a two-year span. **In light of the generous returns posted in recent years, we believe it is time for investors to respect the risks associated with these securities.**

Total returns for *Q1* and past *12 months* (3/31/06)



A Look Ahead:

The outlook for earnings (year-over-year)...

	Q2'06E	Q3'06E	2006E
Financials	10.3%	26.7%	14.9%
Technology	**8.1%**	**6.0%**	**3.4%**
Health Care	4.2%	4.9%	4.0%
Consumer Staples	**2.7%**	**4.7%**	**3.6%**
Consumer Discretionary	13.8%	30.2%	20.5%
Industrials	**13.5%**	**15.5%**	**13.4%**
Telecommunications Services	8.5%	10.9%	10.1%
Energy	**22.3%**	**11.7%**	**16.3%**
Utilities	25.2%	9.9%	14.0%
Materials	**11.4%**	**24.9%**	**11.3%**
S&P 500 Index	**10.1%**	**10.1%**	**7.6%**
S&P 400 Index (Mid-Cap)	**13.2%**	**24.2%**	**16.3%**
S&P 600 Index (Small-Cap)	**16.0%**	**20.0%**	**15.9%**

Source: Thomson First Call/Baseline