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The U.S. stock market rallied in July and was able to hold onto most of those gains despite an "up-and-down" August and September. For the full quarter, the S&P 500 gained 3.6% and is now up 2.8% on the year. The NASDAQ Composite rose 4.8% in the quarter, but is still down 0.6% for the year. Foreign stock markets enjoyed a strong quarter as the MSCI EAFE Index gained 10.5% and is now up 9.6% year-to-date. Interestingly, these strong third quarter gains in stocks came in the face of a weak bond market. The Lehman Aggregate Bond Index fell 0.8% in the quarter and is up a modest 1.6% for the year.

We continue to be very pleased with our fund selection. All of our diversified U.S. and foreign stock funds are outperforming their peer group average so far this year. Additionally, our specialty fund selections (Excelsior Pacific/Asia, PIMCO Commodity Real Return, and American Century Global Gold) are each performing very well this year and adding to the overall returns of our portfolios.

In August we sold all of our remaining holdings of the American Century Small Company fund across all the portfolios we manage. This fund has been a great performer for us. We first bought this fund for our portfolios in November of 1999. At that time, small stocks were clearly undervalued compared to large stocks, with small-value stocks being particularly out of favor. We believed this would change and selected the American Century Small Company Fund (with its reliable quantitative investment approach) to profit from this predicted shift in relative performance. Nearly six years later the picture has completely reversed. Today, small stocks, particularly small value stocks, are clearly overvalued relative to large stocks. We believed the prudent course was to take our remaining profits and re-invest them in funds which offer better expected returns. In the nearly six years that we were invested in this fund, it gained approximately 148%, or 17% per annum. This return outpaced the fund's benchmark, the S&P Small Cap 600 Index, by more than 50% and clobbered the S&P 500 Index's 4% loss during the same period. The initial purchase and subsequent sale of this fund is an excellent example of our contrarian investment philosophy at work.

Looking forward, we continue to believe that stock market returns will be below average in the coming years. We are hopeful that our equity fund selections will outperform the major indices given our focus on large, high quality stocks and our increasing tilt toward more growth-oriented managers. We believe that the recent rise in interest rates offers us a good opportunity to increase the maturity of our bond portfolios, and that bonds represent an attractive alternative to stocks. As such, we will continue to manage your portfolios in a conservative manner with below average stock exposure as compared to the target allocations outlined in your investment policy statements.

Sincerely,

David B. Ackerman, CFA, CFP
Partner