



YEAR IN REVIEW GOLDILOCKS AND THE THREE BEARS

As the title suggests, 2006 ended on a good note with the economy in a “Goldilocks” scenario, not too hot and not too cold. There was a mix of strong returns, as well as good and bad economic news. What remains to be determined are the futures of the three bears (the Federal Reserve, the housing market, and inflation) and how they will impact the Goldilocks economy.

Returns improved for all markets in 2006 (see Figure 1). While the fixed income market improved marginally over last year with the Lehman Aggregate Index up +4.3%, the equity market surged, ending on strong fourth quarter performance, with the S&P 500 Index returning +15.8%. Among the style categories, small cap stocks outperformed large cap stocks while value stocks beat growth stocks.

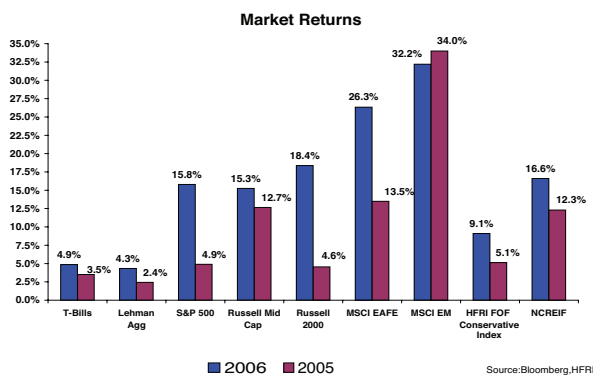


Figure 1

U.S. ECONOMY

The debate of a “hard” or “soft” economic landing continued as the fourth quarter revealed information suggesting both scenarios.

Flat consumer prices in November helped to keep the twelve-month rise in inflation to just 2% - the top of the Federal Reserve’s (“The Fed’s”) “comfort zone”. Monetary policy was left unchanged again in the fourth quarter leaving the Fed Funds rate at 5.25% since June. The absence of rising rates was a key factor behind the fourth quarter equity rally. Even though the Fed is maintaining its tightening bias to ensure a soft economic landing, the market has priced in a rate cut in the first quarter of 2007.

The bad news was that the housing market continued to show weakness. As mentioned in the last MCG Journal, indicators of both new and existing homes sales and prices continued to slump. Home construction applications fell for the tenth consecutive month leaving a 6.3 month supply of houses for sale. Many believe that the housing slowdown has yet to spill over to the other sectors of the economy, and that the direction of the economy and markets remains dependent on the outcome of the housing market.

Treasury Yield Curve

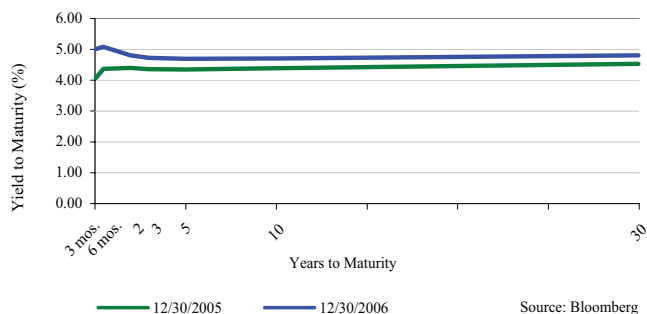


Figure 2

Interest rates rose modestly across the yield curve as the Fed remained on hold, leaving the Fed Funds rate unchanged at the fourth quarter FOMC meetings. Although as mentioned previously, most futures markets have priced in a Fed ease that is expected as early as first quarter 2007.

The yield curve inverted as the short end rose 93 basis points, while the long end raised only 34 basis points over the course of 2006. The curve finished the year inverted in the range from six months to five years (see Figure 2).

EQUITY MARKETS

In 2006, the equity markets performed strongly and the year ended with robust fourth quarter results (see figure 1). The S&P 500 returned +15.8% while the broader Russell 3000 was up 15.7%. Small cap stocks represented by the Russell 2000 led the major U.S. equity indices with a performance of +18.4% which was quite an improvement over 2005’s return of +4.6%.

S&P 500 Index Sector Returns

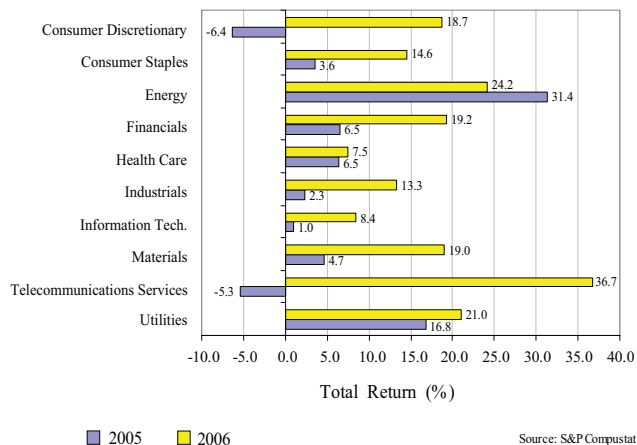


Figure 3

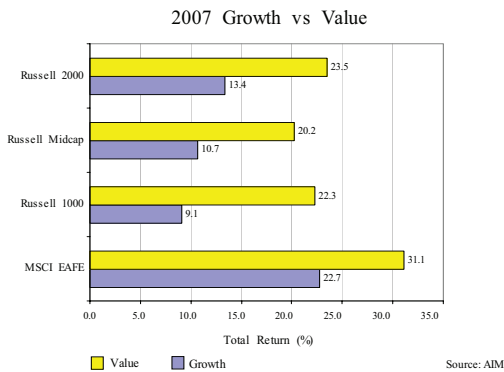


Figure 4

Within the S&P 500 (see Figure 3), the best performing sectors were materials (+11.6%), energy (+11.2%) and consumer discretionary (+10.3%). The worst performing sectors were health care (+1.4%) and consumer staples (+3.7%).

Value stocks outperformed growth stocks in the major indices (see Figure 4). Concerns over inflation and monetary policy drove the divergence in style-based performance. During the first half of 2006, interest rate hikes by the Fed reduced the appeal of riskier growth companies. Despite the Fed's decision to postpone further tightening in the third and fourth quarter, inflation fears remained, thus creating a bias towards value companies.

International equities finished with strong gains in December led by emerging markets. For 2006, the MSCI EAFE and MSCI EM returned +26.3% and +32.2% respectively. Advances in the developed world were led by Europe, while emerging markets continued a three-month rally.

FIXED INCOME MARKETS

Fixed Income markets showed improvement across the board over last year. The Lehman Aggregate Index ended the year at +4.3%, an increase

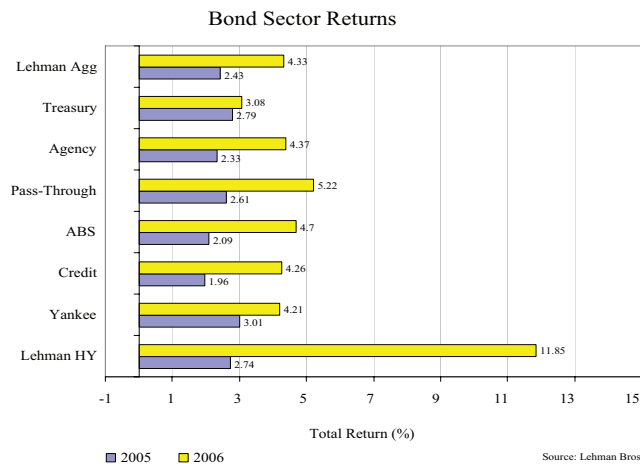


Figure 5

of 190 basis points over 2005. Nevertheless, it still came in below its historical average of +8.8%. Cash (3-month Treasury Bills) returned 4.9% beating both Treasuries +3.0% and agencies +4.4%. The strongest performance came from high yield as reflected by the Lehman High Yield Index return of +11.9% (see Figure 5).

ALTERNATIVES

Multi-Strategy Fund of Hedge Funds ("FOHF's"), which are diversified portfolios of hedge funds, finished the year strong with an average return of +10.3% as measured by the HFRI Conservative Index. The return is consistent with our expectations of the risk free rate plus roughly 3-5%.

Despite assets slowing in the 4th quarter, \$126.5 billion of new money in 2006 nearly triples 2005 inflows. Returns for the year across all strategies ranged from 7.6% (Equity Market Neutral) to 24.3% (Emerging Markets). Returns for Emerging Markets led the industry for the second consecutive year. Event Driven - Distressed (15.8%) and Merger Arbitrage (15.7%) in particular - also had a strong year. Equity Long/Short (11.7%) made a comeback in the latter half of the year.

The active pace of private equity fund-raising in 2005 continued as almost \$84 billion was raised by buyout and mezzanine funds through September 2006. In addition, returns were at historical levels with the 1-year all private equity IRR at +22.5% (through June 30, 2006). For comparison, the 20-year all private equity IRR is +14.2%. Mega-funds continue to grow as funds greater than \$1 billion are no longer uncommon. This phenomenon combined with an increase in club deals (multiple private equity firms investing in a single deal), has led to extremely large companies being taken private. Through June 30, 2006, venture capital returned a 1-year IRR of +16.2%. This positive news reflects renewed health as the sector continues to recover from the bursting of the dot-com bubble. Fund-raising in this space however continues to sputter.

Early in 2006 it was expected that interest rate increases would have detrimental effects on real estate returns. This did not turn out to be the case as capital inflows kept performance high and cap rates steady. In addition, managers began to pursue more value added properties to enhance return. The NCREIF NPI, an index for Real Estate Equity, produced a total return of +16.6%, outperforming last year by 4.3%.

The property markets continue to improve as rents are increasing, concessions decreasing, and new supply becoming constrained due to escalating land and construction costs.

We would like to thank all those who attended our 2007 MCG client conference and we look forward to seeing you next year.

SAVE THE DATE

2008 MCG Client Conference
Friday, February 1st to Tuesday, February 5th
at Sheraton Maui Resort Maui, Hawaii