

Fourth Quarter 2005 Highlights

January 2006
Issue 25

REAL GDP

Change from previous quarter at annual rate, seasonally adjusted



Source: Department of Commerce

UNEMPLOYMENT RATE

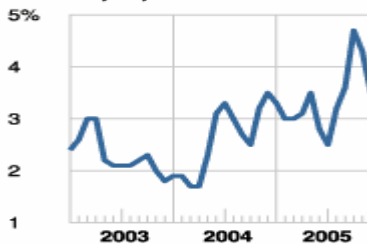
Seasonally adjusted



Source: Bureau of Labor Statistics

CONSUMER PRICES

Change from previous year, not seasonally adjusted



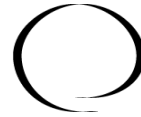
Source: Bureau of Labor Statistics

EXISTING-HOME SALES

Annual rate, in millions of units, seasonally adjusted



Source: National Association of Realtors



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The Sticky Side of Debt

By Charles D. Osborne

Debt is the financial glue that holds our society together. Without it we would produce less, consume less and have fewer assets. This is true for individuals, companies and countries alike. We have come from a place where debt was abhorrent to a place where we encourage it. We no longer have debtors' prisons instead we give tax breaks on interest paid. We encourage debt. We make it easy to borrow and our bankers are our best friends...until we can not pay it back, then things get sticky.

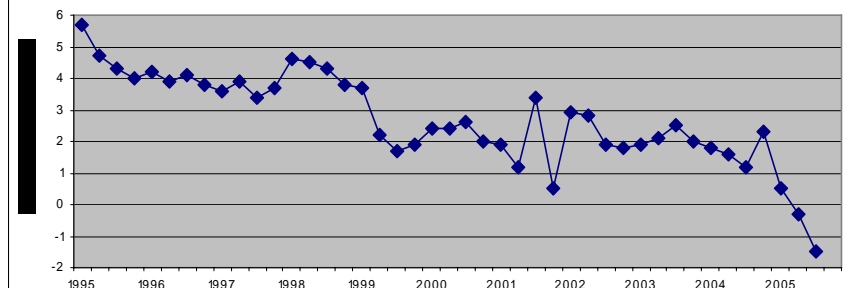
Debt Numbers

The total collective debt of Americans, government, corporate and private is about \$25,000,000,000,000.(rounded to the nearest hundred billion). That is twenty-five trillion in nice round numbers. I wrote it out because it is so fantastically large. This is an increase of 9.1% over the amount last year. Of the total debt, consumers are about 40%. Household mortgages were \$8T up 14% and credit card debt was \$2T up 5%. As a percentage of household net worth it stayed the same as home prices increased.

Personal Savings go Negative

2005 will go down in history as the first year since measurement began in 1952 that the personal savings rate of Americans went negative. We actually, as a collective group, spent more than we made for the first time ever. We either borrowed it or used savings to make up the difference. Why is this a concern now? It puts a lot of pressure on assets to appreciate, incomes to rise and credit to be available, none of which is a given.

Personal Savings Rate

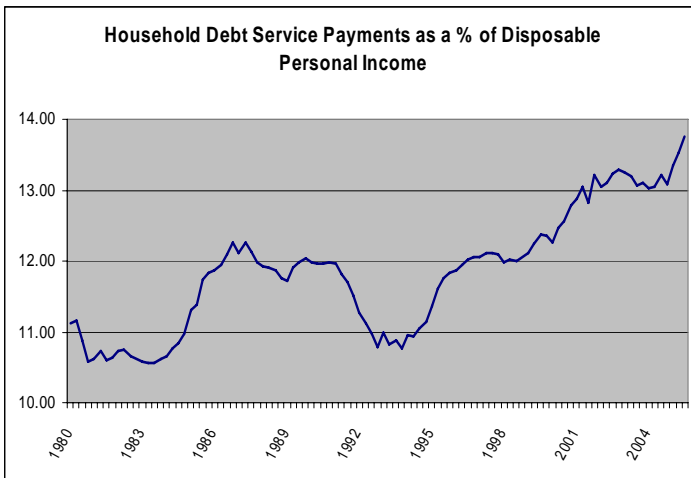


What? Me Worry?

The people I have mentioned this to almost all implied that that was true for them, but they were unconcerned. Their homes were their primary savings vehicle, and their value had increased. In addition, many people had refinanced at lower rates and were servicing their mortgages with little trouble. They have no intention of paying off the mortgage, and in fact most people could not pay off their mortgage, unless they sold their house. 'Debt is Eternal' seems to be the credo. So why worry? This confident attitude had a lot to do with the fact that the devastating hurricanes in the third quarter had only a barely noticeable effect on our economic growth and consumer spending in particular.

Money Crunch

The source of the optimism, home prices, appears to be waning. This coupled with higher energy costs is going to put the pinch on many Americans. The problem lies with the discretionary income squeeze. Disposable personal income was up only 3% last quarter to \$9T annualized, and this is being eroded by increased energy costs as well as higher short term rates. As the consumer drives the American economy we are concerned about the effect of rising rates, consumption of capital and inflationary pressures.



Pressure on Asset Liquidity

The problem with the savings rate going negative is that this puts pressure on assets to rise as a source of capital. We feel strongly that home prices will at best plateau from here until they become more affordable, as mention in our March Memo. The stock market has been laggard and barely outperformed money market funds, and the bond market has been negative. *Without additional sources of capital this means that more pressure will be put on consumer's savings because of higher interest rates and fuel costs, as well as general inflation now running at around 2%.*

Bonding With Our Lenders

We can borrow because lenders all believe that debt is a key component of the capital structure. Debt loads may be viewed as a vote of confidence in the individuals concerned. Lenders believe we will be able to pay debt back because our assets are valuable and our incomes secure. Finally, these debts are mostly long term and no one expects them, or wants them, to be paid off.

Conclusion

Like a dinosaur tip-toeing into the tar pit, today's consumer needs to tread lightly. The ability of individuals to borrow money is a vote of confidence. A slow down due to higher rates would cause problems for the individual. The consumer will be in for a shock if he counts on his home to be his primary source of liquidity in those times.

Debt is an integral part of our growth, a positive force unless taken too far. We are concerned about the reliance on savings in illiquid assets like homes. Disposable personal income is being pressured by energy costs, interest rates and the beginning of inflation. Should any of these factors continue the trend seen in 2005, we seriously doubt that consumer confidence will remain high or the economy fluid.

The Asset Class Review & Preview

By Justin McNichols

The year 2005 possessed many of the necessary ingredients for above trend returns. Earnings grew approximately 11% versus a 6% long-term trend. The ten-year U.S. Treasury yields were up only slightly from 4.22% to 4.39%, leaving rates far below the historic average of over 6.50%. CPI peaked early in the year, and the valuation of equities was quite reasonable at 16 times 2005 earnings. So why were the Nasdaq up 1% and the S&P 500 up 3%?

The main reasons were both factual and hypothetical. Factually, we endured a major natural disaster in addition to skyrocketing commodities prices. Hypothetically, many investors feared slowing earnings (which never came to fruition) and higher interest rates (see slowing earnings) would impale the bull market that began in March 2003.

As we enter 2006, many investors are attempting to gauge the direction of the different major asset classes going forward. In forming a thesis for what areas are overvalued and undervalued, some historical analysis may help.

HIGH QUALITY DOMESTIC EQUITIES: Our thinking here is simple. “The longer equities continue to be priced at a discount on an interest rate adjusted and regression basis, the higher the probability of future above trend (8%) returns”. Our internal proprietary models peg the S&P 500 as 11% undervalued on an interest rate adjusted basis, and 4% undervalued on a regression basis. One of three scenarios must occur for equities to be priced at fair value. 1) Interest rates must rise at least 200 basis points 2) Earnings must fall by about 10% 3) Stock prices must rise above trend. We prefer scenario three.

HIGH QUALITY GROWTH VERSUS VALUE: Our three stage Equity discipline enables the Investment Team to lean a portfolio toward Growth or Value depending on fundamentals and valuation. Although Value has recently outperformed Growth, after Growth’s outperformance streak for six years from 1994-1999, we are indifferent between the two on a valuation basis. The Russell 1000 Growth trades at a P/E of 19 versus long-term earnings growth of 14%. The Russell 1000 Value trades at a P/E of 13 versus long-term earnings growth of 10%. So on a valuation basis, each index has a similar PEG (P/E divided by growth rate). Overall our portfolios reflect this fact by owning a broad array of companies.

INTERNATIONAL EQUITIES: High quality, mature International equities appear to be mildly overvalued on a P/E basis versus domestic counterparts. Very aggressive and very volatile Emerging Market equities have a place in many portfolios, but with a high risk, high reward profile, we prefer to keep tactical allocations on the low side.

DOMESTIC FIXED INCOME: As the Fed ends the interest rate tightening cycle in early 2006, it is possible that a peak in short term yields will lead to a mild rally in bond prices. However, further down the yield curve, longer maturities are sporting yields that are well below historic norms. This may cause bond price rallies to be short lived. With these opposing forces in mind, we are mainly neutral on fixed income.

COMMODITIES: 2005 was certainly the “Year of the Commodity”. Gold up 18%, Metals up 30%, Crude oil up 40%, Natural gas up 85%. Even orange juice and eggs got into the act, up 45% and 40%. But what does this mean for the future? Although very tough to gauge, one fact remains: The bulk of the price increases are behind us. On a historic basis over the last 50 years, the CRB Index, which broadly measures commodities prices, is up about 2% annually. There are three periods over the last 50 years when prices spiked. First, in 1972-1974 the CRB rose 95% in three years. After this period, the Index was flat for over three years. Next, from 1978-1980 the CRB index rose 55%. The next time the CRB Index made a new high was July of 2005... over 25 years later!

Over the last four years, the CRB is up 84% or 16.5% annually. What does this mean? Historically this indicates far slower appreciation at best. On a trend basis, at a 50 year 2% clip, the CRB

should be around 285-290 versus 337 today. Coincidentally, the index began 2005 at 284.

REAL ESTATE: Most bears point to the 6 or 7 years in a row of major price appreciation for real estate, and instantly conclude we are beginning a bear market. However, our internal research points to a different conclusion than the consensus. On a monthly basis, I update housing statistics for the U.S., California, and what I consider “Bubble Areas”. Here are my conclusions: In the U.S. since 1960, the average new home price has increased 6.23% per year. If you draw a trend line from 1960 that extends to infinity, you find three major facts. 1) In 1990, home prices were 33% above trend. This started an eight year period of sub-par appreciation. 2) In 2001, prices were actually 5% below trend. This started the present streak of price appreciation. 3) Today we are less than 4% above trend. So on a national level, we are not near a bubble. HOWEVER! In California (data since 1967), prices are 25% above trend. When you extrapolate that data to regions of California like Sacramento, Fresno, and San Diego, the % above trend reaches as much as 35-40%. So while there are definitely pockets of bubble pricing, the nation as a whole is only slightly overvalued.

HEDGE FUNDS: Although these investment partnerships typically saddle investors with higher risk, 2004 and 2005 were not kind to Hedge Funds as a group. After a fairly flat 2004, the best performing hedge fund style in 2005 was Distressed Equities, up just over 6%. One variable hedge funds typically need is higher volatility. Unfortunately, volatility has been nearly non-existent for over two years. With the post-bear market popularity of Market Neutral Funds (longs match shorts), coupled with low volatility, investors realized that these styles can experience long periods of miniscule performance, while only outperforming during down markets. For 2006, the HF’s need higher volatility.

POTENTIAL HEADWINDS TO DOMESTIC

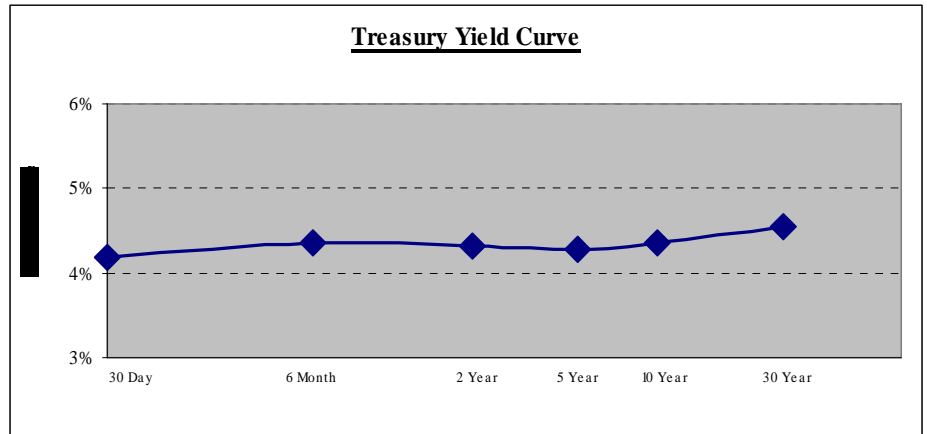
EQUITIES: In general, we feel domestic equities offer the best risk adjusted upside at this point. The potential headwinds to equities this year are most likely associated with the following. First, an unusual and unforeseen shock such as a terrorist attack or natural disaster. Second, rapid inflation. Third, a spike in interest rates which will in turn compress P/E multiples. Fourth, the Fed “over tightens”, knocking the economy back into recession.

2006: Although a balanced portfolio is the key to reducing risk, domestic equities may be the best risk adjusted return candidate looking forward. Alternative asset classes and alternative types of equities are useful in smaller doses as well to balance a portfolio, reduce risk, and reduce correlation to one market.

Fixed Income Round-Up

By Robert C. Gillooly, CFA

January 5, 2006	YIELD
Average Money Market Fund	3.50%
5 Yr AAA Muni Bond (after tax)	4.85%
5 Yr AAA Corporate Bond	4.85%
10 Yr AAA Muni Bond (after tax)	5.44%
10 Yr AAA Corporate Bond	5.14%
30 Yr Fixed Rate Mortgage	5.68%



The bond market ended 2005 with returns that are less than historical measures. Most classes of bonds showed a paltry gain of just over 2% for the year, well below the long-term average of between 5-6%. The Federal Reserve consistently raised rates in ¼ point increments in an 18 month campaign. OPCM agrees with the consensus view that the cycle of rising short rates is largely over and the Fed will signify this in one of their upcoming meetings.

OPCM is quite optimistic for an improvement in bond returns relative to what we obtained in 2005. Productivity has improved and inflation is still benign. These two factors will remain the driving forces behind what appears to be a positive environment for the bond market in 2006.

New Additions to Osborne Partners!

Emily Engie

Emily joined OPCM in May 2005 as a Portfolio Administrator and is our trader and technology specialist. Emily is responsible for obtaining timely and the best execution possible via our electronic trading systems. She also is instrumental in making sure the OPCM website, accounting system, and mission critical technology run smoothly throughout the day.

Prior to OPCM, Emily worked for Mellon Capital Management. She enjoys playing pool, reading, martial arts, listening to music and watching movies. Emily received a B.A. in Mathematics from University of California, Berkeley and is a candidate for the CFA charter.

Lara Rafton

Lara joined OPCM in October, 2005 as an Administrative Assistant. Lara will be making sure all our client statements are accurate, right down to the penny. She will also be assisting our clients with any gifting and/or wire transfers they may have. If you have any such requests, feel free to contact her directly.

Prior to OPCM, Lara has worked for RS Investments here in SF and Fidelity Investments back in Boston, MA. She is fluent in Spanish and is also an avid cyclist and runner; having completed her first ½ marathon last year and planning a double century ride this year. She also enjoys reading, yoga and playing with her dog. Lara received a B.A. in Spanish from Wake Forest University and is taking continuing education coursework in finance at UC Berkeley Extension.

Mckenzie Lauren Lemon

And last, but not least...we are very happy to announce Shannon Lemon's new daughter Mckenzie. She was born on November 25, 2005, weighed 6lbs 6oz, and was 19.25 inches long. Shannon, Mike and Mckenzie are all happy and healthy. Shannon is currently on maternity leave and will return at the end of March.

