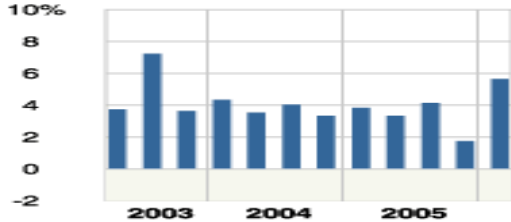


Second Quarter 2006 Highlights

**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



ent on manufacturing and farming to produce our GDP as we are on service.

Of course, there is a third primary source of inflation besides supply and labor, *Consumer Expectations*. The expectation for higher inflation can be very hard to expunge once entrenched. In the 70's, higher oil prices created this type of environment. Although, we have not seen this since, we have seen examples of asset bubbles. The stock market of the 90's and the housing bubble of the last few years are examples of "demand pull" asset inflation. You do not have to buy a house or stocks, but if people feel that the price of everything from clothes to cars is going up, then they buy today because it will cost more tomorrow. This in turn creates the shortages and the associated psychology of inflation. At this

point, however, expectations are still muted, and the Fed is making sure this remains the case.

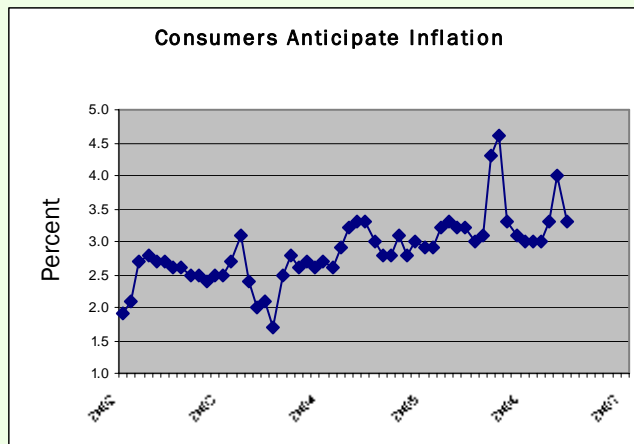
**Tough Talk at The Fed**

In reality, the Fed has little control over commodity prices and labor outside of sending us into a recession, but the threat of a recession can curb our shopping enthusiasm. Consequently they are broadcasting the fact that they will remain vigilant. Virtually every Fed official has been worrying aloud about rising prices, using terms like 'troubling', 'corrosive' and beyond their 'comfort' level. This is a very calculated effort to let us know that they are going to fight inflation with all weapons at hand, as inflation expectations, once embedded, are very hard to exorcize from the system. The tough

talk combined with yet another rate increase is clearly aimed at moderating our expectations of higher prices across the board.

**Balancing Act**

We have had seventeen quarter point rate increases since the Fed started to battle inflation. Many economists are worried that in addition to higher gas prices, slowing housing, and other troublesome macro trends, The Fed's continued raising of rates will send us into a recession. Incomes are flat and higher costs are not being reflected in higher wages. The pinch on the consumer is reflected in the price of specific stocks like Target and Home Depot, but the pinch has depressed stock prices in general.



Source: University of Michigan

**Valuation**

There are an infinite number of trends, events and other things that effect stock prices. Interest rates are very important and they move with inflation expectations. Earnings and valuation perception are the

other major factors. Right now earnings have been strong and are still expected to rise about 8% this year and 6% next year. In terms of valuation, the S&P is selling at the low end of its fifteen year range. It is currently at 15.6, trailing in a range of 14 to 31. At the bottom of the 2003 market stocks sold at 16 times. **Our proprietary valuation model, which adjusts PEs based on interest rates, places the market at the low end of a twenty-five year range.** It is now selling at 12.5 times in a range of 12.5 to 27.5 after adjusting for interest rates. We feel valuations adequately reflect the bad news we

know, and have plenty of upside room for a better environment.

## Recent Global Events Challenge Markets

By Morgan White

### Foreign Markets

The second quarter was marked by a dramatic fall in foreign markets, particularly the emerging markets, beginning in the second week in May. Measured from their absolute tops, some markets had dropped by as much as 60% by the end of June, erasing some but not all of their gains since the beginning of the year. The iShares Emerging Markets ETF (exchange traded fund), a proxy for an emerging markets index, was up 6% for the six months, having been up 26% in early May. The more developed markets showed slightly less volatility, finishing up 8% but having peaked at above 18%.

What worries some investors is that with the advent of globalization, global markets, including those in the United States, appear to be moving more and more in synch with one another. Traditionally, foreign markets have tended not to move in lock step with U.S. markets, thus providing significant diversification benefits. If this lack of correlation disappears, the advantages of investing overseas solely for reasons of diversification disappear as well.

That being said, there remain good reasons for investing abroad. Different regions and different countries have different currencies, different climates, different political and social environments, different resources, and differing levels of economic development. These differences provide opportunities for the astute investor. Moreover, we believe that over time, these differences will result in some retreat from the apparent lock-step that most markets appear to be in today in

spite of the forces of globalization, thus restoring the additional benefit of diversification to investment portfolios.

### Natural Resources

Behaving much like the foreign sector, the resource sector also reached a peak in the second quarter. Gold bullion topped out in May at over \$720 per ounce, up from \$513 at the end of the year. It then plummeted to \$567 before closing out the quarter at \$613, still an impressive gain of over 19% since December. Crude oil began the year at \$61/bbl and topped out at just over \$75 before dropping to \$69 in mid-May. It has since recovered to \$74. Many other commodities exhibited similar characteristics. Some commodities, like lumber, suffered a more severe and sustained downtrend.

All of these corrections are understandable given the large run-ups since the first of the year—a little air escaping from the bubble is not unexpected. That being said, given the seemingly unrelenting demand for many industrial and other commodities from the developing world, China and India most notably, the likelihood of a sustained downtrend is low, in our opinion.

From the portfolio perspective, unlike the world's equity markets discussed above, commodities are not likely to develop a close correlation to other markets. Therefore, they continue to make excellent diversifiers for balanced portfolios.

### Real Estate

Mimicking other markets, real estate investment trusts (REITs) decided to take a breather in the second quarter, giving back about half their year-to-date gains in April and May before recovering nicely in June. While more highly correlated to the equity markets than natural resources, that correlation is lower than, say that of foreign markets to

domestic markets. Furthermore, it has been fairly stable over many years. Therefore, in addition to having outperformed the major domestic and foreign equity markets since 1972, and in addition to paying a healthy dividend as part of that return, REITs continue to play an important role in the diversification of balanced portfolios.

## Stock Buybacks

By Bob Gillooly, CFA®

One of the more prominent trends in the market over the past couple of years has been that many companies are buying back their own shares in the open market. This is clearly a positive development for the shareholders of these companies as this practice will boost the demand for their respective stocks.



Why has this trend escalated in recent years? First, US domestic corporations have been cost cutting and hoarding cash since our last mild recession in 2001. The focus has been to build up the strength in balance sheets and not take on any new spending programs. This disciplined approach has led to a large increase in corporate cash coffers that needed to be spent, and many companies have chosen to repurchase their own shares. A secondary reason is also through government legislation, whereby multinational corporations were given a short window to repatriate their overseas profits back into the United States at a discounted tax rate. Many companies have taken the government up on this deal and upon doing so they now have even more cash sitting on their books.

Regardless of how the company received the cash, the fact that they are buying their shares back aggressively also points toward the attractive valuation of their company. Insiders typically know the value of their stock the best, and it should be a big vote of confidence that a stock is cheap when a large share buyback is announced. Though we expect this trend to continue for the time being, it will not last forever as this phenomenon will eventually play itself out.

Company	Value	Date Announced
Intel	\$25 billion	November, 2005
Proctor & Gamble	\$22 billion	January, 2005
Microsoft	\$19 billion	October, 2005
Pfizer	\$17 billion	June, 2006
Citigroup	\$16 billion	April, 2005
GE	\$15 billion	December, 2004
Time Warner	\$12 billion	November, 2005
Cisco Systems	\$ 5 billion	June, 2006
IBM	\$ 4 billion	October, 2005
Exxon Mobil	\$3.5 billion	April, 2005

## Know Your Options

By Shannon Lemon, CFP®

Stock options can be a substantial part of any employee's compensation package, which is why having a clear understanding of the types of options, the tax implications, and the strategy for exercising them becomes extremely important.

Employees are generally granted two types of stock options: Non-Qualified Stock Options "NSO's" and Incentive Stock Options "ISO's". The main difference between "NSO's" and "ISO's" is the tax treatment of the options. "NSO's" do not generate an immediate tax liability at the time the option is granted; rather the tax liability is generated at the time the option is exercised. At the time of exercise, "NSO's" are taxed at ordinary income rates on the bargain element, which is the difference between the fair market value and the grant price at the time of exercise.

On the contrary, if “ISO’s” are held two years from the grant date and one year from the exercise date, they do not generate an income tax liability when exercised, however, the bargain element is considered a preference item on the individual’s tax return for calculating “AMT”, the Alternative Minimum Tax liability. When the stock is later sold after the required holding period, any gain is treated as a Long Term Capital Gain “LTCG”. If an ISO is exercised or sold before the holding period requirements, the option becomes non-qualified and is taxed at ordinary income rates .

Depending on the type of option and the employee’s ultimate goal, whether it is liquidity, diversification, or long term growth, selecting an appropriate options strategy is extremely important.

**Cashless Strategy** – This is the most common strategy used. The brokerage firm where the options are exercised lends the capital to the employee while simultaneously selling the shares to create liquidity and cover the transaction costs.

**Exercise and Hold** – This is a bullish strategy when the company is expected to have future growth. With this strategy, the employee commits the capital to exercise. The tax implications for “NSO’s” are considered ordinary income on the bargain element at exercise and then LTCG on additional gains after a 12 month holding period. For “ISO’s” if all holding periods are met, additional gains above the bargain element are LTCGs.

**Exercise and Sell to Cover** – This is a hybrid approach that is used to exercise and sell shares to cover the taxes and transaction costs, while the remainder shares are held for future appreciation.

**Stock Swap** – This strategy is implemented by using company stock that an employee

already owns to fund the exercise of the new option shares. One of the benefits of this option is that shares do not have to be sold so capital gains are not generated to fund the exercise; the bargain element is immediately taxable. The employee will then usually receive two lots of the stock back, one with a low basis and one with a high basis, offering financial planning flexibility.

**83(b) Election** – This strategy can be utilized to exercise options before they are vested when the employee expects the company stock to appreciate significantly. This option strategy can only be done by making the 83 (b) election prior to the shares being vested. The 83(b) election for “NSO’s” converts ordinary income to the lower capital gains treatment. For “ISO’s” the early exercise reduces the bargain element and the likelihood of falling into AMT. Employees must still wait for the end of the vesting period to sell their shares.

It can often be difficult for employees to be objective about their own firm’s stock and develop a time frame to exercise the options granted. Osborne Partners can help by providing a comprehensive stock option analysis and customized strategy. The analysis organizes option awards, unvested options, vested options, and exercised options into a concise and easy to understand report. More importantly, the customized strategy lays out a long-term plan to reduce concentrated positions of company stock, and exercise vested options. A long-term timeline is shown to track the progress of the ultimate goal of reducing risk, while diversifying the portfolio.

## Fixed Income Roundup

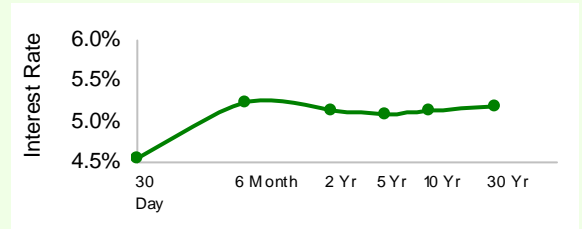
By Bob Gillooly, CFA®

The bond market has been extremely busy of late digesting commentaries from seemingly every one of the Federal Reserve board mem-

July 3, 2006	YIELD
Average Money Market Fund	4.50%
5 Yr AAA Muni Bond	4.00%
5 Yr AAA Corporate Bond	5.72%
10 Yr AAA Muni Bond	4.29%
10 Yr AAA Corporate Bond	6.03%
30 Yr Fixed Rate Mortgage	6.38%

bers. Many market pundits used to criticize Alan Greenspan for his lack of telling information in his public remarks. Now new Fed Chairman Bernanke and his peers have taken to disseminate more forthright market data, and the market is reeling from it.

### Treasury Yield Curve



The bond market has performed poorly year to date, and much if this can be cited by two factors.

First, the new candid and explicit nature of

the Fed's commentary is a bit of a shock to the market participants, and is quickly being translated into negative price movements. Not unlike the stock market, the bond market does not like unexpected news and will usually react poorly to it even if the information is not that bad. Next, the Fed has raised interest rates now in 17 consecutive meetings, stifling any price appreciation from bonds we own. We expect this streak to be broken in the second half of the year creating a more favorable environment for bond performance.

The OPCM team does not anticipate short bond yields to increase substantially throughout the balance of the year. We are consequently encouraging clients to be fully invested in their fixed income allocations, and focusing on short 1-2 year federal agency and municipal bonds.

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### New Additions to Osborne Partners

We are excited to announce the addition of two new Portfolio Managers to our wealth management team and the opening of a new Osborne Partners Palo Alto office.

Our two newest members are Bob Beim and Morgan White, both coming to us from Woodside Asset Management where they were Managing Directors. Mr. Beim has 37 years financial industry experience, is a licensed CPA and is an expert regarding Real Estate matters. He is a graduate of the University of California, Berkeley and has an MBA from the Stanford Graduate School of Business.

Morgan, also a Stanford MBA, has 33 years industry experience and brings a wealth experience in managing clients assets. He is an expert in the areas of Natural Resources and Global Investing. Morgan has completed his Bachelor and Masters degrees in Electrical Engineering from Stanford University as well as his MBA.