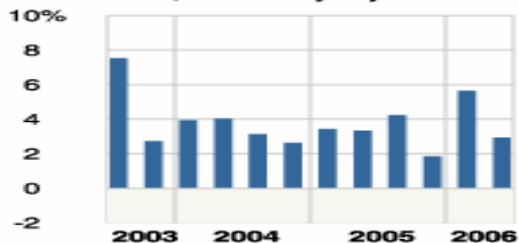


### Third Quarter 2006 Highlights

#### 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



Source: National Association of Realtors



## Interest Rates and Housing

By Charles D. Osborne

Often it is difficult to pinpoint an event or uncover a trend in a quarter that is significant to investors. This was not the case in the third quarter of 2006. There were two events in the quarter that were meaningful. The first was the cessation of interest rate increases by the Federal Reserve. The second was the first decline in eleven years in home prices. The two events were not unrelated.

After precipitous drops in 2001 to ameliorate the effects of the recession, the Fed held interest rates steady for a while. This powered the housing market through the recession and early recovery period. Then in 2004 they started increasing them in seventeen consecutive steps. During this period the stock market did very little, while the home real estate market continued to do very well.

### Affordability

Although the rate increases were intended to keep inflation at bay, mortgage levels were still very low on an historical basis. The average for the last twenty years is just above 8%, and is now about 6.7% for new homes. The initial even lower rates in 2001 had the effect of making houses so affordable that more Americans now own homes than ever before. As the stock market dawdled, home prices shot up around the country. Median home prices went up in some areas far in excess of normal 5%-6% trends, and the housing market became out of reach for many. Then in August, the median price on a home dropped about 2% from a year earlier, the first drop since 1994.

**Now What?**

One of the better elements of owning illiquid assets like real estate is that in bad times you do not have to open the Wall Street Journal and watch them decline in price every day. The hopelessness of watching your stocks or bonds drop actually accelerates the process, but you can not gauge the value of your home every day. The press hysteria surrounding the decline in housing prices may affect this somewhat, but the declines are after a sharp run-up, and are still above trendline. We just have to remember that scary headlines sell newspapers. My guess, however, is that

the average homeowner who is thinking of selling will probably sit tight and wait for a better market.

**Recession Coming?**

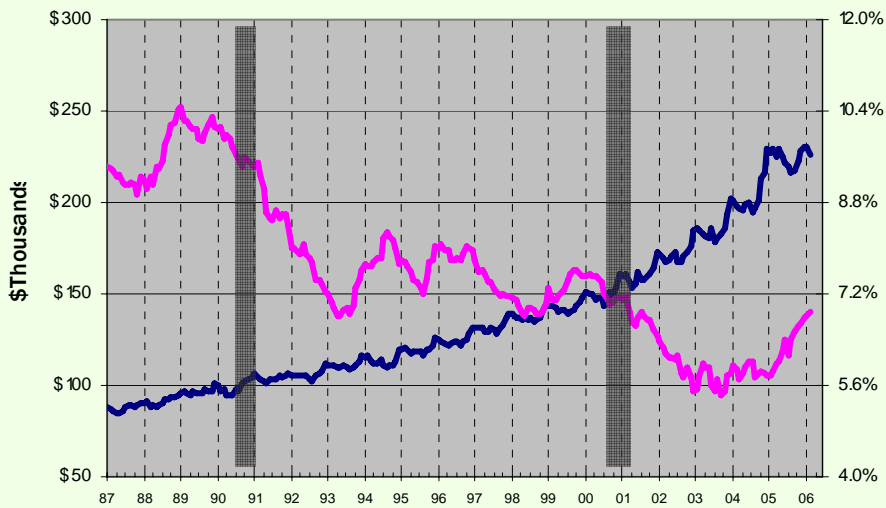
Will declining or stagnant real estate prices force the economy into a recession?

Housing has always been very cyclical and is an important part of the economy. Consumer spending is affected in several ways, directly and indirectly, as we have detailed in the past.

The question for us is how the inevitable drop, and we do think it is inevitable in many areas, will affect the stock market. We know the economy will be negatively impacted. Two out of the five jobs created in the last five years have been housing related. Certainly that growth will not continue. People have mortgaged their homes to spend money on a variety of things. This source of cash will be vastly reduced. The speculation on homes as investments (a total of 23% of last year's transaction) and vacation homes (13% of transactions) will be less enthusiastic. Why? The Fed procedure of gradually raising interest rates has flattened the yield curve and added pressure

on the expense side of consumer spending. The Housing Opportunity Index, a measure of affordability determined by average income and mortgage rates is at an all-time low, after coming from an all-time high in 1999. (OPCM June 2005 Economic Memorandum)

Although real estate may stagnate for the near future it has not significantly slowed the economy. Consumer spending thus far has not slackened considerably and corporate profits should be up this year and next. Our exports are growing and capital spending is up. Also for the first time in several years we are seeing real growth in the stock market.



**Declining mortgage rates versus improving single family home prices. Recessions in gray. Mortgage Rates still low historically while the housing market seeks normal growth.**

We have often held that the key factors in the stock market are earnings, interest rates and valuation. All three of those elements are positive at this point. The Fed has stopped raising rates for the time being. Valuation is still very

reasonable, and earn-

ings should be up this year and next. The fact that home prices may drop in some areas and stay flat in others should not cause a recession and could easily send investment dollars to the stock market.

**Recent Global Events Challenge Markets**

*By Bob Beim*

**Foreign Markets**

Many of the stock markets in other parts of the world performed even better than our own this quarter in terms of their local currencies. Because the U.S. dollar did not move much this quarter, relative to most other currencies, U.S. investors in foreign markets enjoyed those returns in full.

After the beating endured by many foreign stock markets in the second quarter, it helped immensely that the Federal Reserve brought to a halt its measured program of raising U.S. interest rates. Investors were encouraged that the U.S. economy was less likely to slip into a recession and, further, that the global economy was also less likely to do the same.

To give you an example of some of the third quarter returns in other stock markets, in their own currencies, the Philippines was up 15.8%, Mexico 13.6%, Indonesia 15.8%, Spain 12.4%, Netherlands 11.2%, Germany 6.0%, France 5.8%, and U.K. 3.6%. Very few foreign stock markets lost ground for the quarter.

### Natural Resources

Oil, gold, coal, natural gas and other natural resources were hit hard this quarter, dropping about 10% as a group. The price of oil, as measured by the front-month contract for light, sweet crude, hit an all-time high of \$77 a barrel on the New York Mercantile Exchange in mid-July before dropping 23% to \$59 a barrel during the first week of October.

The prices of oil and other commodities are greatly affected by the demand for them from growing economies around the world, as well as by geopolitical and other events that threaten their supply. For example, oil prices have dropped recently as a result of the end of the summer driving season, the reduction in tensions between the U.S. and Iran, a milder than anticipated hurricane season and the announcement of a new oil discovery in the Gulf of Mexico. On the other hand, OPEC has threatened to cut production in order to drive prices back up.

The prices of oil and other commodities will continue to be volatile and not highly correlated to the movement of world equity markets. We also like them in our portfolios as a hedge against unpredictable geopolitical risks.

### Real Estate

Our exposure to real estate is primarily through equity real estate investment trusts, or REITs.

The third quarter performance for this group was a strong 9.3%, bringing their return for the nine months through September 30 to 23.4%.

It is astounding that REITs have marched along so well since 2000, with annualized returns in excess of 20%, far outperforming all other asset classes. REIT valuations are high by historical standards, but they are nonetheless in line with the valuations of the underlying real estate that they hold. However, one can certainly argue that the underlying real estate is over-valued, and it may well be.

Like any other asset class, real estate values will be subject to correction from time-to-time. However, this has been an excellent asset class in our portfolios, not only because of its outstanding returns but also because of its low level of correlation to U.S. stocks in general. As long as the U.S. economy stays healthy, we expect real estate fundamentals to stay healthy.

### Tracking Real Estate Markets

By Bob Gillooly, CFA®

Gone are the days where we rely on the article written in the San Francisco Chronicle, NY Times, or USA Today to keep track of price changes in the real estate market.

The Chicago Mercantile Exchange (CME) now lists futures for 10 major metropolitan real estate markets and a national composite. So there is now a formal way to check what prices are doing in Boston, New York, and San Francisco on a real time basis. The futures are being sponsored by Standard & Poors and are called the S&P/Case-Shiller Home Price Indices. The data and composition of these indices were developed by Yale University professor Robert Shiller and Wellesley College professor Karl Case, and though the futures are only 4 months old their data and analysis go back over ten years.

<u>Metro area</u>	<u>July/June %chg.</u>	<u>1yr % Chg.</u>
Boston	-0.1%	-2.3%
Chicago	0.3%	6.5%
Denver	0.6%	2.8%
Las Vegas	0.2%	5.6%
Los Angeles	0.2%	11.2%
Miami	0.0%	16.5%
New York	-0.5%	7.1%
San Diego	-0.2%	0.7%
San Francisco	-0.2%	2.9%
Washington DC	-0.3%	4.4%
<b>Composite</b>	<b>-0.1%</b>	<b>6.7%</b>

## Fixed Income Roundup

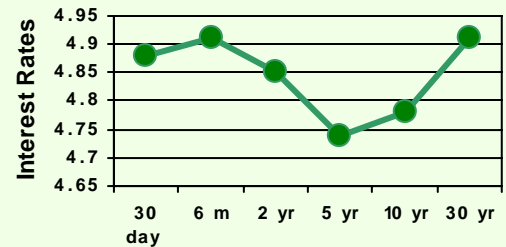
By Bob Gillooly, CFA®

January 5, 2006	YIELD
Average Money Market Fund	4.75%
5 Yr AAA Muni Bond	3.65%
5 Yr AAA Corporate Bond	5.26%
10 Yr AAA Muni Bond	3.88%
10 Yr AAA Corporate Bond	5.52%
30 Yr Fixed Rate Mortgage	6.17%

The bond market rallied in the 3<sup>rd</sup> quarter for many of the same reasons as the stock market. The Fed finally put a pause to raising short interest rates and energy prices declined dramatically quelling inflation fears.

Long bond rates once again defied most market strategists and fell by more than .25%. This leaves the yield curve remarkably flat, once again, which means as investors it doesn't reward us to buy longer term maturities at present. Given the current environment, the OPCM team continues to focus on short term bonds for new money.

Treasury Yield Curve



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It is the policy of Osborne Partners to not disclose any non-public personal information about you to any unaffiliated party while you are an active or inactive client, except as permitted or required by law.

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