

TO: CLIENTS & FRIENDS
FROM: TWIN FOCUS CAPITAL PARTNERS, LLC
RE: QUARTERLY COMMENTARY – OCTOBER 2006

“Prophesy as much as you like, but always hedge.”

- Oliver Wendell Holmes, 1861

- The Dow Jones pushed the index close to the all time high set in January 2000 as we celebrate the 4th consecutive year in the most recent bull cycle that began in October 2002.
- The leadership in the current rally has not been broad based but rather concentrated in the largest of the large cap companies on the backs of mediocre trading volumes.
- Successful investing involves harmonizing realistic expectations with prudent execution. In simpler words, we attempt to identify risk-adjusted profit opportunities and then allocate capital in calculated proportions.
- We do not believe that recession is inevitable; however we are keenly keeping an eye on the mounting risks including historically large global trade imbalances, low real interest rates, and flat-to-inverted yield curves.
- For the last 17 consecutive quarters, profits have grown in the double digits aided by an increase in productivity and, despite tepid wage growth onshore, strong consumer spending propped by home equity withdrawals..
- We believe that the markets are range-bound, currently at the upper end. Moreover, we have entered into a lower return environment. The proliferation of hedge funds has created even more market participants chasing absolute returns and lowering profit potential. With everyone in pursuit of higher yields, we continue to feel that potential return is not commensurate with implied risk.

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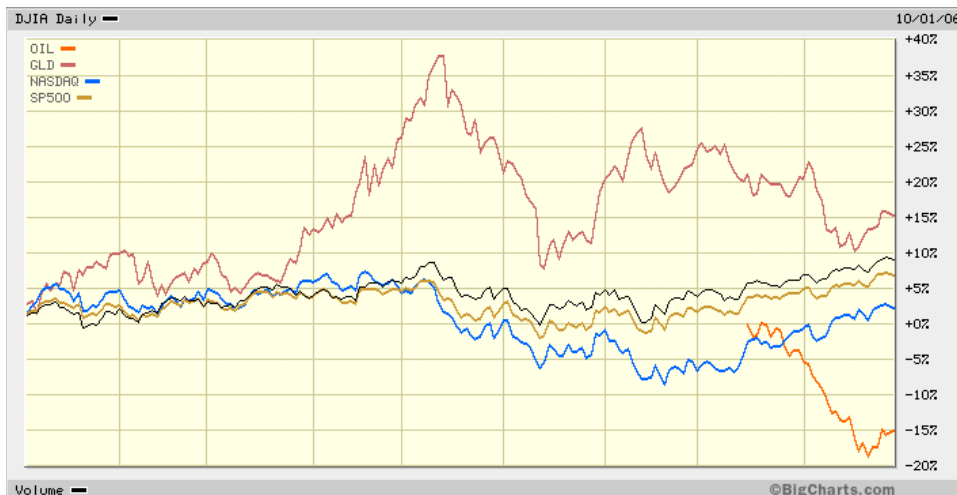
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Twin Focus Capital Partners, LLC is a Registered Investment Advisory firm established as a global multi-client “Family Office”. Twin Focus was created in an effort to engender an environment where our philosophy and signature capabilities could best work to deliver success to a select group. We look to uncover opportunities through exhaustive research, exploring non-traditional paths, and taking a disciplined approach to risk management. While we are mindful of respective benchmarks, our investment approach is focused on absolute returns.

A recent advance in market indices lifted the S&P 500, Dow and Nasdaq into positive territory by 8.97%, 7.01% and 2.41% respectively. The Dow Jones pushed the index close to the all time high set in January 2000 as we celebrate the 4th consecutive year in the most recent bull cycle that began in October 2002. The S&P 500 recently reached a high unsurpassed in the past 5 ½ years, although it and the Nasdaq are still quite a ways from their all time highs – reached in early 2000. Compared to the peak to trough draw-downs of the S&P and Nasdaq (49% and 78% respectively), the Dow suffered a less severe loss of 38%. From the low hit in October 2002, the S&P 500 is positive by a cumulative 72%.¹



September, usually the worst month for the markets, may prove to be one of the best of this calendar year. The S&P was up more than 2.46% during the month and the Dow posted an impressive 5.4% for the third quarter. The S&P had its best quarter in over nine years and the Dow in over a decade. With such a dramatic rise, we are concerned that the market has gotten a bit ahead of itself. After a dismal second quarter earlier this year, the markets began to rally two weeks into the third quarter and really gained momentum the first month of autumn. We note that the rally has not been all-encompassing - a hint that there is little conviction regarding the market direction. There is a great deal of ambiguity among economic prognosticators regarding the rate at which corporate profits can grow, and more so, the direction of overall global growth. The concerns may be manifest into some level of retrenchment as corporate profits are disseminated for the third quarter.

Regardless, we can be certain of uncertainty, and therefore, volatility. As is typical, the market's volatility, measured by the VIX, spiked when the markets hit their 2006 bottom in June/July. Today, given the market participants' giddiness, the VIX is at the bottom end of the range, near historical lows. This has often signaled market tops, as investors tend to be greedy at tops and fearful at bottoms, resulting in hedging positions.

Successful investing involves harmonizing realistic expectations with prudent execution. In simpler words, we attempt to identify risk-adjusted profit opportunities and then allocate capital in calculated proportions. We feel that asset allocation (proper beta exposure) will be

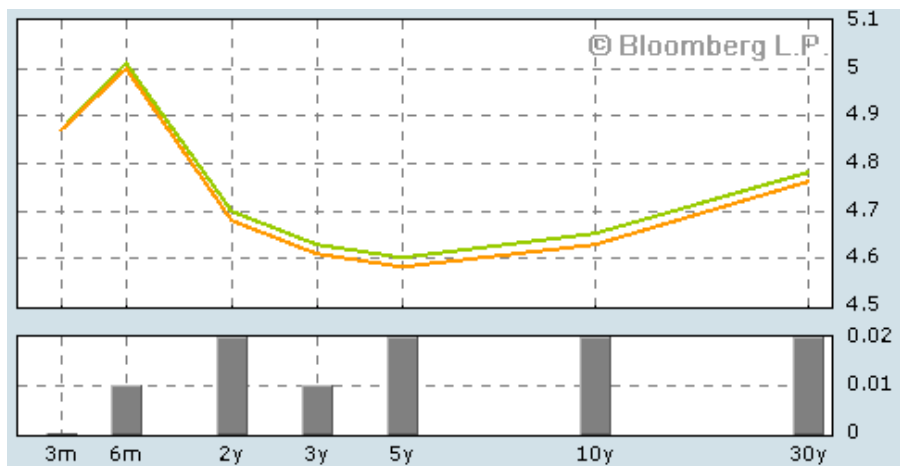
¹ “Happy Birthday, Bull Market. (Now, Make a Wish.)”, Paul J. Lim, New York Times, October 1, 2006

a key determinant in return attribution going forward, and investors must widen their investment universe. We remain defensive given our lack of conviction from a fundamental perspective.

We continue to believe that the market is in a secular (longer-term) bear market where we may not see inflation-adjusted prices much higher than they are today. Although as history has demonstrated in bear markets, we may experience shorter-term bull cycles that can last from 3 to 5 years. On that basis, we feel that the market is range-bound and currently weighing in at the upper end. The leadership in the current rally has not been broad based but rather concentrated in the largest of the large cap companies on the backs of mediocre trading volumes.

The topic du jour seems to have flipped from inflationary pressures to deceleration in the economy. Housing has been slowing, evident by the month over month retrenchment in activity. Treasuries have rallied significantly over the past two months, bringing the yield on the 10-year note to 4.6% and inverting the yield curve even more so than in previous years. The big debate now is whether or not we are in for a hard (i.e. recession) or soft (i.e. economic slowdown) landing.

At the most recent meeting of the Federal Open market Committee, members kept rates at 5.25%, the second consecutive decision of inactivity, after 17 consecutive 25-basis point increases since 2004. Although inflation remains a risk, the Fed noted the recent pullback in energy and other commodities (the CRB index of commodity prices posted a 14% decline -- the largest since 1974). Tight supply and strong investor demand sent some commodities to multi-decade or even record highs. We believe that rising demand out of India and China tips the long-term supply/demand equation for industrial commodities favorably. In the short run, however, some may have become overbought as commodity allocations in portfolios popularized among institutions and individuals. This could lead to potentially violent corrections. Furthermore, slowing in China and in the US could lead to a protracted downturn across the board, including in oil.



The recent steep declines in commodity prices (gold and oil, particularly) may have resulted, in part, from easing tensions in Iran and North Korea and the threat of a hurricane season. However they could also be interpreted as the beginning signs of a global slowdown. Oil tends to move sharply in both directions, either from a supply shock or a mounting supply which often leads to a glut. In the shorter term, we would not be surprised to see oil correct further, possibly into the \$50's or below. OPEC has said that it will cut supplies if necessary to hold oil at \$60 or above. Whether or not their tactics will prove effective is another question. We do however continue to believe that oil and certain other commodities will go higher as the demand increases from domestic and foreign sources, including industrializing nations. That being said, the globalization-led commodity super-cycle will have its delays along the way. Investors must remember that markets are often irrational, regardless of momentum or fundamentals, and don't always go straight up.

Recession Risks

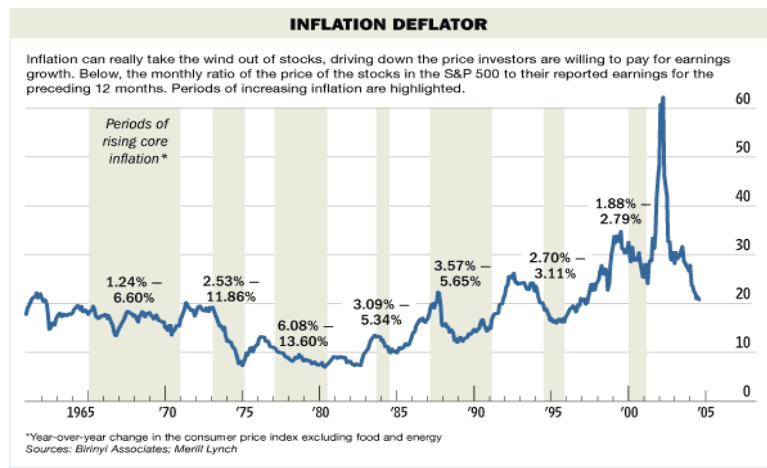
We do not believe that recession is inevitable; however we are keenly keeping an eye on the mounting risks including historically large global trade imbalances, low real interest rates, and flat-to-inverted yield curves. Credit spreads (which measure the compensation offered to riskier bonds over treasuries) have widened recently as rates have fallen -- often an early sign of concern over defaults. The negative sloping yield curve is, at the very least, warning of a slowdown. It is a mistake to extrapolate from recent market performance an unjustified hope that current conditions will continue. Given close correlation to housing,, consumer spending and the markets may begin slowing as well. We are concerned about the rest of the world's reliance on the US as a consumption engine, as well as the high correlation of global yield curves. The old saying of "The US sneezes and rest of the world catches a cold" often proves true.

We continue to believe that the global imbalances in the trade and current account deficits will ultimately require adjustments in currency markets and more notably, materialize into further downward pressure for the dollar. The past few years, the dollar received support from interest rates hikes by the Fed, the Bank of Japan's zero interest rate policy and the European Central Bank's hold on rates. The recent reversal of those encouraging policies will likely see the decline of the dollar as money seeks out higher returns elsewhere.²

A global slowdown could lead the Fed to cut rates to lower levels in efforts to spur the domestic housing market and buoy consumer spending and US consumer imports. These events combined with the overall business cycle could help narrow the US current account deficit. Pimco's self-proclaimed Bond King, Bill Gross, is in part basing his thesis on this potential, and calling for a US bond bull market, "which began almost two months ago, remain[s] in its infancy." The best way to play it, he notes, is via duration above index and concentrated in the front-end of the curve. He goes on to say that although many foreign central banks are still increasing rates, once the US starts cutting, the rest of the world will follow. Generally, lower rates have a positive effect on stock prices, however there comes a time when low rates mean the economy is in trouble.

Inflation

It is clear in our minds that we are in an inflationary environment. When our "core inflation" number (which leaves out asset prices including energy and housing) is adjusted, true inflation is much higher. There has been no wage pressure because individuals have used home equity extractions as ATM withdrawals; which is all fine and good as long as rates are low and strong home values persist. A recent report from the National Association of Realtors indicated that year over year existing home prices declined for the first time in over a decade. Inventories of unsold homes have hit new highs which could lead to even further declines as home sellers are forced to slash prices remaining order to compete and move product. Homebuilders have been reporting downward revisions in profit forecasts.



² "Global Perspectives", Richard H. Clarida, Global Strategic Advisor, Pimco, September 2006

³ Chart: "Inflation Can Have Illusory Allure", Peter A. McKay, The Wall Street Journal, July 12, 2004

Un-compelling Stocks & Nice Profits

Although equity valuations are off their historic highs, earnings have grown while stocks have treaded water over the past five years, bringing P/E's down. Valuations are still not overly compelling at 15 or 16 times forward earnings. Investors would need to buy into the argument that already record-high profit margins can persist. Margins are almost 100% above their historical average. While this can be attributed partially to gains in productivity and outsourcing to China, we find it hard to believe that we can get anymore efficient. As famed market prognosticator, Jeremy Grantham, frequently points out, profit margins are the most predictably mean reverting sequence in finance (that's what capitalism is all about!).

For the last 17 consecutive quarters, profits have grown in the double digits aided by an increase in productivity and, despite tepid wage growth onshore, strong consumer spending propped by home equity withdrawals.. Global outsourcing to cheap labor in many of the world emerging nations has cause steep declines in unit labor costs and has been a key factor in causing profits to more than double since 2001. Strong profit growth has helped to offset the bite of rising interest rates and higher energy prices. It is often said that it can take 12 to 18 months to feel the lagged effect of fiscal and monetary policy. We could see the weakness in housing and pullback in consumer spending hurt profit growth next year by anywhere from 10 to 15%.

On a broader more secular basis, we find it difficult to believe that the overvaluation brought on by an 18-year bull market can be corrected in three years. Historically, the duration of a bear market has paralleled that of the bull that came before it. We believe that the markets are range-bound and that we have entered a lower return environment. The proliferation of hedge funds has created even more market participants chasing absolute returns and lowering profit potential.

In Vogue

With everyone in pursuit of higher yields, we continue to feel that potential return is not commensurate with implied risk. The significantly under-funded state of corporate and municipal pension plans and the desire for 8 to 9% returns in a mid-single digits return environment is currently burning holes in the pockets of investors. It has driven massive amounts of capital into hedge funds and private equity. Recent estimates indicate that since 2005 we have been well on the way to raising \$300 billion of capital in the private equity space. This can be levered up to over \$1 trillion in buying power.⁴ The sheer amount of capital has driven up the average size of transactions. The takeaway point is that there is too much capital chasing too few deals and thus, investors should be conservative on their performance expectations.

In a recent *WSJ* article, legendary billionaire hedge fund manager Steven Cohen who runs SAC Capital argued that with over \$1.2 trillion in capital invested in nearly 8,000 hedge funds, times have changed and the new environment is much tougher.⁵ The data indicates that with so many investors chasing absolute returns, the average hedge fund return has drifted lower. In a recent interview, Mohamed El-Erian, who just this year left fixed income powerhouse Pimco for the Harvard endowment, elaborated, "In addition to stretched valuations in several market segments, the outlook for high returns is being adversely impacted by three inter-related developments: first, the large-scale migration of endowments and foundations to similar asset allocations; second, indications that other institutional investors, including large public and private pension funds, are following; and third, limits on the availability of appropriate investment management capacity."⁶

We tend to agree that more market participants increase efficiency and arbitrage out opportunities. We also feel that there is greater systematic risk as the number of strategies increases, so does correlation across those strategies, due to the squeeze in investment opportunity set. A sharp decline in the broad markets may provide a shake-out. According

⁴ "Why Risk Is Rising for LBOs", Barron's, Tom Burnett, September 25, 2006

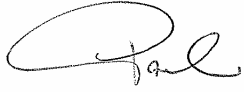
⁵ "The Hedge-Fund King Is Getting Nervous", Susan Pullman, The Wall Street Journal, September 16, 2006

⁶ "Generating Returns Isn't Merely an Academic Question", Randall W. Forsyth, Barron's, September 29, 2006

to Hedge Fund Research, 848 funds closed operations in 2005, a trend that could very likely continue.⁷

We value the trust you have placed in us as stewards of your overall financial well being. As always, should you have any questions regarding these or any other topics, feel free to contact either of us directly.

Respectfully,



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⁷ "The Hedge-Fund King Is Getting Nervous", Susan Pullman, The Wall Street Journal, September 16, 2006