The Long & Short of It

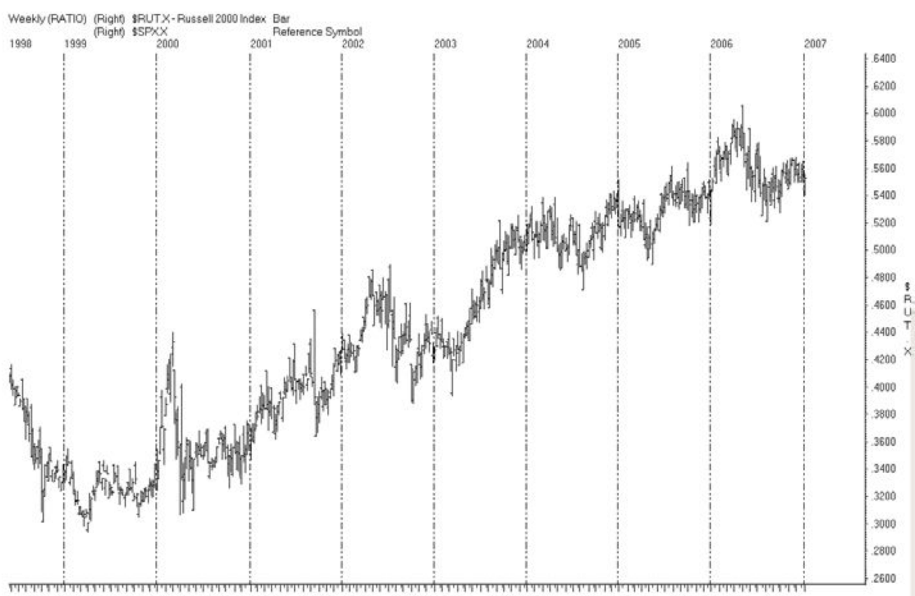
Stocks were the star performers during the fourth quarter. The total return of the S&P 500 stock index was a solid 6.7% for the quarter and 15.8% for the year. The average domestic stock mutual fund total return was 6.5% for the quarter and 13.1% for the year. Much of this performance was driven by the merger and acquisition activities of well-capitalized companies and private equity funds that were flush with cash.

In addition, the election appeared to create an increased check on government activity, or at least the potential for gridlock, which Wall Street typically appreciates. On average Wall Street seems less interested in ***who** has power, or **how*** power is wielded, as in ***how much*** power is exercised, preferring the more stable, predictable environment provided through limited change in the playing field. This stands to reason, as investors prefer a more certain investment landscape to one of constant turmoil.

Small Versus Large

Small capitalization stocks once again outperformed large last quarter, allowing them to claim one more year of victory. The Russell 2000 Small Cap Index returned 17.0% for 2006 versus 13.3% for the Russell 1000 Index (large cap). Although we touched on this subject last quarter, we feel it is important enough to warrant some additional coverage.

Numerous casual market observers have recently commented about the outperformance of large cap stocks over small cap stocks during 2006. Obviously, this is not what happened, but only their perception of reality. Despite their misperception, large cap stocks were able to participate in the rally for the first time in 7 years, nearly keeping up with small cap stocks throughout the rally.



The chart to the right shows the degree to which small cap stocks (represented by the Russell 2000) have out-performed large cap stocks (represented by the S&P 500) since 1999. Large cap stocks have significantly lagged their small cap brethren for quite some time now.

To put the most recent decade into perspective,

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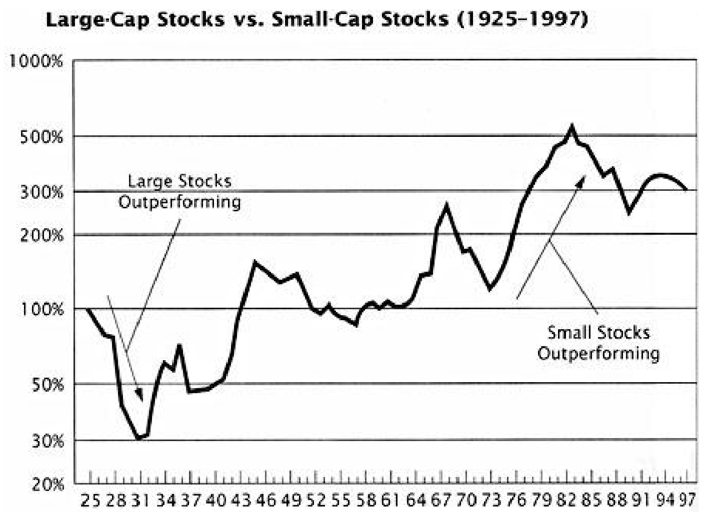
the chart on the right shows the historic relationship between the performances of the two groups from 1925 to 1997. It is clear that small caps have outperformed large caps over the long run. According to Ibbotson Associates, from 1926 to 2002, small company stocks outperformed large company stocks 12.1% to 10.2%. This represents a 19% better result on average each year.



So why hold large cap stocks at all? The significantly greater volatility that comes with holding small caps is the reason they are not the dominant holding in the average investor's portfolio. From 1926 to 2002, the 33.2% standard deviation of small company stock prices was 62% more volatile than the 20.5% standard deviation of large company stock prices. So, the better results have come at a price paid in the form of volatility, as well as some fairly significant cyclical gyrations. For example, while the early 1940's, late 1960's, and late 1970's were very good for small caps, the late 1920's saw the small caps give up nearly 70% of their value relative to large caps. More recently, between 1982 and 1989, small cap stocks gave up about half of their relative value, dropping from what was a 5 fold cumulative advantage to only 2.5 times.

Year End P/E Multiples		
Year End	**S&P 500**	**Russell 2000**
2000	**27.4x's**	**15.9x's**
2001	**46.5**	**18.3**
2002	**31.9**	**16.9**
2003	**22.8**	**20.4**
2004	**20.7**	**21.8**
2005	**17.5**	**21.0**
2006	**18.0**	**25.6**

Returning to the most recent strong performance of small companies, the table to the left shows how valuations have been impacted by relative price changes over the years. Large companies are now significantly under-priced compared to small companies based on the price-to-earnings ratio. For the Russell 2000 (small companies) the P/E ratio is 25.6 versus 18.0 for the S&P 500 (large companies).

After an extended period of excess performance, and with valuations for small cap stocks now being relatively unattractive, we expect to see large caps begin to keep up with or outperform the small caps for the next several years. Further support for this is the fact that the Fed has likely finished raising interest rates for this cycle. As a result, investors are likely to change their focus to the prospects of recession. The need to hold larger, safer companies should become more apparent when investors again ponder how the Goldilocks economy (soft landing) eventually will be upset by the three bears, though their identity is, as yet, a mystery.

Sarbanes-Oxley and Unintended Consequences

One final topic worthy of note during the quarter was the increasing dialogue about the implications of Sarbanes-Oxley (Sarbox). Sponsored by Senator Paul S. Sarbanes and Representative Michael G. Oxley in 2002, the act imposed rigorous new standards on all public companies for financial accounting and internal controls. Some advocates of Sarbox are claiming victory in 2006 as the filing rate for class-action lawsuits involving securities issues this year declined 38% from last year and, in fact, was the lowest rate since Congress passed securities class-action reform legislation in 1995.

Created in response to the accounting scandals at Enron, WorldCom, and others. Today many critics feel that the law went too far and is hurting U.S. competitiveness. In 2006, public companies will spend an estimated $6 billion on Sarbox compliance. According to a report by AMR research this equates to roughly $3.5 million dollars on average per public company. Another study published by the AEI-Brookings Center estimates that Sarbox has cost the U.S. economy over $1 trillion, if opportunity costs (such as deploying this cash flow to productive investments within the firm) are taken into account.

Specifically, the section of the law requiring companies to perform internal audits has turned out to be far more costly than proponents projected, especially for smaller firms. These costs have led some small companies to go private and some foreign firms to withdraw their stocks from American exchanges. Worldwide, American exchanges hosted only 5% of the world's initial public offerings (IPO's) in 2006, down from 50% in 2000.

For example, many small technology companies who in the past would have gone public today are hoping to be bought out by an established company. Throughout the 1990's an average of 160 technology companies per year went public. In 2006, through the end of the third quarter, only 37 technology companies had offered themselves to the public.

Paradoxically, Sarbox's strict rules on oversight by boards of directors would have been insufficient to prevent the collapse of Enron. Nor was it necessary for prosecution. Senior managers of Enron, WorldCom and other corporations, where fraud was committed, have been convicted of accounting fraud under laws predating the act. It also failed to resolve the major conflict of interest created when auditing firms are paid by the companies they audit.

Over the last several months there has been a rising call for relief from Sarbox. In addition, the Free Enterprise Fund is plaintiff in a lawsuit being heard in the district court of Washington, D.C., claiming Sarbox to be unconstitutional. In mid-December, 2006, the Public Company Accounting Oversight Board proposed relaxing the methods auditors use to sign off on the effectiveness of public companies' internal controls. Incremental adjustments are not likely to fix the problems created and/or not addressed by Sarbox. Watch for a major overhaul.

There are, as usual, many economic and political variables over which investors may speculate. Yet our approach has always been to keep the focus of our efforts on the fundamentals and pricing of each of the companies that we follow.

In the long run, stock price valuation matters. When we find attractively priced companies, they typically face some well-publicized challenge. To overcome the challenge and have their stock price return to fuller valuations requires having a plan for resuming or continuing a still-viable business, as well as a strong enough financial position to implement the plan.

The companies contained within our current portfolios are financially stronger than they have been in over a decade. They are also very attractively priced, as investors remain enamored with small cap investments. Through time, lengthy, uninterrupted trends tend to draw in many investors. The more stable and lengthy the trend, the more dramatic the reversal is when the consensus breaks and the trend changes. Having experienced such a run over the last seven years, small caps are primed for a change in trend. We look forward to this reversal of fortune, as history eventually repeats itself.

Contrarian Value Equity Composite Portfolio Top 10 Holdings
as of 12-31-06

Company Name	**Percent of Portfolio**
Electronic Data Systems Corp.	5.8%
American International Group, Inc.	5.2
Marsh & McLennan Companies, Inc.	5.1
ConocoPhillips Oil Company	5.1
BB & T Corporation	4.8
Gannett Company	4.6
Verizon Communications	4.5
The Home Depot, Inc.	4.1
Pfizer, Inc.	3.8
JP Morgan Chase & Co.	3.3

Contrarian Value Equity Composite Portfolio Fundamentals
as of 12-31-06

	R&W Equity Composite	S&P 500
Number of holdings	29	500
Wtd. Avg. Mkt. Cap. ($B)	76.8	101.6
Price/Earnings Ratio	16.7	19.4
Price/Book Ratio	2.7	3.5
Price/Cash Flow	8.1	9.9
Dividend Yield	2.6%	1.8%
Return on Equity	16.9%	22.0%