

A LOOK AHEAD AT THE YEAR AHEAD

**Ten Investment Themes for 2007 and Our
Five Strategic Wealth Management Themes to
Capitalize on Them**

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THE MDE GROUP, INC.

Your family's most trusted advisor



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A Glance Back on The Year That Was

Before we look forward to 2007, we feel it is only appropriate to assess the accuracy of our prior year predictions which are summarized in the table below. As the title of this report indicates, our investment themes are more than cocktail party conversation. Rather they reflect our best thinking and ultimately are used to design investment strategies that may capitalize on these forecasts. We realize the inherent difficulty in making forecasts and fully expect to never be 100% correct. Nevertheless, we are pleased to report that eight of the ten forecasts we made last year, in our view, were assessed to be correct. Of the remaining two, one was incorrect and one was partially correct.

Where did we go wrong in 2006? The S&P 500 delivered a healthy total return of 15.8% in 2006, noticeably above its long-term average of approximately 12% per year. We predicted positive returns for the S&P 500, but below its long-term average. The stock market was helped by robust corporate earnings, the pause in Federal Reserve interest rate hikes, and record levels of merger and acquisition (M&A) activity. In retrospect, we were happy to be “wrong” on this prediction since the upside to the market’s returns benefited our client portfolios. We were also partially incorrect on our forecast for an increase in market volatility. The VIX index ended the year at 11.6, modestly below its starting value of 12.1. However, there was a very significant spike to 23.8 on June 13th. VIX also averaged 12.8 over the entire year, 5.8% above its starting value.

Report Card For MDE’s Investment Themes For 2006

Prediction	Assessment	Comments
1) GDP growth will slow down in 2006 as the home equity incentive loses steam	Correct	GDP started off the year strongly, growing at a 5.6% annual rate during Q1. Yet by 2006Q3, real GDP increased at an annual rate of only 2.0 percent. The Commerce Department provided an initial estimate of GDP growth for the final quarter at a 1.1% annual rate, clearly a material slowdown from beginning year values. The nationwide weakness in the housing market played a significant role in the slowdown.
2) Mergers and acquisition (M&A) and stock buyback activity will continue to remain at strong levels - above recent averages	Correct	Deal values surpassed \$4 trillion worldwide, well ahead of the prior record of \$3.3 billion experienced during the peak of the Internet Bubble in 2000.
3) Market returns will remain below their long-term averages of low teens, as rising interest rates, rising volatility, and a slowdown in housing activity helps offset good corporate earnings and a modestly growing economy.	Incorrect	The S&P 500 returned 15.8% for the year. The bulk of the returns came in the second half of the year, including a very strong 4 th Quarter, where the S&P surged 6.7%
4) Volatility, as measured by VIX, will increase	Partially Correct	The VIX index ended the year at 11.6, modestly below its starting value of 12.1. However, it did spike to 23.8 on June 13th. VIX also averaged 12.8 over the entire year, 5.8% above its starting value.
5) The Fed will stop raising short-term interest rates in 2006 to avoid the potential negative implications of an inverted yield curve	Correct	In August, the Fed paused its campaign to raise short-term interest rates after raising them 17 consecutive times beginning in June 2004.

Prediction	Assessment	Comments
6) While market forces will want to drive the 10-yr Treasury yield higher, structural reasons, and underlying fundamentals of controlled inflation and a slowing economy, will keep interest rates largely range-bound in 2006	Correct	The 10-Year Treasury was range bound for most of the year, averaging a 4.8% yield, modestly above its starting value of 4.4%. Its 52-week low yield was 4.3% and its high was 5.2%.
7) Oil prices will remain above \$50 for the bulk of the year and there will be increased interest (and further tax breaks) for alternative energy approaches.	Correct	Oil prices traded well above \$50 per barrel for the bulk of 2006, including a spike to \$78 per barrel on July 13 th . On August 8 th , President Bush signed into law the first national energy plan in more than a decade. The President's national energy plan encourages energy efficiency and conservation, and promotes alternative and renewable energy sources.
8) Alternative investments continue to provide portfolio diversification benefits and risk mitigation, but selectivity is crucial	Correct	Hedge fund assets under management swelled to \$1.3 trillion by year-end, as consultants continued to recommend increased allocations to this asset class. True market neutral hedge funds posted modest single digit returns in 2006, while those with significant beta exposure performed better. Perhaps the biggest hedge fund story of the year was the blowup of Amaranth Advisors, a once \$9 billion hedge fund that lost more than 60% of its value in one month.
9) Capital spending will continue to increase and keep the economy out of recession in 2006 in the event of a decline in consumer spending	Correct	Of course there was no recession in 2006, despite the weakness in the residential housing market. The consumer did not collapse, but some retailers, such as Wal-Mart, were materially affected by less than robust consumer spending. Capital spending did not surge, but did increase at an 7.6% annual rate over the course of the year.
10) International investing continues its momentum as investors look for the best global investment opportunities. International stocks in selected markets will continue to shine, albeit with higher volatility.	Correct	International markets continued their strong performances, outpacing domestic indexes on the heels of a weak dollar and robust global economic growth. The MSCI Developed World ex US Index rose 25.7%, outpacing the S&P 500 by 9.9%. When stocks fell globally during Q2, emerging markets were the hardest hit, with many down more than 40% in the span of two months or less.

MDE's Ten Investment Themes for 2007

While we firmly believe that no one can know the unknowable or predict the unpredictable, we also realize that as wealth management advisors we are paid to deliver advice. So it is a core part of our job to analyze the world around us and to make investment recommendations based upon our best thinking. Our advice at MDE tends to be strategic and long-term in nature, but nimble enough to adapt to the ever-changing investment landscape.

With this in mind, we would like to share with you our thinking on some of the significant factors we believe will play an important role in the year that has just begun. Just as was the case last year, we can state with some confidence that some themes we offer for 2007 are likely to be correct, some incorrect, and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major themes of 2007 are neither on our list, nor on anyone else's. With these important facts in mind, we humbly offer you our top ten investment themes of 2007.

1. **No recession in 2007.** In our view, corporate earnings growth will revert near its average historical levels of approximately 6%-8% per annum. Concomitant with low interest rates and relatively healthy corporate balance sheets, the economy will likely achieve a soft landing.

2. **The Fed will remain on hold for most of the year.** Although the market consensus suggests that the Fed will cut interest rates at least once in 2007, there is also a vocal minority calling for a Fed sponsored increase in rates due to the threat of rising inflation. This battle between inflation doves and hawks will likely keep the Fed on hold for the majority of its meetings in 2007.
3. **Stock market returns will be below average for the 3rd year of the Presidential Cycle, but still reasonably attractive due to an expanding P/E multiple, modest earnings growth and flow of funds away from real estate speculation.** The Presidential Election Cycle Theory holds that the first and second years of a President's term are the worst for the stock market as he makes tough decisions soon after the election is completed. However, during the third and fourth years of the term, the President does all he can to get reelected (or to have his party remain in power). Historically, the third year of the cycle is the strongest, with the S&P 500 averaging a rise of 22.1% during these years. In our view the lofty heights of a 20%+ return are unlikely to be obtained due to strong stock market performance since the spring of 2003 and moderate corporate earnings growth. Reasonable valuations, low interest rates, and substantial liquidity should result in positive returns for the market over the course of 2007.
4. **Real estate prices stop falling nationally, but continue to fall in some overdeveloped areas.** Real estate prices fell approximately 3% nationally in 2006, its first decline on a year over year basis in more than 30 years (adequate records were not kept prior to the mid 1970's). Areas that experienced the greatest rises in property values over the past 5 years, such as Miami, Las Vegas, and select areas of California, are likely to continue to see falling prices due to a large inventory overhang and a flight of speculative capital.
5. **Continued strong M&A / LBO activity due to strong corporate balance sheets, low interest rates, and large cash on hand of many corporations and private equity funds.** Cash on corporate balance sheets, in excess of \$600 billion, remains at or above record levels. Investor interest in private equity continues to surge, with these funds holding hundreds of billions of dollars in yet to be invested capital. Furthermore, the only way for larger firms like Johnson & Johnson or AT&T to grow earnings at double-digit rates is through acquisition. In short, M&A and LBO activity should remain at very strong levels, although it is questionable if last year's record of \$4 trillion in global deal activity will be surpassed.
6. **The Dollar will be under further downward pressure as foreign central banks hike short-term rates and investors re-focus their attention on the U.S. trade and budget deficits.** In our view, the Dollar will not go into a freefall, especially given its decline vs. the Euro and Yen over the past few years. However, we see no change in the long-term secular trend of a decline in the Dollar unless there is a material change in the U.S. trade deficit or a material increase in saving rates among U.S. consumers. A negative shock to the system (e.g. terrorist attack, major political event, or unexpected bankruptcy of a leading global financial institution) may actually result in a rise in the Dollar due to flight to quality behavior on the part of panicked investors.
7. **Opportunities continue to exist in overseas markets with lower valuations and higher yields compared to the U.S., but selectivity becomes critical.** The continued globalization of our "flat world" is a long-term secular trend that is manifest. The bulk of overseas markets grow at faster levels than "Supertanker" America's projected long-term GDP growth rate of 3% per annum. Furthermore, valuations for many of these overseas markets are also more favorable than those in the U.S, although they clearly are coupled with an increased amount of political risk. We continue to prefer global managers that take an opportunistic, not dedicated, approach to emerging markets, due to recent strong performance and inherent volatility of the stock markets in these regions.
8. **Fund flows into alternative investments will continue to increase, but at a decreasing rate due to the maturation of the asset class, investor dissatisfaction with high fees, lack of liquidity, limited transparency, and unspectacular returns.** Alternative investments, once a niche investment for the wealthy and largest endowments, are now mainstream. Accordingly, investors who were late to the hedge

fund party, such as many pension funds and newly minted money from Asia and the Middle East, continue to contribute an important part of each incremental dollar that flows into the hedge fund space. Hence, we project that hedge fund assets under management will continue to increase at low double-digit rates. Nevertheless, capital inflows cannot disguise growing dissatisfaction with high fees, limited transparency, and the lack of liquidity that is still the standard for most hedge funds. The MDE Group has been a vocal critic of these unattractive elements inherent in most alternative investments and has pioneered creative approaches to breaking down these barriers in ways that benefit our clients.

9. **Cash and short-term money market instruments will continue to offer excellent investment merits relative to long duration bonds.** The flat to modestly inverted yield curve signals that investors are not being paid to take on interest rate risk. Furthermore, with credit spreads tight it does not appear prudent to load up on high yield debt. Accordingly, tax-free money market accounts, currently yielding on average 3.4% net or 5.7% on a tax equivalent basis, appear to provide an attractive return to risk tradeoff in the current fixed income climate. However, short-term fixed income securities are most affected by reinvestment rate risk, which may become material if the Fed cuts interest rates at some point in 2007 to speed up a slowing economy. Cash equivalents are an opportunistic investment, not a strategic one.
10. **Infrastructure investment opportunities will continue to emerge, reflected in both increased assets under management for this segment and in wider investment offerings.** New Jersey and Pennsylvania are contemplating the sale / long-term lease of their Turnpikes to solve state budget imbalances. This news follows the sale of the Indiana Turnpike and Chicago Skyway in prior years to a group that includes Australian investment bank, Macquarie, a pioneer in the infrastructure field. Investors are attracted to securitized infrastructure products due to their healthy income / dividend component and steady cash flows. Other prominent institutions, such as Goldman Sachs and Carlyle Group, have launched new infrastructure funds. Although the infrastructure movement is somewhat in its infancy, privatized infrastructure assets may ultimately become as prevalent globally as the gaming industry, since it provides a politically expedient solution to shoring up ever-present government budget deficits.

MDE's Five Strategic Wealth Management Themes for 2007

Investment themes in and of themselves are interesting, but of little value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Themes, we would like to offer Five Strategic Wealth Management Themes for 2007, along with specific techniques to implement them.

1. **Slowing U.S. Economy.** Exceptionally strong GDP growth at the beginning of 2006, gave way to anemic (< 2% GDP growth) by the end of the year. The weak residential housing market played a significant role in the decline, but the Fed may be able to reignite the economy via accommodative monetary policy if necessary.
 - ◆ We favor opportunistic managers that emphasize quality firms and non-distressed dividend payers. Quality firms should be able to grow earnings at healthy rates in difficult economic environments. Dividend paying companies provide cash returns and an element of stability in an uncertain economic environment.
 - ◆ We continue to have a material allocation to global and international managers whose portfolios may benefit from the superior growth prospects of many foreign companies.
 - ◆ We believe alternative and hybrid managers will add value, especially during times of economic sluggishness or distress, vis a vis traditional long only managers, given their different return drivers.

- ◆ We continue to add fixed income managers to our investment portfolios, whose funds will likely benefit in the event of falling interest rates.
2. **Heightened Corporate Activity Via M&A, LBO, and Stock Buybacks.** Corporations and private equity funds are flush with cash and need to put this capital to work. Accordingly, we expect continued high levels of corporate activity with respect to mergers and acquisitions, leveraged buyouts, and stock buybacks.
- ◆ We continue to recommend merger focused mutual funds. We believe these funds will continue to add value in 2007, although they may be hard pressed to match the double-digit returns they achieved in 2006.
 - ◆ Despite high levels of expected activity, we wish to exercise moderation in capital allocations to merger funds due to the narrow spreads that permeate this segment. Narrow spreads reduce returns and increase risk in the event of a broken deal.
 - ◆ Our investments in traditional long only investments should do well in a climate of vigorous corporate activity since many of our manager's holdings will be bought out at significant price premiums.
 - ◆ Many of our managers have a high weight in their portfolios to financial stocks, such as Goldman Sachs and Morgan Stanley, that benefit greatly from vigorous capital market activity.
3. **Weak U.S. Dollar.** Given the flood of Dollars in foreign hands due to persistent trade imbalances and budget deficits, it is logical to assume that these overseas investors will seek to reduce their dollar risk and diversify their holdings. Additionally, the emergence of the Euro as a viable primary currency and China's peg of its RMB to a basket of currencies, portends additional weakness for the Dollar.
- ◆ As noted above, we continue to have a healthy exposure to global and international funds, which may benefit from a falling Dollar.
 - ◆ In 2007, we will introduce at least one new international fixed income manager whose returns will likely benefit from a falling Dollar.
 - ◆ Our alternative investment allocation continues to be overweight in market neutral managers, whose holdings are generally immune from movements of any particular market sector or variable. Hence, these managers should be able to garner positive returns in a weak Dollar environment.
4. **Emergence of Infrastructure Investments.** Infrastructure may be broadly defined as a segment that provides essential or core services to the economy as a whole. Accordingly, infrastructure investments would encompass toll roads, bridges, pipelines, utilities, and other entities that provide vital services or facilities on a domestic or global basis.
- ◆ We continue to recommend investments in oil and gas master limited partnerships (MLPs), our best performers in 2006, and an energy infrastructure play.
 - ◆ We are looking creatively at bringing new infrastructure investments to our clients, with a particular focus on investments that provide high and stable levels of dividends / income.
5. **Broad Diversification Remains the Best Approach for Mitigating Market Volatility.** Risk, almost by definition, comes to the forefront at unexpected times because if you were aware of an impending disaster you could insure it. Rather than taking the unsophisticated "shotgun" approach by naively diversifying across

a plethora of investments (resulting in overdiversification and unnecessary fees), we carefully screen each of our investment classes – equity, fixed income, alternative, and hybrid – for cross correlations, or lack thereof, and value added contributions on both individualized and aggregate bases. The net result is that MDE's investment portfolios are more diversified than ever.

- ◆ We continue to maintain a strong commitment to alternative investments. As we have noted several times, the term “hedge fund” is a misnomer. Traditional market neutral hedge funds posted disappointing low single-digit returns in 2006, primarily due to the lack of volatility throughout much of the year. Funds with material beta exposure, such as Long / Short Equity and Event Driven, performed better, hence we emphasize that these funds are not truly hedged and entail material market risk. Therefore, we caution those investors chasing performance in the hedge fund sector, since a correction in the market might be a rude awakening to those who think they are significantly hedged in *any* hedge fund. Although on balance we were disappointed with the returns market neutral hedge funds provided in 2006, they did provide good downside protection during limited periods when the market experienced losses.
- ◆ We continue to look creatively at fixed income investments. Last year, we made the tactical decision to move some of our traditional long only fixed income investments to Auction Rate Preferred securities. This turned out to be a wise move since short duration fixed income investments provided very attractive returns on a risk adjusted basis, relative to the Lehman Brothers Aggregate Index, which returned only 4.3% gross in 2006, or 2.6% net. Similarly, we have recently added managers to our investment portfolios that conduct carry and spread trades resulting in fixed income like returns but with different risk exposures.
- ◆ In a world awash in liquidity and a compensation structure that greatly rewards outsized returns, the incentive for market participants to take on additional risk (through leverage, concentration, or other methods) is almost overwhelming. Hence, we can be certain that while risk may be somewhat dormant, it will certainly reemerge at some point in the future. MDE's diversified investment portfolios provide our clients with the best chance of navigating a future storm with minimal disruption to their goals and objectives.

One commonality among all of our 2007 themes is that we have a preference for building and preserving wealth in a slow and steady manner, relative to the zig-zag or performance chasing approach followed by many of our competitors. We do this by continually scrutinizing our clients' existing investments and the market climate and by adding new managers that contribute value relative to our existing recommended portfolios. Our preference for steady returns and continued due diligence is heightened by the market's apparent lack of concern for risk. We at MDE look forward to the opportunity to discuss our Ten Investment Themes with you, as well as the ways in which our Five Strategic Wealth Management Themes can be custom tailored for your personal situation.