Obermeyer

ASSET MANAGEMENT COMPANY

FOURTH QUARTER 2005

One year ago, if investors had known that 2005 would bring 1) Katrina, Rita and Wilma to wreak havoc on southern states; 2) a downgrade of GM and Ford debt to junk; 3) further deterioration in Iraq; 4) an indictment of a leading Bush insider; 5) $70 oil; 6) $15 natural gas; 7) headline CPI nearing 5%; 8) Fed funds at 4.25%; and 9) Avian Flu, many would have sold the market and lost money.

Most US financial assets (stocks and bonds) were effectively flat for the year despite a torrent of data, made-for-media horror stories, rumors, commentary, scandals, etc. The reason for this can be summed up in one word – liquidity. Our new Fed Chairman, Ben Bernanke, made this observation in a March 10, 2005 speech; he explained that the *global* savings glut (a.k.a. liquidity coming from foreigners) continues to fuel consumption and asset inflation. As long as these funds continue to flow into the US, we can expect a relatively low volatility, low return, and low inflation environment.

Why low inflation?

We have managed to absorb a tripling of oil prices and a quadrupling of natural gas prices without a real outbreak of inflation, and very few forecasters think we'll see such increases in the near future. Inflation in key Asian economies remains in the 2% range[1] despite those soaring energy prices because there has been so little cost pass-through. If there was only slight evidence of pass-through when the global economy was growing very rapidly, it is unlikely to occur now that the global economy is slowing down.

To further keep inflation low, China and India will continue to grow (albeit not in a straight line) and each government has the goal of employing every single worker…capacity be damned. This trend will continue to put pressure on US profits and wage rates. Moreover, technology has facilitated more efficient international trade, including the flow of funds, and as Adam Smith predicted – where there is free trade, there is no inflation. However, for items where prices are set locally, i.e., event tickets, health care, housing, etc., inflation has ramped up. While much of this doesn't factor into the statistics, it does affect people's lives and will likely contribute to a slowdown in the US economy.

Our Investment Committee continues to believe that cheap money will continue to keep asset prices high, but also that many risks persist and caution is advised. The recent rally in gold prices (bullion up 18% for the year) signals not only that the Fed is near the end of its credit tightening campaign, but also that risk in financial assets is increasing. We expect that 2006 will be another year where investing in a broad US market index will not produce great results because of already high valuations, high susceptibility to global competition and plentiful opportunities abroad. Our portfolios don't resemble the S&P500 Index because this is not likely where the returns will be.

Many TV commentators (who are often in the S&P500 tracking business) point to the cash hoard that US corporations have on their balance sheets, and imply that these dollars are just waiting to be put to work to the benefit US-based investors. *We disagree*. While it's true that there is record cash, it's not clear that it will be put to productive use any time soon and, if it does, that it will find its way to US-based investments. US companies have big competitive disadvantages with companies based abroad…not the least of which is the fact that health care and various environmental and product litigation costs must be priced into finished goods (example: the domestic auto industry). In contrast these costs are not borne by many foreign competitors. Also, the large amount of share buybacks we've seen do not necessarily benefit existing shareholders because much of this is real cash going to cover dilution from past option grants to insiders (hard dollars *not* invested in productive assets) and the buybacks are often made at prices above intrinsic value.

What isn't talked about much is the fact that energy companies have generated the lion's share of earnings growth by US companies over the past few years and that the non-energy sector performance has been lackluster.[2]

It is for all the above reasons that valuation analysis is the cornerstone of our investment strategy. We never want to overpay for securities and we seek to invest in companies/industries that are under-appreciated but, in our opinion, also have solid prospects. At the same time, prudent allocations to non-US investments and strategic opportunities (such as natural resources and gold) will be important for portfolio returns. We remain confident that this approach reduces overall portfolio risk and positions our clients to benefit from evolving global trends. We are focused on increasing our clients' share of total global wealth – a much better objective than just trying to beat a US market index.

The entire Obermeyer team enjoys partnering with each of our clients to help them achieve their financial goals. If you are concerned that you may not be positioned to benefit from emerging trends, or have questions about your current situation or our investment philosophy, please contact us at 970-925-8747. We would welcome the opportunity to meet with you.

[1] Source: Bloomberg.
[2] Source: BMO Nesbitt Burns.