

WEALTH MANAGEMENT ADVISORS, INC.
Third Quarter Investment Commentary
October 2006

The Quarter in Review

While the third quarter began on a weak note, August and September were both fairly friendly months to investors (as measured by the S&P 500), although volatility was a bit higher than we have been used to over the last few years. The Federal Reserve decided to pause in its increases in interest rates, and inflation did not run amok after that decision.

One positive development during the quarter was the welcome decline in gasoline prices, dropping over 40 cents per gallon in just over a month. (Kevin insists that the 2006 peak in gasoline prices came when he was on the family vacation in Yellowstone, a claim that has yet to be verified.)

Historically, September has been the weakest month of the year for the stock market, and the only one in which the Dow Jones Industrial Average has shown negative returns, on average, since the 20th century began. The fact that we survived September in good shape is a positive outcome and gives us hope for the rest of the year and 2007.

Hedge Funds and Volatility

When you hear the phrase “hedge fund”, what do you think of? The super-rich? Lots of risk? Nothing? Well, let’s go through a brief history and description of hedge funds, and why they are important to you as an investor, even if you don’t actually own a hedge fund.

Before we start, let’s go through a quick glossary of terms.

Long – to own a stock

Leverage – borrowing funds to increase exposure to an investment, sometimes by a multiple of up to 100 times

Short – to borrow a stock and then sell it, hoping that the stock price declines, and then buying the stock back at a profit

Incentive fee – a fee paid to a money manager based upon the return of the fund

Accredited investor – someone who earns an individual income of more than \$200,000 per year, or a joint income of \$300,000, in each of the last two years and expect to reasonably maintain the same level of income, or a net worth exceeding \$1 million (excluding personal residence), either individually or jointly with his or her spouse.

The idea of the hedge fund in America goes back to the early 1960’s, to a man named Alfred W. Jones. He was the first to establish a private fund that used leverage to both go long and short stocks, and charged an incentive fee. Currently, most hedge funds have a fee schedule

of 2% of assets, plus 20% of the gains, otherwise known as “2 and 20”. This pricing philosophy continues today, but the strategies for investment have become much more complex.

“When you come right down to it, there are half a dozen superstar investors in the world, a number of good investors, and a multitude of what you might call journeymen. The superstars...consistently put up the big numbers and generally run their own hedge funds.” – *Hedgehogging*, by former Morgan Stanley global strategist Barton Biggs.

The mutual fund universe is currently made up of about 20,000 funds, when you consider many funds have multiple share classes. Strip away those redundant funds, and you get about 8,300 discrete mutual funds. There are currently 8,500 hedge funds, which is amazing when you consider that only accredited investors (as defined above) can invest in hedge funds. Accredited investors comprise only about 3% of the U.S. population. There has been an explosion of hedge funds over recent years, as investors have looked for non-traditional ways of investing after the 2000-2002 bear market, and hedge funds have received a lot of financial press exposure. There has also been a migration of top talent from the mutual fund industry to hedge funds as the financial rewards can be staggering.

If you are still with us to this point, here is where we discuss volatility in the financial markets, and the role that hedge funds play in that volatility. The very nature of the hedge fund incentive fee schedule encourages volatility. Let's say I am a hedge fund manager with \$2 billion dollars under management, using the standard 2 and 20 fee schedule. My base fee is \$40 million (2% of \$2 billion). If the fund is up 10%, the incentive fee is \$40 million (20% of the 10% return on \$2 billion). But, if the fund loses money, I forfeit the incentive fee. In fact, I don't get the incentive fee for any client until that client makes money above his/her initial investment. For example, if an investor gives me \$10 million and loses \$2 million, I get no incentive fee until they get back over \$10 million. So, does it make a difference to me if you as an investor lose 1% or 20%? Not really, as either way it means I don't get that incentive fee. So, as a hedge fund manager I am encouraged to take great risk to capture gains, and do a lot of short-term trading to capture that gain quickly, or hopefully minimize any losses. This introduces volatility into the financial system. So, whether you invest in hedge funds or not (we rarely do), you are still affected as an investor by the actions of the hedge fund managers.

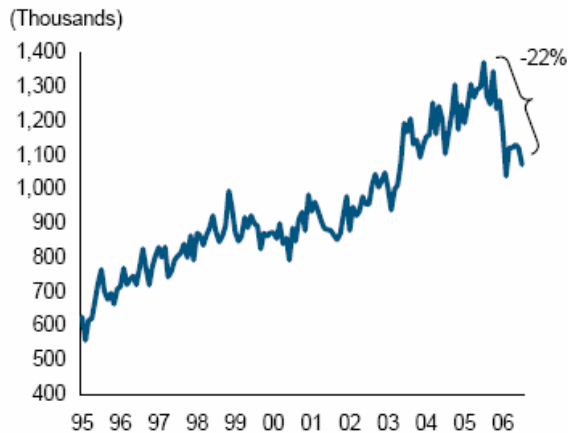
Change in Terminology

We have made a slight change on the reports for this quarter. In the past, we have used the word “Specialty” to identify those investments that have a low correlation to the stock markets. Real estate and commodities are prime examples of these assets, which have historically not moved in synchronization with the broad stock market. We have changed the description of this category to “Alternative”. When reading our trade journals, financial publications like the *Wall Street Journal*, or heaven forbid, watching CNBC (boo-yah, Jim!), we see that the word “alternative” is being used with a greater frequency. So, in order to fall in line with the mainstream vernacular, we are adopting the term “alternative” to designate these assets on our reports.

Housing Crash or Soft Landing?

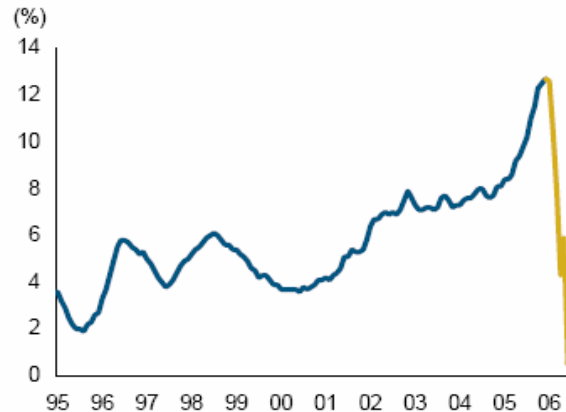
We have written for months about lofty housing prices in some parts of the country, and the creative financing that has been made available to homeowners to be able to afford said housing. As rates have come up over the past few months, the foundation of the housing market has shown some cracks, particularly in over-heated sections of California, Florida and parts of the East Coast. The following two charts give us an indication of what is happening with the housing market.

New Home Sales



Source: National Association of Realtors and US Census Bureau

Percent Increase in Median Home Price



1995-2005: trailing 12-months average, 2006: year-over-year
Source: National Association of Realtors

We have never believed that we were headed for a nationwide housing crash. We still contend, however, that some parts of the country are so over-priced that prices could correct by over 40%. This has happened before, e.g., Los Angeles and Denver in the mid-to-late 1980's. All that really needs to happen is that housing prices stop appreciating at a rapid pace (see chart, above right), which prohibits homeowners from treating the house like an ATM and borrowing on increased equity. However, if you listened to Best Buy's most recent quarterly earnings conference call, consumers were still spending, and on big-ticket items.

So, this unfolding drama bears watching. For those homeowners in the right position (staying put in the home, reasonable fixed-rate mortgage, solid employment), the effects will be minimal, although very few are immune to an economic slowdown. For those homeowners at risk (little or no equity, variable-rate mortgage, possible job loss) the situation could be dire. The lifeline that could be thrown to these people would be rate cuts from the Federal Reserve. If the economy wavers at all, look for Fed Chairman Bernanke to propose those cuts early next year.

What Is Next?

"Predictions are difficult, especially when they are about the future." - physicist Niels Bohr. There is a glass (not crystal) ball on Kevin's desk. It is always murky because Bruce gets his

fingerprints all over it in a deliberate attempt to provoke its owner. While we don't need to get into details about that at this time, the bottom line is that while we cannot predict the direction of the financial markets, we do have opinions.

As always, there are both positive and negative factors that influence our views of the financial markets. The negatives are all we usually hear about in the news, and they include Iraq, Iran, energy prices, the housing crash (see above) and a host of other issues. On the positive side, corporate balance sheets have been cleaned up, profit margins are up, price to earnings ratios are reasonable, interest rates have quite possibly peaked, and gas prices are down significantly over the last few months. Robert Mellman, senior economist at J.P. Morgan Chase believes that lower gas prices alone could boost fourth-quarter economic growth from a forecasted 3% annualized rate to 3.7%.

So, we feel that the scales are slightly tipped to the positive.

Closing Comments

Back in September a guest columnist (a CPA turned stockbroker) in the *Kansas City Star* had this to say: "Superior investing is about finding the profitable trends and exploiting them. When the trends end or look overextended, get out.." We could not *disagree* more. This is the mindset that led many a tech investor to ruin in 2000. The problem is that it is almost impossible to know when a trend is about to begin or end, and most people don't invest in that trend until it is almost over. The following quote summarizes a much more sensible approach, one that is the basis of our investment philosophy.

"How do we deploy portfolios when we do not know what the future holds? Harry Markowitz's answer was diversification. It is mine, too; diversification is an admission of ignorance about the future." - Peter Bernstein, economist and author of several books on investing

Here in Kansas City, the season is beginning to change. The hot days of summer are now behind us, with cooler temperatures and the promise of crisp, sunny days ahead. The Holiday Season is on the horizon. We hope that each one of you has a great fourth quarter, and that you are able to spend time with family and friends.

Kevin S. McGrew

Bruce E. Bower

Paul L. Watkins

Patrick L. Warren

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