

WEALTH MANAGEMENT ADVISORS, INC.
Fourth Quarter Investment Commentary
January 2007

The Quarter in Review

The biggest domestic news during the fourth quarter was the national elections. The Democrats swept back into power in both the House and the Senate, and immediately took aim at oil, big drug companies and Iraq. Although tax increases are also being discussed, those might be difficult in light of the facts, which of course have never been hurdles for politicians in the past. See "Tax Trivia and the Election", below.

The big international news came in October, when North Korea allegedly tested a nuclear device. The French put a gastronomic spin on the test. "The devil is in the details," said French nuclear proliferation expert Bruno Tertrais. "It's like cooking. The fact that you have the recipe does not make you a chef." Russell Seitz, a consultant to the Los Alamos National Laboratory, said that the explosion was only equivalent to "...A hundred thousand bucks worth of ammonium nitrate..." a common fertilizer. Leave it to Dear Leader Kim to blow up fertilizer instead of using it to help grow food for his starving citizenry.

Here are a few statistics for the quarter and the year -

- While the Dow Jones Industrial Average did lose ground on the last trading day of the year, the index made history by breaking through the 12,000 level for the first time, and continued to have strong performance through the end of 2006.
- Outstanding consumer credit fell by \$1.2 billion, or an annual rate of 0.6% in October, the biggest decline in 14 years, according to the Federal Reserve. Much of this was attributable to a steep decline in mortgage borrowing.
- The Consumer Price Index in November 2006 advanced only 2.0% higher than the level of a year earlier, giving hope to a possible reduction in interest rates by the Federal Reserve in 2007.
- The U.S. share of the world's stock market value fell to 49.4%, the lowest share in decades, adding support to the idea of increasing foreign bond and stock exposure in portfolios.

Avoiding the Pitfalls

Blaise Pascal was a very influential 17th century French mathematician and philosopher who contributed to many areas of modern mathematics. It is estimated that Pascal had an IQ of about 173, putting him very high on the historical list of geniuses. One of his more interesting lines of thought is known as "Pascal's Wager", in which he discusses the choice to believe or to not believe in God. Essentially, Pascal theorized, if you do not believe in

God and live a life of sin and debauchery and God does not exist, you end up unscathed. However, if God exists, you run the risk of eternal damnation. Conversely, if you live a life of virtue and believe in God who exists, you are rewarded in the afterlife. If God does not exist, you have still led an exemplary life and helped your fellow man. Pascal chose to believe, renounced his sinful ways and retired to a monastery.

“Let us weigh the gain and the loss in wagering that God is. Let us consider the two possibilities. If you gain, you gain all; if you lose, you lose nothing. Hesitate not, then, to wager that He is.” – Blaise Pascal

In an abstract way, Pascal’s Wager can be applied to investing. If we believe that a downturn in the stock market will never come, we would merely own a stock index, and possibly even borrow funds to increase our investment. This is called “leverage.” However, should we be wrong in this belief, we are punished with possibly irrecoverable losses. If, on the other hand, we diversify properly, believing that the stock market will ultimately incur losses, we can minimize our exposure to these losses. If we are lucky enough to invest in a period in which there is no bear market, we consider ourselves blessed.

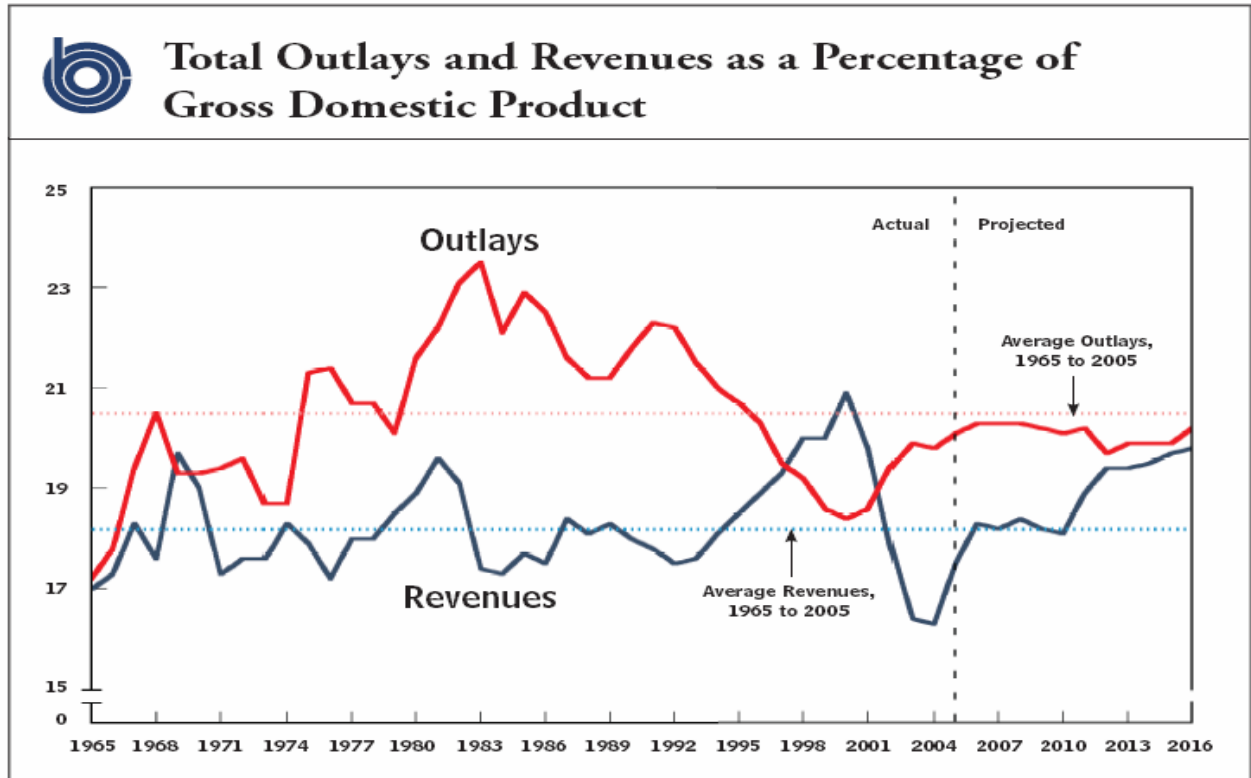
From March 31, 2000, which was very close to the peak of the market, through September 30, 2006, the S&P 500 showed a *cumulative* loss of .92%, including dividends. As with the Dow Jones Industrial Average, investors in an S&P 500 index fund would have been only treading water for those six and one-half years. Things have been much worse in the NASDAQ Composite, which was still off 48.99% cumulatively at that date, for an annual return of *minus* 9.84%. Let’s look at this in real numbers. An investment of \$1,000,000 into the S&P 500 would now be worth \$991,800. If a person were dependent upon that investment for his livelihood, where would he or she be today? This would obviously result in a very tenuous position. WMA clients can look at their portfolios during the same period and see a much more positive result, evidence that our philosophy of dynamic asset allocation is effective over time.

Tax Trivia and the Election

According to the IRS, based upon tax returns filed, the highest 1% of earners in the US made at least \$328,000 in 2004, and they accounted for 19% of the country’s total Adjusted Gross Income. The same top 1% of filers paid a substantial 36.9% of all income taxes, the second heaviest tax burden shouldered by top tier earners since the 1988 Tax Reform Act passed. It should also be noted that the top 1% of wealthiest Americans now earn more than the bottom 40% combined, and the wealthiest 1% also hold approximately 40% of the nation’s wealth. The bottom 20% basically has zero wealth.

Congressional Budget Office (CBO) data show that federal tax receipts for fiscal year 2006 were well above the same period in FY-05. Withheld income taxes increased 12.6% over fiscal year 2005; non-withheld (quarterly estimates) income tax payments surged by 21%, while corporate tax receipts grew by 27%, to their highest level in relation to the Gross National Product (GDP) since 1978. The CBO attributed these increases to robust economic activity in both 2005 and 2006. As far as the deficit goes, the deficit as a

percentage of GDP was 1.9%, below the average of 2.3% since 1965. The graph below shows the trend looks promising, with the deficit slowing being reduced over time.



Source: Congressional Budget Office

Blowing Our Own Horn

Every year, Charles Schwab & Company (Schwab) retains the CPA firm of Moss Adams, LLP to conduct a financial and operational survey of advisors who use Schwab as custodian for their clients' assets. Moss Adams, LLP is a large regional CPA firm based in Seattle, WA, and has a division that consults to our industry. Almost 1,100 firms participated in the most recent study, which covered the 2005 calendar year. Moss Adams, LLP analyzes this comprehensive data using several different criteria and develops what the company refers to as the "Best-Managed Firms" list, comprised of only 25 firms from the participants in this study. We are happy to say that we have been named to that list for 2006, which is the third time in the last four years we have made it into that elite group. In addition to being selected to this group, we have also been invited to attend the Schwab Explore conference for the last several years. Held annually in June, this conference is limited to only about 120 of the more than 5,000 advisors who custody their clients' assets with Schwab. Besides enjoying the great locations at which this conference is held, it is a terrific opportunity to meet other advisors and exchange ideas on investing, client service and practice management.

Looking Ahead

The October commentary from Legg Mason Capital Management discussed 2007 at least as eloquently as we can, as below.

“At the risk of sounding like a broken record, we remain constructive on the outlook for the U.S. equity market for ... 2007. “

“We believe the overall economic backdrop is also supportive. The economy is definitely slowing, but not precipitously, in our view. The housing market is weak as speculators exit the scene, but the positive long-term fundamentals – namely, employment and income growth, moderate interest rates, household formation and immigration – remain in place. All of these factors point, in our view, to a mid-cycle slowdown, rather than a recession.”

“Next year (2007) is the third year of the Presidential election cycle... Historically, the third year of the election cycle has been by far the strongest. Since 1929, the S&P 500 has been up 16 of 19 times in pre-Presidential election years and flat once, averaging gains of 14.7% over all 19 periods. Since 1958, the S&P has been up in all 12 pre-Presidential years, averaging gains of 19.0%. Could returns in 2007 be that good? We certainly believe it's possible, though perhaps, not likely.”

“Whether or not 2007 turns out to be as good as history suggests it could be, we believe that investors can have reasonable expectations of a decent year in the market next year. As we look at the available evidence, we see 2007 as a year of moderate economic growth, high single-digit profit growth, moderating inflation and – beyond mid-year – declining short-term interest rates. We believe this environment will be a constructive one for investors in U.S. equities.”

The managers at Tweedy, Browne, who are rarely positive about anything, had this to say in their most recent semi-annual report. “Unemployment is at a 5-year low, inflation is under control despite a six-fold increase in the price of oil, corporate profits are at an all time high, and tax revenues are reducing the Federal budget deficit by numbers no one predicted. Economically, the US is in good shape, especially compared to other developed nations.”

There has been no shortage of positive outlooks for 2007. Normally, all that enthusiasm would make us nervous. However, we have to go along with the crowd on this one, as the average investor (which excludes anyone reading this, of course) has yet to get wildly bullish. According to J.P. Morgan, 2006 will mark the seventh consecutive year in which no new money has flowed into large-cap domestic mutual funds. Since 1999, there have been net redemptions annually in this category, and investors have yet to get confidence to get back into that segment of the market. History suggests that the market will have to go up further for most individual investors to have the confidence to invest again.

Simply because the stocks of large companies, as measured by the S&P 500 haven't done much of anything so far this decade doesn't mean things *have* to improve, but let's look at some interesting figures recently reported in *Barron's*. The Great Depression, 1929-1938, provided a positive real (after-inflation) return of 1% per year on average. Even including

dividends, the current market needs a real index gain of almost 6% a year on average during the remaining years of this decade just to match the Great Depression. Given today's economic conditions, shouldn't we hope for better than that? For the market in this decade to produce the average real performance of the past 81 years, which is about 10.4%, the real rate of return during the remaining years of this decade would have to exceed 26% per year. Well, we are not that optimistic, but we certainly do not feel that this decade will be the worst since the Great Depression. Actually, Kevin is never really optimistic about anything, so having him not think that the stock market will crash and the Earth will fall into the sun is a huge leap forward.

Closing Comments

We trust that everyone enjoyed a joyous Holiday Season, and were able to spend some time with their families. It was wonderful to see 2006 reward us with good returns, even above what we had anticipated, and it was heartening to see positive returns for the third year in a row, with client portfolios up substantially since the end of 2002. We look forward to helping all of our clients realize a prosperous 2007 and beyond.

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