

Annual Client Report

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Capital Advisory Group
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The CapGroup Annual Report

The *CapGroup Advisory Board* is an informal group of outside advisors that assists the firm's management with strategic business planning. This "interview" captures the essence of our Annual Report to our Advisory Board on the state of the firm, as well as our outlook on the economy and the investment markets in the coming year. We trust that it will be of interest to all of our Clients.

Advisory Board: *As is our custom, we would like to start with a summary of the major developments during the year that are affecting your business operations and your competitive positioning in the investment advisory industry. Let's start with your reflections on the decision to join Focus Financial Partners, LLC at the beginning of 2006.*

CapGroup: We are happy to report that the Focus business structure turned out to be a perfect fit for us. As you know, Focus is a consortium of prominent independent investment advisers, linked together by an ingenious ownership sharing structure that strongly encourages and rewards the sharing of ideas and processes, while also preserving each firm's local identity and autonomy. Importantly, it also provides us efficient access to the capital we will need to grow and replace investment professionals when they retire. Basically, our decision to join Focus was driven by our desire to continually improve our services (be the very best that we can be) and to perpetuate the firm beyond the working lifetimes of its existing leadership.

Beyond being able to maintain our local identity and autonomy, it was critical that the Focus services philosophy be based on a services paradigm that limits member firms to those that follow the emerging "fiduciary advisor" model. Fundamentally, that means we all fully acknowledge fiduciary status in serving all of our Clients and adhere to investment practices and standards of conduct that place the Client's interest above our own. Our legal duty of care is similar to that of physicians, lawyers, accountants and other professional services and stands in stark contrast to the far lower standards required of the investment brokerage industry. We could not associate with an organization of firms that did not endorse and enforce the fiduciary standard for their members.

Advisory Board: *You now have a year of experience with the Focus structure. How is it working?*

CapGroup: So far, it has worked out better than we expected. As promised, we have fully retained our autonomy in the delivery of our services, and we have benefited from the investment ideas and systems sharing with the other member firms. There is also progress toward the use of our investment consulting experience and fiduciary compliance expertise to lead a Focus-wide investment consulting service for middle market institutional funds or medium-sized foundations, endowments and pension plans. Most of the other member firms specialize in providing wealth management services for individuals and families, so we expect to learn a great deal from leading the institutional consulting initiative, resulting in enhancements to our service offerings for both our institutional and individual Clients.

Financially, the Focus business plan is well ahead of schedule. From four Founding Member firms with roughly \$4.5 billion of Client assets under advisement at the beginning of the year, Focus closed 2006 with eight member firms with over \$7.5 billion of Client assets. Over a single year, Focus has become one of the top five independent wealth management organizations in the nation, with many prominent independent investment advisory firms presently seeking Focus membership. Ultimately, Focus will include up to thirty member firms across the nation with a dominant market position, offering our Clients the advantages of a very large financial services organization without the inherent conflicts of interest and service dilution problems. We are very fortunate to have been selected to be a Founding Member.

Advisory Board: *We are glad that the Focus relationship is working out so well. You mentioned your expertise in fiduciary compliance as being an advantage for your Clients and for other Focus firms. Could you explain that further?*

CapGroup: More and more investment assets are coming under the control of so-called “investment fiduciaries”; that is, people who serve as trustees, board directors and investment committee members of charitable organizations, retirement plans and personal trusts. For the most part, these people are non-investment professionals who take on the serious responsibility for the prudent investment of assets for the benefit of others. This function is becoming so important to the welfare of so many people in our society that a body of state and federal laws and regulations is developing to govern the activities of these investment fiduciaries. The result is a complex legal environment that often confuses and concerns many well-meaning stewards who are asked to serve in this fiduciary role.

We recognized this trend as far back as the mid eighties, and we have been active in the movement at the Center for Fiduciary Studies at the University of Pittsburgh to educate investment fiduciaries and to follow investment management processes that encourage high standards of fiduciary conduct. Our dedication to those standards of conduct has helped our Clients, both institutional and individuals, to make intelligent decisions through some very turbulent markets over the past twenty plus years.

More recently, the Center’s research has culminated in the development of a type of “gold standard” for fiduciary conduct called the *Global Fiduciary Standard of Excellence* (“*the Standard*”), backed by an assessment process based on ISO 9000. Joining with three international firms, the Center’s parent company, Fiduciary360, has established a certifying organization in Toronto called the Center for Fiduciary Excellence (“Cefex”) to oversee a certification process and the credentialing of consultants who conduct assessments of conformity with the Standard.

We were the first firm in Virginia and one of the first in the nation to have professionals credentialed to perform the consulting assessments leading to a Cefex certification. While a full-blown Cefex certification may be impractical financially for our medium sized institutional Clients, we can provide a legitimate opinion of conformity to the Standard through a Consultants Assessment of Fiduciary Excellence (“CAFE”). We expect this level of assessment to become highly valued by our Clients, as it gains widespread use by fiduciary investors and acceptance nationally by the legal and accounting professions. Our institutional Clients naturally seek to do the very best job possible in carrying out their stewardship responsibilities, and they are understandably concerned about managing their legal risks as investment fiduciaries. We

believe the CAFE will meet both objectives, so we are integrating this additional service into our standard investment consulting services.

Advisory Board: *The term “fiduciary advisor” sounds familiar. Wasn’t there something about that in the Pension Protection Act that was passed last year?*

CapGroup: Yes, as part of this massive piece of legislation, the Congress recognized the need for independent advice for 401k plan participants and included a “safe harbor” of sorts for plan sponsors who provide employees access to competent one-on-one investment advice. Without getting into the details of that law, it was interesting that the Congress actually coined a new term to describe the qualified advice giver, emphasizing the objectivity required of a “fiduciary adviser”.

At the time the law was passed, we were working on a task force with the Paladin Registry, Cefex and Fiduciary360 to develop a system for rating investment advisers who work with the investment fiduciaries serving as trustees, board members and investment committee members. We had begun describing ourselves as “fiduciary advisors” (with an “or”) to acknowledge the basic nature of our Client relationships at CapGroup, so we encouraged the task force to use that term in setting up the ratings standards for those firms who are qualified to work with investment fiduciaries. They agreed and Paladin will soon begin offering ratings on *Fiduciary Advisors* to help institutional investors evaluate the various firms that would offer them investment consulting services. They will also independently evaluate and rate *Fiduciary Advisers* who offer services directly to 401k plan participants.

Advisory Board: *That sounds very interesting as we have witnessed the evolution of the Paladin Registry as the most respected independent organization that rates and screens investment advisers. What will they charge the institutions for this service?*

CapGroup: It is uncertain right now, but probably very little. They will make most of their money from other educational services they provide and from charging the firms like us a rating due diligence fee. We recommend that you wait until February and then visit them at www.paladinregistry.com. You will be able to put in a firm’s name and retrieve their rating.

Advisory Board: *We agree with the need for an objective rating service to help consumers of investment services, both individual and institutional, weed through all the hype and propaganda. Everyone’s sales pitch sounds the same to us.*

CapGroup: In a nutshell, that’s the problem – the sometimes vast difference between what is promised and what is going to be delivered is not apparent up front. So far, the regulators (SEC, NASD, states, etc.) have been unable to effectively protect the public from the incompetence and conflicts of interest that pervade the investment brokerage industry. According to Paladin, Fiduciary360 and other objective analysts, only a small percentage of people rendering investment advice to individuals, either as brokers or registered investment advisers, are both competent and use business structures that eliminate or minimize the potential for conflicts of interest. The advisers to institutional investors tend to be of higher quality, as the clients are usually investment committees that normally use organized search and selection processes to hire investment consultants and money managers. Most, however, do not have backgrounds in

fiduciary compliance, and their consulting processes leave their clients exposed to unnecessary legal and financial risks.

Again, the Paladin's ratings of "Fiduciary Advisors" should be very helpful in that regard, as they will be screening for advisors who have been credentialed at the Center for Fiduciary Studies as Accredited Investment Fiduciary Analysts (AIFA®) or Accredited Investment Fiduciaries (AIF®). As a testament to our commitment to fiduciary excellence, we require all of our institutional consultants to maintain accreditation at the Center. We now have six professionals who are accredited, and I know of no other middle market consulting firm that requires its consultants to maintain accreditation. We are very serious about fiduciary excellence.

Advisory Board: *Speaking of investment professionals, we recently learned that you have added two experienced consultants by merging a smaller investment consulting firm into your operation. Can you tell us more about that?*

CapGroup: Yes, for almost a year we have been talking with our old friends Bob Patterson and Bill Beach about merging their practice with ASC Advisory, Inc. into our firm. We have known Bob and Bill professionally for well over a decade, as they have offices in Charlottesville and Norfolk, and they are also long-term members of the Independent Adviser Group of Callan Associates. Both gentlemen are highly respected in the investment consulting community, and the merger with them was an obvious win-win. From our perspective, we are gaining two experienced and extremely competent institutional investment consultants who share our philosophy and have already mastered the complex technologies that comprise the Callan investment consulting platform. They also provide us more exposure in Tidewater and Central Virginia to increase our Client base. Bob and Bill now have access to the full range of services we offer and the significant resources of Focus, so their Clients should benefit in many ways. Importantly, the Focus platform helped us to work out a merger that works well for all parties.

Advisory Board: *Now, let's discuss your assessment of the past year in the global investment markets and your view of the primary factors that are likely to influence investment returns in 2007.*

CapGroup: 2006 turned out to be a very good year for global equities, as domestic stocks gained about 16%, while developed foreign countries and emerging markets stocks were up over 26% and 32%, respectively. As you know from reading our *Markets Outlook Summary* each quarter, we remained optimistic about global equities all year, despite the very difficult period last spring and summer and the constant media warnings of serious economic troubles ahead due to high energy prices, the housing downturn, the growing budget deficit and the tapped out American consumer. Of course, the negativism about the war in Iraq and Afghanistan was accentuated during the political campaign this summer and fall as well.

The bond markets were reasonably healthy during the year, despite continuing Fed monetary tightening, worries about increasing inflation and an inverted yield curve. In the face of those headwinds, domestic investment grade bonds returned 4.33%, but developed foreign bonds gained only about half that amount.

We continue to be optimistic as we enter the New Year, despite slowing economic growth and legitimate longer term concerns about structural imbalances in our international balance of payments and our growing internal budget deficit. As you know, we use our *Markets Outlook Summary* to examine the primary factors affecting the short to intermediate term (6 months or so) environment for stocks and bonds. Without getting into too much detail, we expect our *Markets Outlook Summary* for the first quarter of 2007 to continue to include a preponderance of positive factors for global equities, with the prospects for the fixed income markets neutral at best.

For the longer term, there are global structural forces at work that contradict conventional economic analyses. For example, despite highly stimulative U.S. monetary and fiscal policy for several years, very accommodative policy from most other countries and dramatic increases in energy prices and other commodities, worldwide core inflation remains just above 2%. We believe there are three interrelated macro forces acting to hold inflation down and improve economic stability – globalization, the application of new technologies in the developed world and market reforms and deregulation worldwide. We expect these positive effects to persist much longer, assuming the larger economies like the U.S. resist the political cry for protectionist trades policies.

Advisory Board: *But what about our trade and budget deficits? Won't these chickens have to come home to roost some day?*

CapGroup: Yes, those are negative factors that have serious implications for our long-term economic prosperity. It is very difficult to predict how these imbalances will be corrected, but the forces of globalization should delay the “day of reckoning”, which may well turn out to be a long-term process rather than an event. Sophisticated economic researchers, like the preeminent Bank Credit Analyst, postulate the existence of a “Debt Supercycle” that began after World War II. Since that time, our policymakers have increasingly used public debt to smooth out economic cycles and finance our economic growth. Unfortunately, the American public has also increasingly used credit to finance current lifestyles, no doubt to the detriment of future consumption. While current and projected levels of both public and private debt have negative implications for the growth in our standard of living going forward, the likelihood of the financial Armageddon scenario predicted by some analysts is hard to support in an integrated and interdependent global economy. It's simply not in anyone's self interest to abruptly call in our debt. We have plenty of worries, but the end to our ability to finance our debt is not an imminent concern.

Advisory Board: *Okay, but what about the effects of terrorism on investment decision making?*

CapGroup: Of course, terrorism is a serious threat to worldwide economic growth, especially if weapons of mass destruction are used and/or the Islamic militants are able to take control of the oil fields in the Middle East. But terrorism is not new; it's just no longer limited to localized “hot spots” like Israel and Northern Ireland. The fact that it has become a global enterprise begs for a global effort to suppress it. Unfortunately, it can never be totally defeated and it is essentially unpredictable. The markets seemed to have acquiesced to that fact by building in an additional risk premium for equities and lowering the risk premium for more defensive bonds, effectively shortening investment liquidity horizons. However, our review of history discourages attempts to time markets based on existing or expected geopolitical tensions.

Advisory Board: *Looking back over the past few years, it is apparent that equity market returns have exceeded the expectations of the large institutional consultants like Callan Associates. Is that type of forecasting inherently flawed and losing its value as an investment planning tool?*

CapGroup: That is a very interesting question and exhibits some common misconceptions about the uses of asset allocation modeling tools. First, asset allocation modeling programs are not intended to predict a specific outcome or return in a given year, which is nearly impossible, but a potential range of returns for various asset mixes over time. If the inputs for expected return, risk and correlation are rational from a historical context and adjusted to reflect existing economic conditions, market valuation levels and cyclical influences, they can generally be relied upon to create reasonable expectations for ranges of future returns, especially maximum tolerable annual losses, and to therefore guide important asset allocation policy decisions.

Second, in our judgment, these modeling tools should not be used to justify tactical changes in asset mix, which are usually shorter term decisions based on assessments of unusual opportunities or risks in various asset classes. Finally, they have very limited use in integrating the use of hedge funds and some other non-traditional investments into portfolio structures dominated by traditional investments in the equities and fixed income markets. Hedge funds and most other alternative investments vehicles are generally not representative of asset classes, so decisions to use hedge funds should not be based on the same optimization algorithms used for diversifying traditional categories of long-only investments in stocks and bonds. At the end of the day, the extent to which hedge funds are used in a portfolio strategy is primarily a judgment call, with product due diligence a far more important consideration.

Despite the inherent weaknesses of asset allocation modeling tools and the standard finance theories that support them, they can be used by experienced analysts as an effective guide to intelligent diversification planning. In fact, the evolving body of fiduciary law mentioned above strongly encourages the mean variance optimization approach to investment diversification planning and risk management. We have used Callan's asset allocation modeling tools since 1992, and we have watched the Callan technology evolve and adapt without stretching the limits of their statistical validity. The current generation of this technology is now being used by Callan and the members of the Independent Adviser Group to advise close to \$1 trillion of client funds, and we continue to believe in the efficacy of the Callan technology and our ability to use it to guide our Clients' decision making.

At the Annual Conference of the Callan Independent Adviser Group in December, Callan's top analysts presented their current thinking and gave us a preview of the 2007 Capital Markets Projections which are due to come out in early February. In summary, Callan expects a continuation of the low inflation, low interest rates environment for the next five years, resulting in below historic average returns for the global equities markets. Overall, there should be little change from the 2006 projections, so we are providing them as a preview of the statistics we will be using for annual investment policy reviews in 2007:

2006 (2007?) Callan Capital Market Projections

Asset Class	Index	Projected Annual Return	Projected Standard Deviation (Risk)	Projected Yield
Equities				
Broad Domestic Equity	Russell 3000	9.00%	16.90	2.10%
Large Cap	S&P 500	8.85%	16.40	2.20%
Small /Mid Cap	Russell 2500	9.85%	22.70	1.20%
International Equity	MSCI EAFE	9.20%	20.10	2.20%
Emerging Markets Equity	MSCI EMF	9.80%	32.90	0.00%
Global Broad Equity	90% EAFE/10% EMF	9.25%	19.75	2.00%
Fixed Income				
Domestic Fixed	LB Aggregate	5.00%	4.50	5.00%
Defensive	LB Gov't 1-3 Year	4.25%	2.30	4.25%
High Yield	CSFB High Yield	6.75%	11.40	6.75%
Non US\$ Fixed	Citi Non-US Gov't	4.90%	9.60	4.90%
Other				
Real Estate	Callan Real Estate	7.60%	16.50	7.00%
Absolute Return	HFRI Fund of Funds	6.50%	10.20	0.00%
Cash Equivalents	90-Day T-Bill	4.00%	0.80	4.00%
Inflation	CPI-U	2.75%	1.40	

Advisory Board: *We understand that a major benefit of your long standing relationship with Callan is their ability to provide you a window into the investment planning of some of the largest institutional investment funds? What are the big funds doing to improve returns in this environment?*

CapGroup: Basically, the returns outlined above represent the theoretical “beta” or market component of returns; that is, the returns expected from a fully diversified asset class. Beta returns can be efficiently captured by index mutual funds or exchange traded funds (ETFs), without assuming active management risk. Therefore, an obvious answer to increasing overall returns is to take on more “beta risk” by increasing the allocations to global equities, and many institutions are simply increasing the policy ratio of stocks to bonds.

But when expected beta is suppressed by market and economic forces, there is naturally renewed interest in capturing excess returns above the indices, commonly referred to as “alpha”. To that end, we are witnessing a whole new generation of “systematic” approaches to active management, including a wide variety of enhanced indexing approaches, the uses of “alpha transport” strategies and the practice of relaxing the long-only constraint to allow managers to seek extra alpha by shorting stocks in up to 20% to 30% of their portfolios (e.g., 130% long and 30% short). These highly “systematic” approaches to alpha generation are technology driven and can be complementary to the traditional “anticipatory” approaches to active money management that seek excess returns with more conventional securities selection processes.

In addition, more and more institutional investors are seeking extra returns by using alternative investments such as hedge funds, private equity, global securitized real estate, direct real estate investments, real return strategies and commodities. The total domestic investment in hedge funds is estimated to now exceed \$1 trillion, and they continue to gain acceptance with endowments, charitable foundations, wealthy individuals and retirement plans who are seeking to improve returns and manage portfolio volatility. The Commonfund reports that charitable foundations dedicated 34% of their assets to alternative investments in 2005, with about half of that amount allocated to hedge funds. Since many of these products are designed to be non-directional, theoretically meaning they have no beta, they can have an important risk reduction function in portfolio construction. But the emphasis on alpha generation produces a wider range of manager performance and requires much higher levels of due diligence in the manager selection process. We continue to believe that the extra manager risk is best managed by using very high quality fund-of funds managers.

Advisory Board: *Yes, the highly publicized demise of Amaranth Advisors in the late summer sent a shock wave through the hedge fund industry. Were any of the fund-of-funds you recommend invested in Amaranth?*

CapGroup: Fortunately, none of our managers were invested with Amaranth, and we have avoided the other large hedge fund failures over the past few years. This is not just good fortune, but is the result of the highly disciplined due diligence processes of the find-of-funds managers we select. For example, Amaranth exhibited several “red flags” prior to its meltdown and was removed from the portfolios by our managers.

By and large, our Clients are benefiting from their allocations to hedge fund-of-funds and other forms of alternative investments. As you know, we depend heavily on Callan’s hedge fund research group for manager due diligence, and we do our own research on products we recommend. Tim Jester, our Director of Research, is a Chartered Alternatives Investment AnalystSM and has an extensive background in alternative investments. Our capabilities in evaluating alternative investments managers and their products are extremely important, as more and more investment products are combining traditional long-only money management with trading strategies used by hedge funds. The growth of these hybrid products will continue to evolve, driven by the application of information processing technology, the continuing integration of the global financial markets and the evolution of investment products using financial derivatives.

Advisory Board: *These are certainly challenging times for all investors. I guess that’s good news for CapGroup and the investment services industry in general.*

CapGroup: Yes, these are challenging and exciting times for us, and we are confident that our resources and capabilities are world class. But we can’t ever rest, so we continue to invest considerable resources into planning and preparation to improve our services to our Clients. Again, with the additional depth of resources and support from Focus and its Member Firms, the quality of our services should be enhanced significantly. We are very excited about our future.