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BUY THE NUMBERS

Asset Class Valuation

Fall 2006

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Portfolio Solutions, LLC

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INTRODUCTION

Over the long run, a majority of a portfolio's performance is driven by its strategic allocation between stocks, bonds, real estate, cash, and other asset classes. As such, the greater understanding an investor has about asset class selection and how different investments blend together in an efficient portfolio, the better prepared they will be to allocate capital today and in the future to match their financial needs. Once an asset allocation is implemented, each year the portfolio should be rebalanced back to the strategic asset allocation. Rebalancing controls risk and has the added benefit of capturing an excess return by buying low and selling high.

Some investors may choose to make asset allocation changes after near-term market movements or a belief that something will happen in the markets. We generally do not recommend investors do that. All financial markets relentlessly seek fair value based on current economic news and a consensus estimate of future conditions. In the long run the trends change slowly within a cyclical range, and the markets eventually move to reflect those changes. In the short-term a small change in an economic variable or belief can cause a dramatic shift in asset pricing. In retrospect it is easy to see that the markets were acting incorrectly, such as the bubble that occurred in the NASDAQ during the late 1990s. However, while the markets are in an overvalued or undervalued situation, it is extremely difficult to recognize it.

Buy The Numbers: Asset Class Valuation illustrates some of the relationships between the pricing of fixed income and equity markets, and current trends in those markets. While we do make a few rough forecasts, those forecasts are meant to educate rather than as a market timing mechanism.

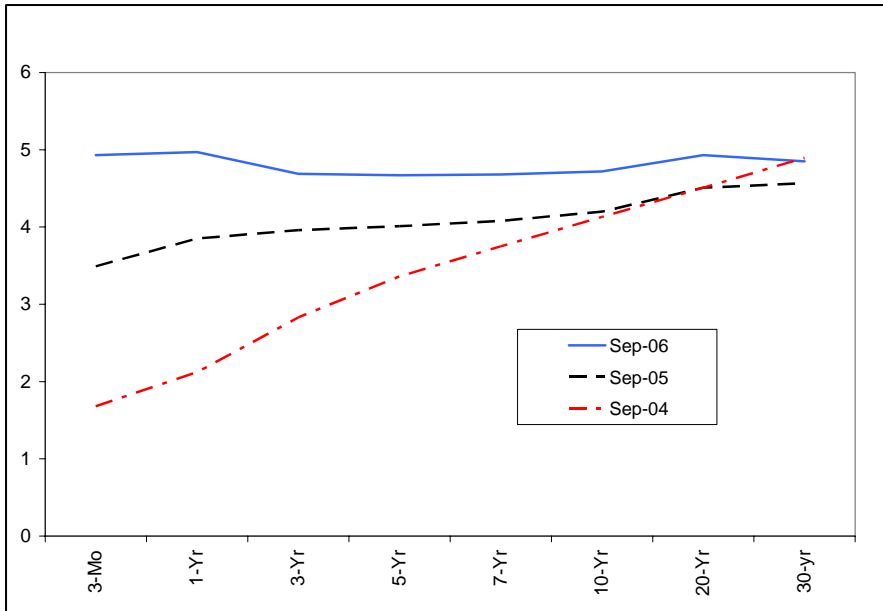
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“In the short run the stock market is a voting machine; in the long run it is a weighing machine.”

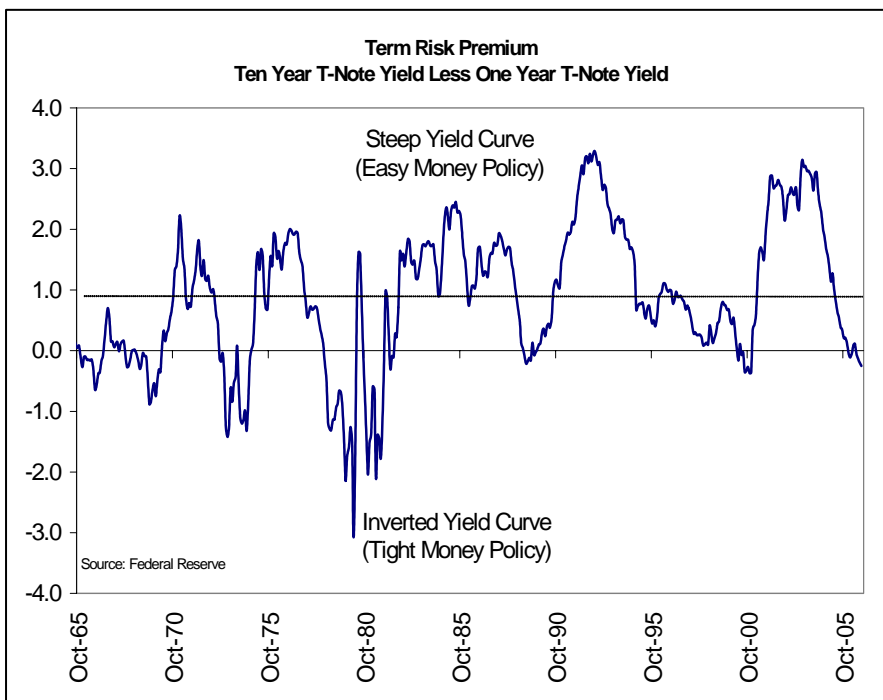
Benjamin Graham

INTEREST RATES & FIXED INCOME ANALYSIS

THE YIELD CURVE

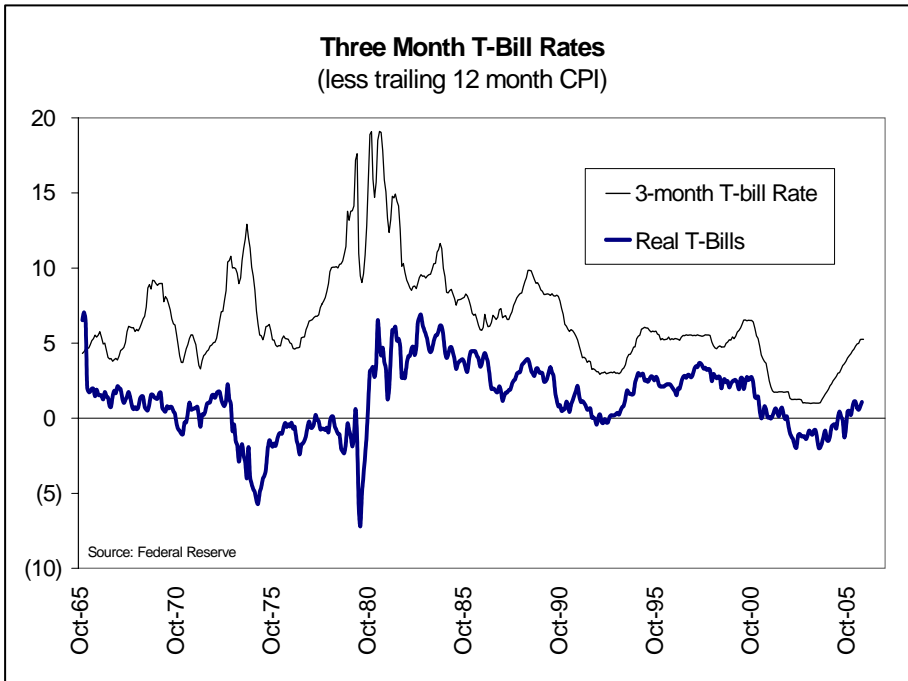


The yield curve is inverted, meaning that short rates are higher than long rates.

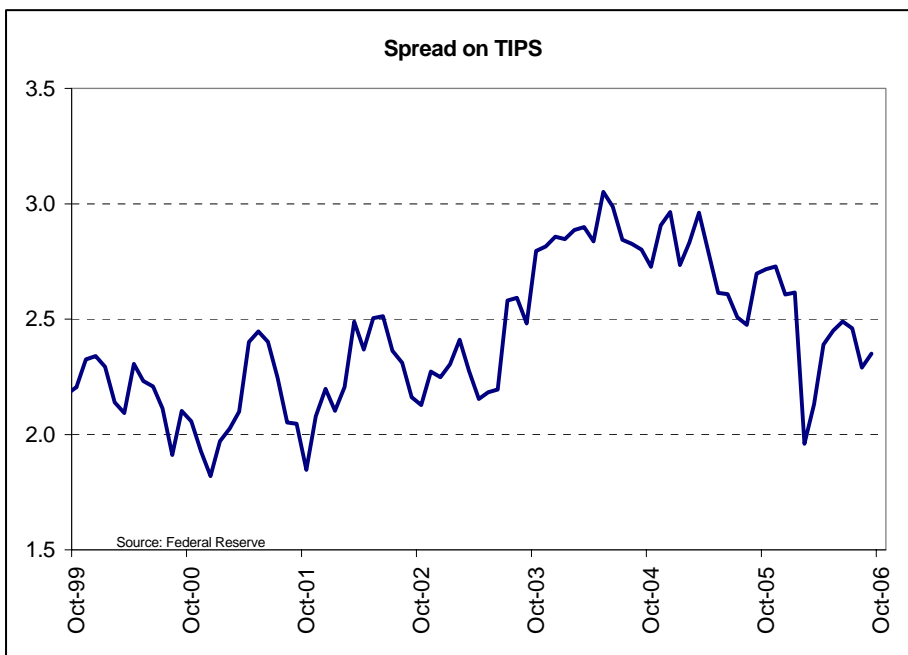


The spread between 1-year and 10-year Treasury continues to tighten. The spread has fallen to -0.25%. Typically a spread below 0% may indicate an economic slowdown.

REAL INTEREST RATES & INFLATION EXPECTATIONS

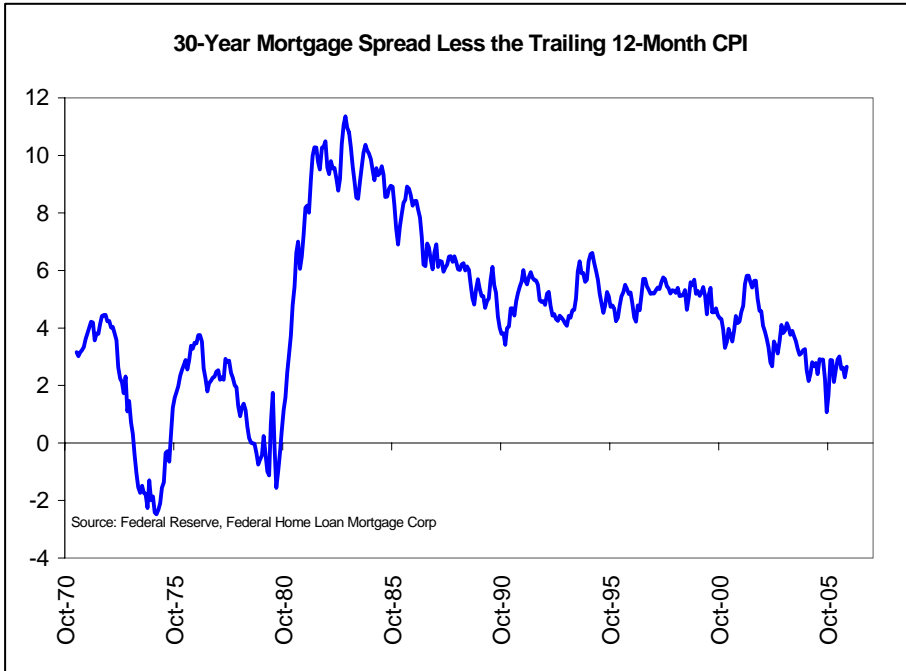


Despite higher short-term rates, real three month T-bill yields are positive again.



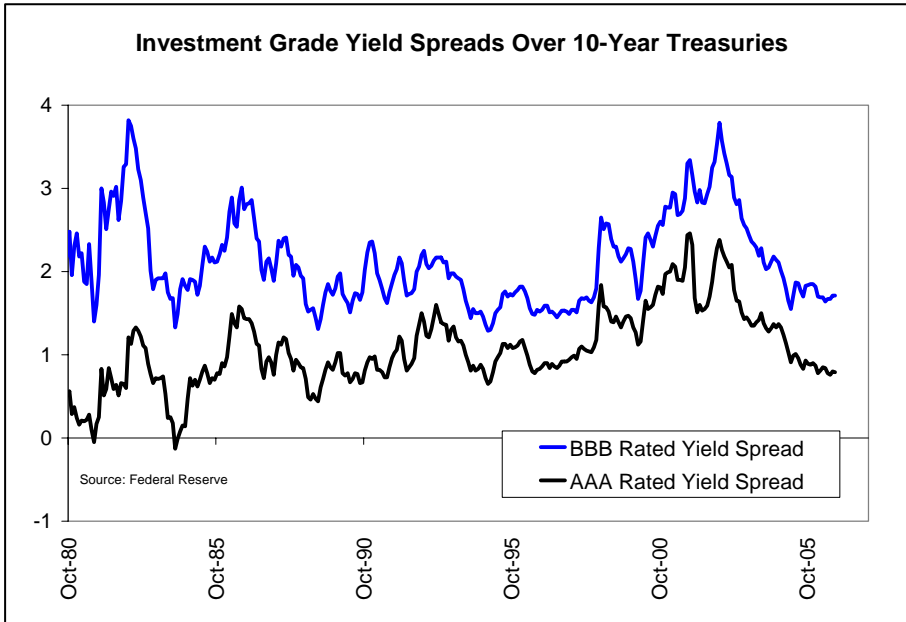
The spread on TIPS has decreased from 2.5% in the winter of 2006 to around 2.3%, this indicates that inflation expectations are moving lower.

GOVERNMENT BACKED CREDIT SPREADS



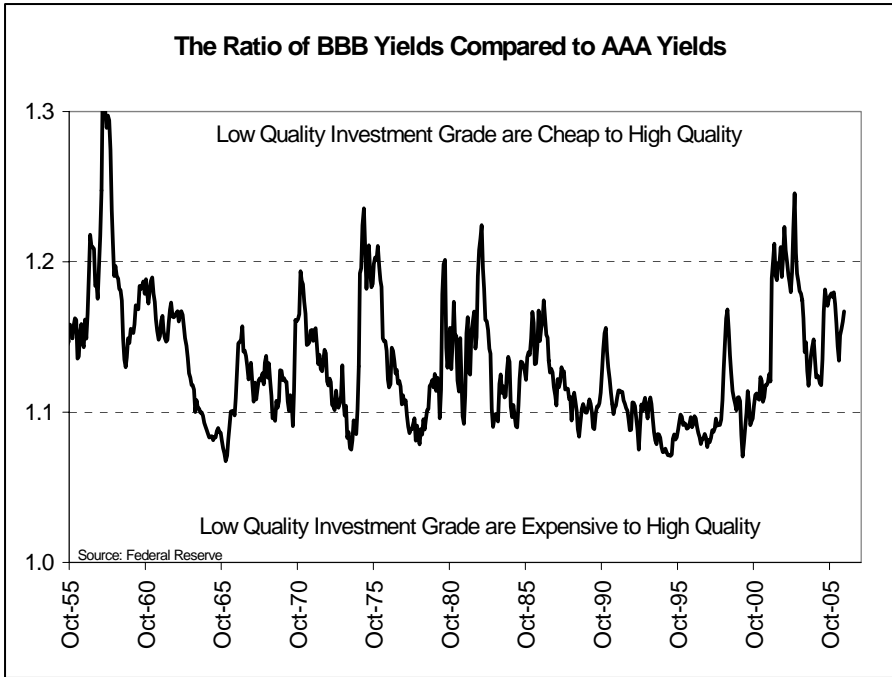
Despite higher mortgage rates, the spread between 30-year mortgages and the CPI remains low. As long as home values go up with inflation, financing a home is still attractive.

INVESTMENT GRADE CORPORATE BOND CREDIT SPREADS



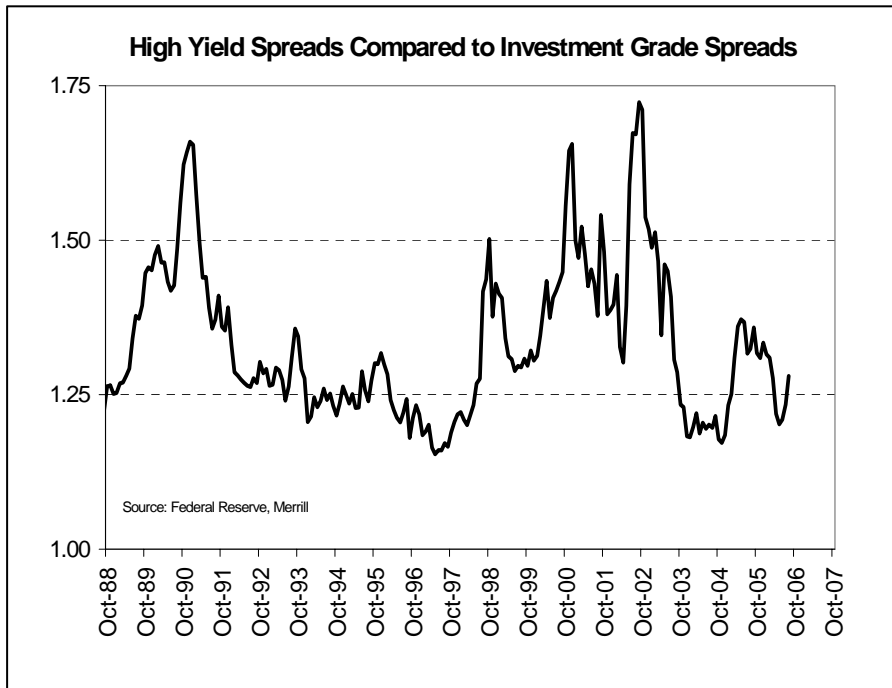
BBB rated bond yields widened, but are still under 2% over Treasuries. AAA bonds remain lower than 1% since they fell in May of 2005.

The Ratio of BBB Yields Compared to AAA Yields



The ratio of BBB corporate yields to AAA corporate yields have widened in the last quarter signaling a move to quality among investment grade bond buyers.

HIGH YIELD CORPORATE BOND CREDIT SPREADS

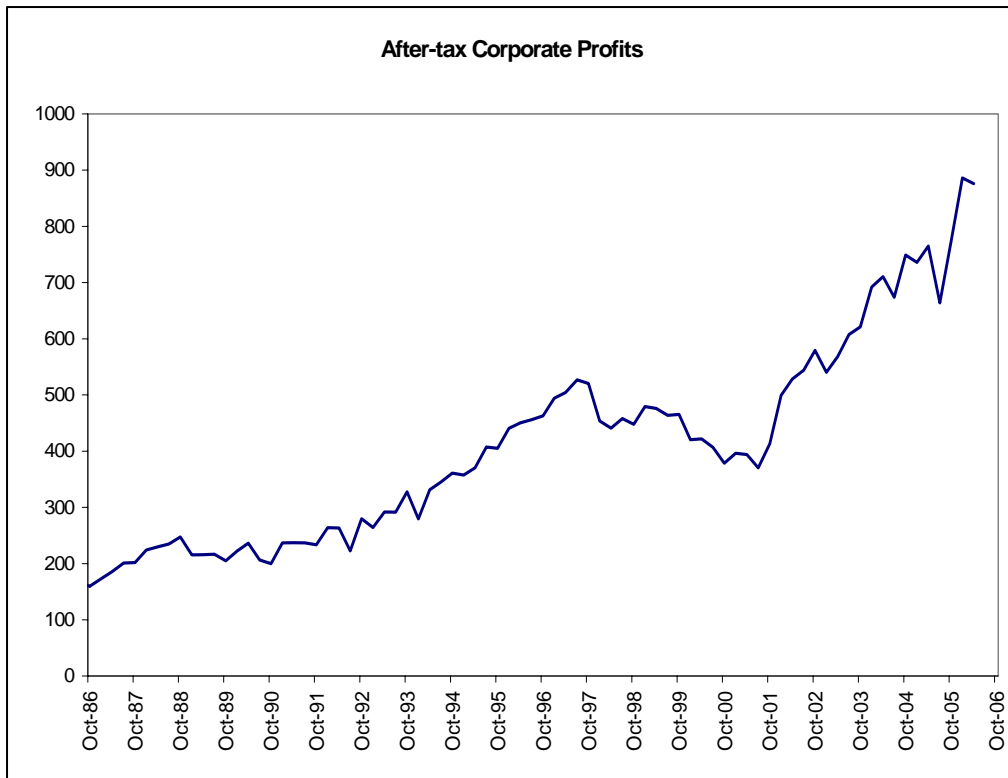


High yield bond spreads are also widening this year. The yield ratio of high yield bonds to investment grade bonds has increased from 1.2 to about 1.35 since April 2006.

EQUITY EVALUATION & ANALYSIS

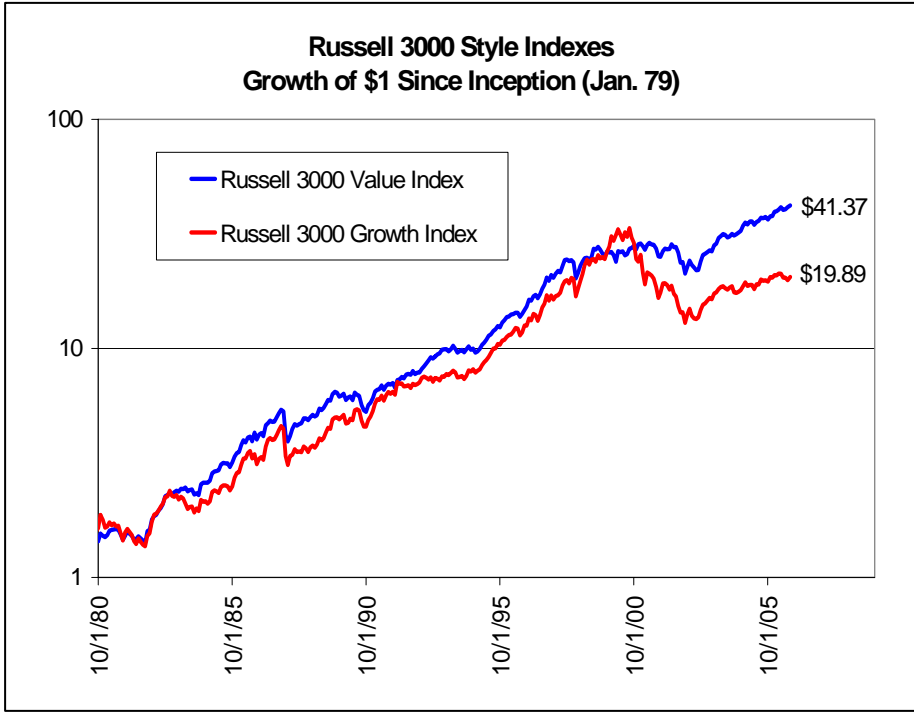
ECONOMICS DRIVE EARNINGS

After-tax corporate profits have continued to be robust. Real GDP growth coupled with low inflation drives real corporate earnings growth; and real earnings growth drives stock prices. In a healthy economy, after-tax corporate profits are expected to be about 6% of GDP, and that is what US corporations are generating today.

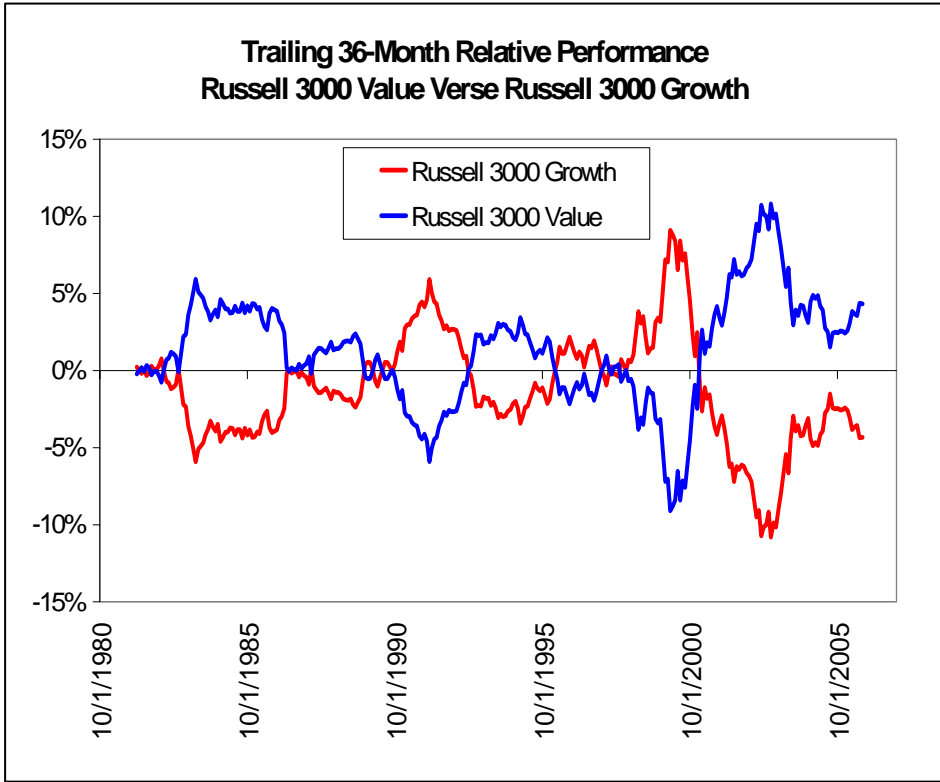


U.S. STYLE ANALYSIS

Growth versus Value

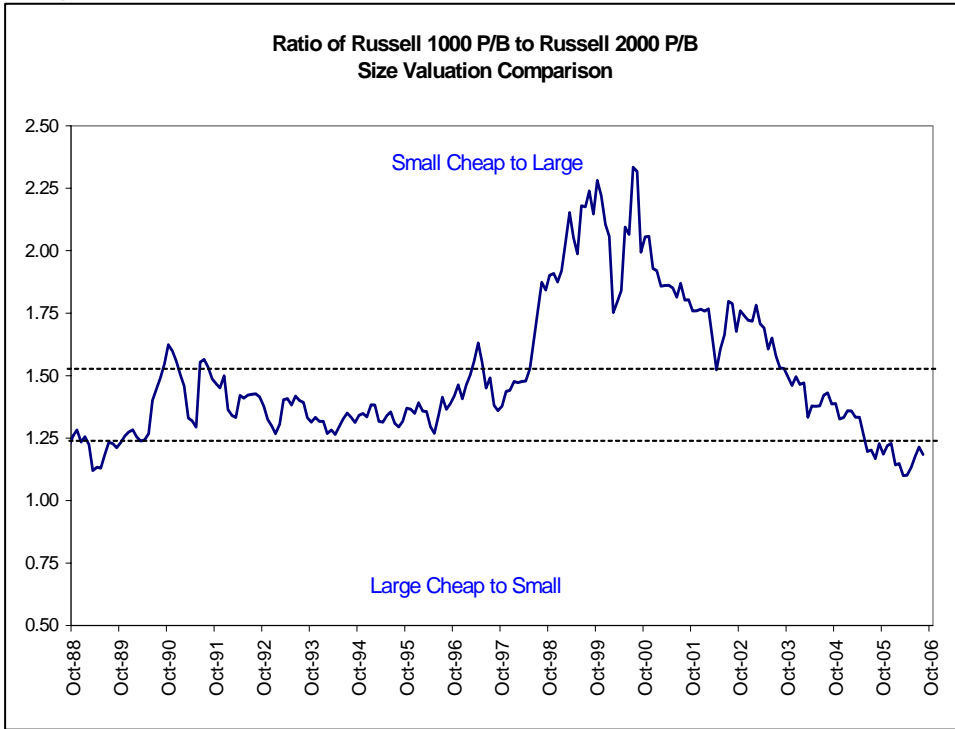


Since 1979, the Russell growth index has lagged the Russell value index.

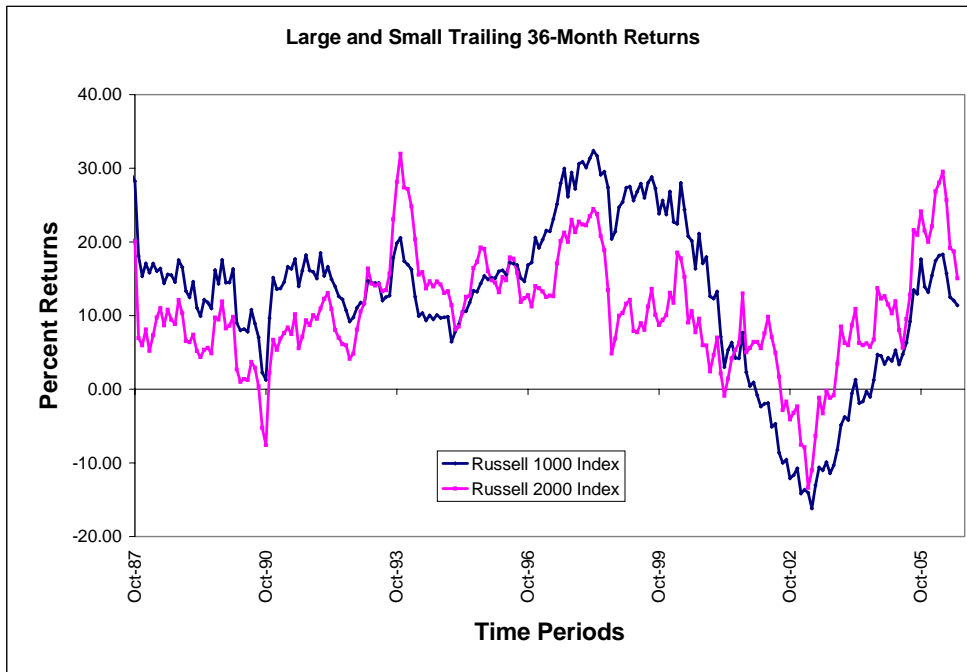


The figure to the right illustrates the difference in trailing 3-year annualized returns between the Russell 3000 Growth Index and the Russell 3000 Value Index.

Large versus Small

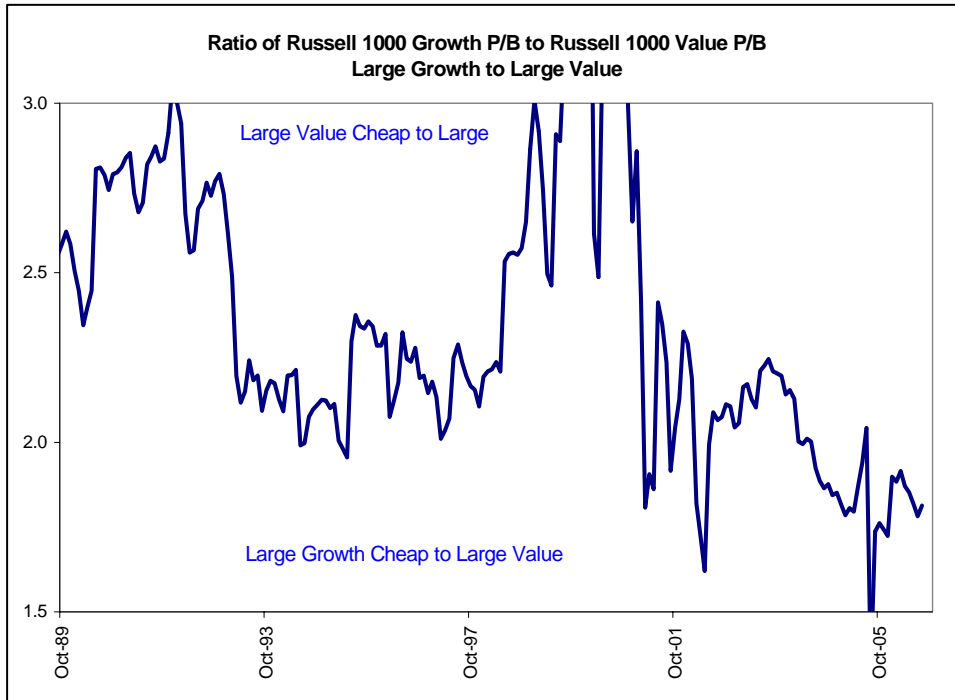


Large stocks still look cheap compared to small stocks based on a comparison of price-to-book (P/B).

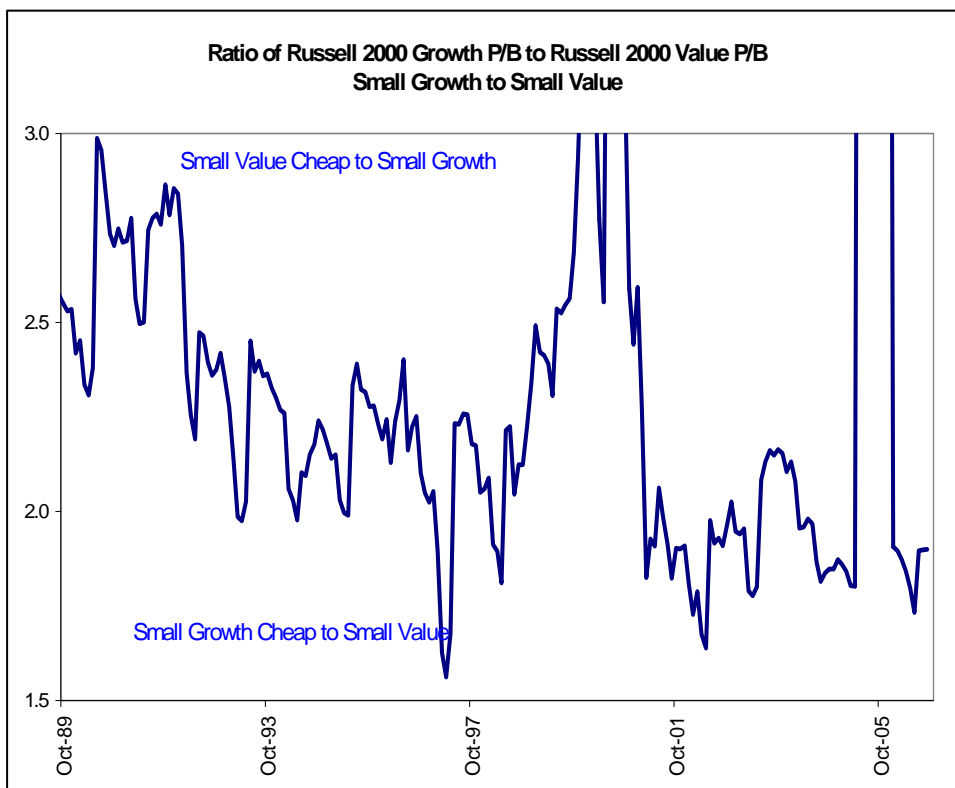


Small has beaten large over the past 3-years, but the spread is narrowing.

Growth versus Value

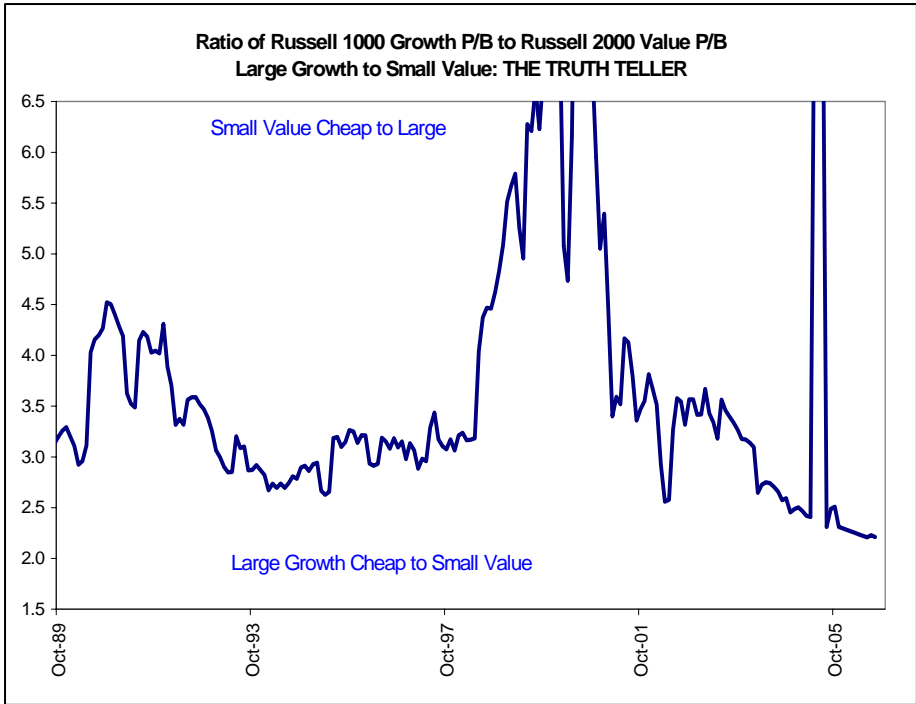


Large growth looks reasonable compared to large value based on P/B values.

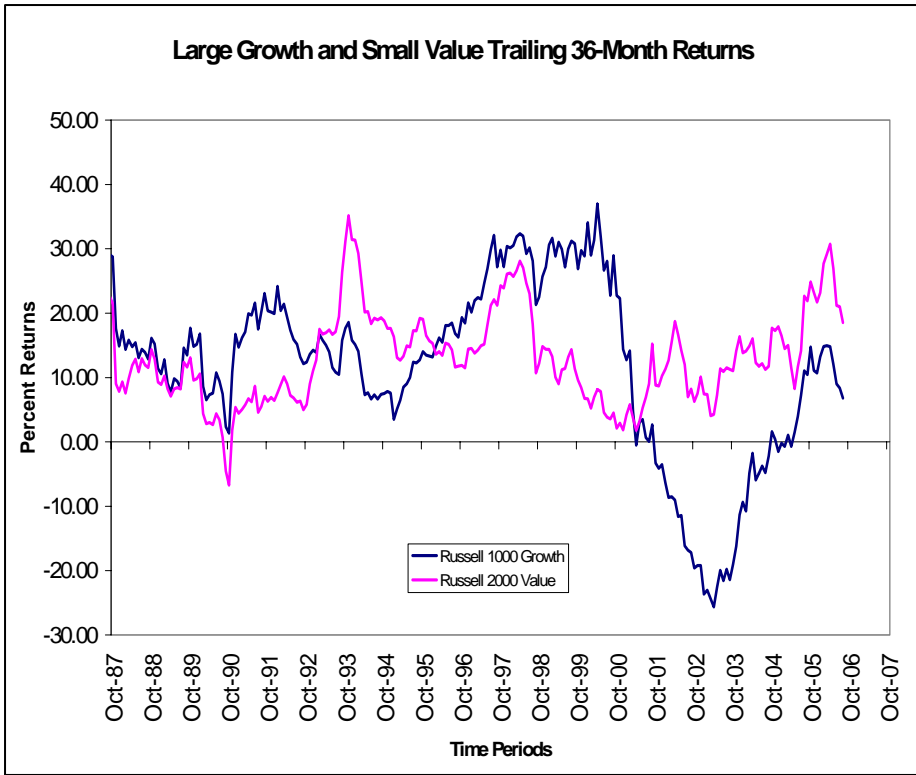


Small growth is still cheap to small value.

Truth Teller – Large Growth versus Small Value



Large growth is historically cheap to small value.



Small cap value stocks have outperformed large cap over the last three years. However, over the next cycle large cap growth may stage a comeback.

PORTFOLIO SOLUTIONS, LLC is a low-cost investment management firm with its main headquarters in Troy, Michigan. The company provides fee-only asset allocation and portfolio management services to individuals, corporate, and non-profit organizations nationwide. For more information including management fees and account minimums, call 800-448-3550 or visit our website at www.PortfolioSolutions.com.

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- Economic Analysis** – news and information that shapes the financial markets
- Asset Class Valuations** – compares and contrasts past and current valuations.
- Asset Class Correlations** – charts changing dynamics between asset class returns.

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