



## Financial Review

Equity markets rallied in the third quarter as investors cheered the Federal Reserve ending its string of moves to raise short-term interest rates, as well as a broad-based decline in energy and commodity prices. The S&P 500 Index rose 5.6% for the quarter, while the benchmark index for small-cap stocks, the Russell 2000 Index, gained a more modest 0.4%. For the first nine months of the year, each index is up almost 9%.

Slowing economic growth, as well as moderating inflationary pressures, have finally forced the Federal Reserve to pause in the tightening cycle. Growth in GDP in the second quarter slowed to an annual rate of 2.6%, with some Fed officials predicting reduced growth for the remainder of the year. Many observers expect home construction to continue to decline over the coming quarters as the supply of unsold homes increases. This slowdown may further hurt consumption as declines in mortgage refinancing and home equity loans result in less cash available for spending.

A sharp decline in commodity prices also contributed to economists more favorable outlook toward inflation. The decline in spot prices for natural gas and oil reflects moderating global tensions, an uneventful hurricane season, as well as concerns about diminished global economic growth. Additionally, volatility in the natural gas futures market was influenced by the forced liquidation of a hedge fund's substantial positions. We believe the decline in energy prices has run too far as some market participants were forced to sell at any

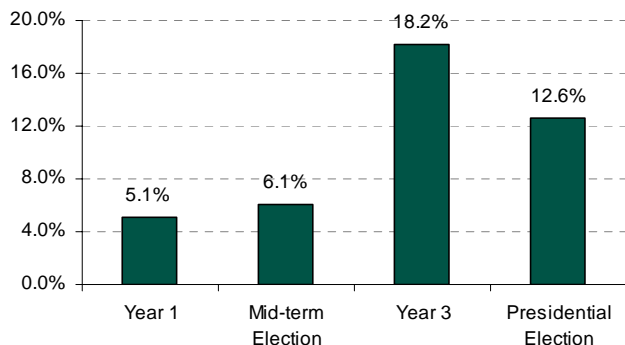
price, and therefore we expect oil and natural gas prices to edge higher over the coming months.

With most economic data pointing to moderating growth and reduced inflationary pressures, we believe the Fed will sit on the sidelines for the remainder of the year. For the time being, we expect investors' collective attention to focus on the upcoming mid-term elections, as control of both the House of Representatives and the Senate are in play.

## Elections and Investing

With an important election on the horizon, we thought it would be interesting to take a look at historical patterns between the election cycle and the stock market. From 1926 through 2005 - a period that includes numerous recessions, wars, and dramatic shifts in political sentiment - the S&P 500 Index has generated an average annual return of 10.4%. Analyzing the return based upon the year of the presidency produced somewhat surprising results.

Presidential Election Cycle  
S&P 500 Index Annual Returns  
(1926-2005)



The first two years of a presidency have historically been sub-par, achieving mid-single digit returns on average. In the year following mid-term elections, however, the average annual return has exceeded 18%. What is truly impressive is the consistency for this performance – in the third year of a presidency the S&P 500 has produced returns exceeding 20% in 13 of the 20 periods covered, and has not suffered a decline since 1939.

What could explain the higher return for the year following mid-term elections versus the other three years in the cycle? One possible justification is that in the first two years of a president's term, markets are concerned with major changes in domestic and foreign policy coinciding with newly elected members of the executive and legislative branches of government. With mid-term elections only focused on the legislature (at the national level), perhaps the markets view the economic environment after those elections as being less prone to substantial changes. Following this premise, it is noteworthy that the two years after mid-term elections have historically produced such strong results relative to the first two years of a president's term.

Does the past success of the markets in the year following mid-term elections make us extraordinarily bullish for 2007? The simple answer is no, as we do not approach investing by simply extrapolating the past into the future. Although the historical returns have been impressive, it is important to note that there have been less than stellar investment results as well - one of the observations (in 1931) was a decline of over 40%.

Although we are optimistic that the stock market will perform well next year, our enthusiasm is tempered by economic and geopolitical uncertainty. We believe stock

prices will be supported by: corporations with historically strong balance sheets, substantial private equity funds seeking investment opportunities, and decent (but slowing) corporate profit growth. We remain cautious regarding the ability of the economy to achieve the "soft landing" Fed officials and market participants are hoping for, as we see growing signs that the economy is facing more of a threat from a cash-strapped consumer. Additionally, we think the market is presently too optimistic regarding the outcomes of the conflicts in Iran, Afghanistan, North Korea and the Middle East.

Regardless of the future direction of the market, we remain committed toward the goal of protecting and growing our clients' assets through careful analysis of each investment's risk and potential for reward – regardless of asset class.

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## Core Equity Portfolio

During the quarter we initiated positions in Devon Energy and Pfizer.

Devon is the largest US-based oil and gas producer, with 90% of the company's reserves located in North America. Production growth should begin to accelerate in the second half of the year, reflecting positive results from their drilling program, recent acquisitions, and restoration of Gulf of Mexico production impacted by last year's hurricanes. Devon presently trades at a valuation discount to its peers, and significantly below recent financial transactions.

Pfizer, the world's largest pharmaceutical company, appears to be positioned to enjoy earnings growth after three years of stagnation. Pfizer's stock price, meanwhile,

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has languished even longer – losing over 50% of its value since 1999. Pfizer seems to be turning the corner, as generic competition on some of the company's drugs appears to be fully discounted in the stock price.

Additionally, Pfizer received better than expected proceeds in the disposal of its consumer products division, and will use the money for product acquisitions and share buybacks. At 12x earnings and a dividend yield of 3.9%, Pfizer's valuation is extremely attractive.

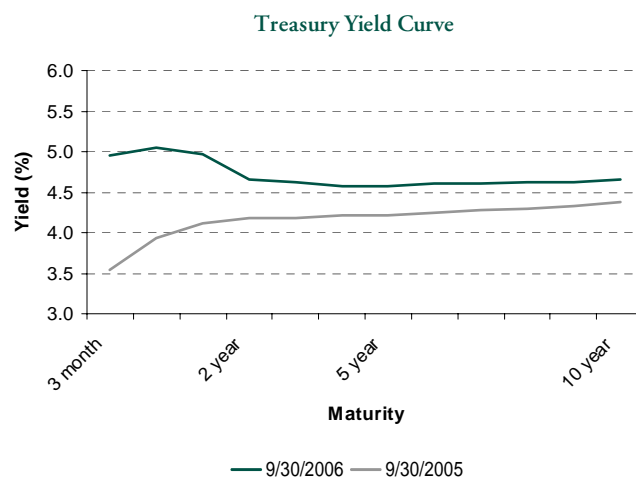
During the quarter, we eliminated our positions in Kerr-McGee, Servicemaster, and Windstream. Kerr-McGee was acquired by a competitor - Anadarko Petroleum - in an all cash transaction that represented a 40% premium over the share price prior to the announcement of the deal. Servicemaster and Windstream were sold in order to initiate a position in a more attractive investment – namely Pfizer. Our view of Servicemaster diminished due to the belief that despite restructuring efforts, profit margins will remain challenged in an environment of elevated energy costs (as well as difficulty increasing revenues with a stretched consumer). Windstream is the wire-line business that was recently spun off from Alltel. While we maintain a favorable view of Alltel's wireless business, we view Windstream's wireline business as unattractive from both a growth and cash flow perspective.

The portfolio remains slightly weighted toward protecting against a slowing economy, with emphasis toward stocks in the health care and consumer staple sectors. We have also maintained an above average weighting in energy – a decision that has served us well over the last few years, but modestly hurt third quarter performance due to the decline in commodity prices. Our thesis on energy

remains: that over the next few years a prolonged tightness in supply - particularly oil - will result in higher earnings for most companies in the sector.

## Fixed Income Markets

Yields on fixed income securities abruptly declined in the quarter, as evidence mounted for slowing economic growth. The yield for the benchmark 10-year treasury ended the quarter at 4.63%, down about 50 basis points from June. The Federal Reserve Board abstained from raising rates for the first time in two years, leaving the Fed Funds Target rate at 5.25%. The market now anticipates that the next move by the Fed will be to lower rates sometime next year, presumably in response to anemic economic activity.



Portfolios will maintain durations close to benchmark levels, as we do not envision substantial movement in the yield curve for the remainder of the year. Corporate bonds have proved to be surprisingly strong recently in spite of the weakening economic environment. Looking forward, callable bonds remain the most attractive investment in taxable bonds.

## Alternative Investments

Alternative investment strategies provided positive returns for the quarter, generating annualized returns of mid-to-high single digits. Most **Equity Long/Short** funds trailed behind the gains of the broad market. This was due to many managers assuming a more conservative positioning after the summer sell-off. Robust merger activity has aided **Convertible Arbitrage** managers, as acquired companies often have embedded premiums in their convertible debt for change of control provisions. The buy-outs have created opportunities in the new issuance market as well, offsetting the headwind created by low volatility.

With the economy continuing along a path of modest growth, new investments within the

**Distressed Securities** market are becoming scarce. Overall default rates in the economy bottomed in mid-2005, but the increase in bad debt has been gradual and confined to a limited number of industries. A surge of bankruptcies among auto parts suppliers in late 2005 was the last widespread opportunity for these managers. Many funds are reallocating resources to other areas while they wait for a turn in the cycle.

**Specialty Finance** managers continue to perform well. Investment in this sector is limited by the specialized nature of these deals that provide few economies of scale. However, this is also the reason smaller funds achieve outsized risk-adjusted returns when compared to larger, multi-billion dollar funds.

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## New Investments

During the quarter, qualified clients invested in M&J/Sansome, LLC a real estate offering from our partner M&J Wilkow Properties, Inc. (“Wilkow”). This investment involves the purchase of an office building located in downtown San Francisco’s North Financial District, the largest sub-market in the city’s Central Business District.

The eight-story, 147,989 square foot office building was developed in 1929 and most recently renovated in 2001. Market trends in the Central Business District present an appealing opportunity for investors. The District has experienced three years of

decreasing vacancies and strong increases in rental rates. City restrictions continue to restrain new development. The Property is situated among the most prominent buildings and business addresses, commanding the highest rental rates in the area. Presently, most existing leases for the Property are below market rates.

The five-year strategic plan for the Property includes: substantial renovation, conversion of first floor office space to retail service-based tenants, replace existing tenant leases at market levels, and selling the property in 2011.

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## Final Note

This letter as well as other significant communications can be emailed to you instead of sent through regular mail. Please send your email address to **info@cedhill.com** to be added to our email distribution list.

## One Year Economic Overview

		Sep 2006	Sep 2005
<b>Stock Market</b>			
S&P 500 Index	▲	1,335.85	1,228.81
Russell 2000 Index	▲	725.59	667.80
<b>Fixed Income Yields</b>			
3-Month Treasuries	▲	4.98%	3.53%
5-Year Treasuries	▲	4.55	4.21
10-Year Treasuries	▲	4.63	4.33
30-Year Treasuries	▲	4.75	4.52
<b>Inflation Monitor</b>			
CPI-Trailing 12-Month Growth	▼	3.8%	4.7%
CPI-(Excluding Food/Energy)	▲	2.8	2.0
Market Expectations*		2.4	2.4
Gold (per ounce)	▲	\$598.30	\$479.50
Crude (per barrel)	▼	62.91	66.24

\*Comparison of yields for 10-Year Treasury and 10-Year TIPs