

January 22, 2007

### Fourth Quarter 2006 Review

#### I. Fourth Quarter Market Performance

The U.S. stock market jumped in the fourth quarter, with the broad-based S&P 500 Index rising 6.7%. Smaller stocks led the way, with the Russell 2000 Index rising 9%. As was the case in 2004, the market rallied strongly after the cloud of uncertainty hanging over the elections had dissipated. And true to form, it made no difference which political party made headway. The market just likes the drama to be over with.

Bonds (Lehman Brothers Aggregate Index) had an average quarter, returning 1.2%. There was little change in the yield curve with the Fed Funds rate remaining at 5.25% and 10 Year Treasuries yielding 4.7%. Alternative investments were led higher once again by Real Estate – which gained an impressive 9%.

#### II. Full Year Summary

For U.S. investors, 2006 was a strong year. The S&P 500 gained over 15%. Most major asset classes were up double digits. International returns were particularly strong with the EAFE Index (in U.S. \$) rising over 25% and the Emerging Market Index (China, India, Russia, etc.) rising over 30%.

As in 2005, corporate earnings for S&P 500 companies were very strong, growing at an estimated 17% - more than twice the historical average. Also helping returns was Gross Domestic Product growth that slowed down to more sustainable levels, low unemployment, controlled inflation and slowly declining energy prices. Below is a chart highlighting the performance of several asset classes:

**Fourth Quarter 2006 Market Performance**

<b>Index</b>	<b>Quarter</b>	<b>1 Year</b>
S&P 500	6.7%	15.8%
Russell 1000 Growth (Large Cap)	5.9%	9.1%
Russell 1000 Value (Large Cap)	8.0%	22.3%
Russell Mid Cap	7.7%	15.3%
Russell 2000 (Small Cap)	8.9%	18.4%
Russell Micro Cap	10.3%	16.5%
EAFE (International) in US \$	10.0%	26.3%
MSCI Emerging Markets in US \$	17.6%	32.6%
Lehman 1-5 Year Government/Credit	4.2%	1.0%
Lehman Aggregate	1.2%	4.3%
Lehman High Yield	4.2%	11.9%
Dow Jones Wilshire REIT (Real Estate)	8.9%	36.1%
Credit Suisse/Tremont Long/Short Equity	7.0%	14.4%
Credit Suisse/Tremont Convertible Arbitrage	3.3%	14.3%
Credit Suisse/Tremont Managed Futures	8.2%	8.1%

Source: PSN

### **III. Outlook for 2007**

The fundamentals of the U.S. economy and stock markets are likely to remain favorable in 2007. Valuation levels are modest, corporate profits are expected to rise, interest rates are low and will probably remain steady, inflation is contained and unemployment is low (less than 5%).

Gross Domestic Product (GDP) growth should also come in at a comfortable level. Last year at this time, SHFG predicted that the Fed would stop raising interest rates only when the uncomfortably high GDP growth rate dropped below the 3% level. We also predicted that such a development would be good for investors. That is exactly what happened. The Fed stopped raising the Fed Funds rate in July, 2006 when GDP growth slowed down, and the market rallied to new highs. We believe GDP growth will stay in the comfort zone of 2-3% for much of 2007.

At this point, the two greatest risks to our benign 2007 forecast are the possibility of recession and inflation. They are briefly discussed below.

#### **Recession Odds**

A recent, semi-annual Wall Street Journal survey of economists pegs the chances of a recession at 27%. GDP slowdown to the point of recession would likely be triggered if the manufacturing sector gets substantially worse. Manufacturing activity has weakened in recent months due to the pronounced slowdown in the housing market and to a weak auto sector. Some economists feel that housing will get worse. History shows that a steep drop in housing starts, like we have seen recently, has often led to a recession.

However, our economy is less manufacturing and more service-based today than it has been in decades past. Between 75% and 80% of U.S. workers are now employed in the service sector. Statistics show that employment trends in the dominate service sector of the economy (fields such as financial and professional services, retail, healthcare, restaurants, leisure and entertainment) are strong.

Other macroeconomic forces effecting GDP growth are also favorable. These include business investment (deployment or distribution of record corporate profits) and record government spending levels.

#### **Inflation**

The head of the Federal Reserve, Ben Bernanke, recently stated that he is more concerned about rising inflation than he is about recession risk. The decision for the Fed centers more on whether to raise interest rates (to fight inflation), not whether to cut them.

To us, the continued Fed focus on inflation is comforting and indicative that it will likely not become a problem. Other than the Fed, there are three other areas directly related to inflationary pressures that SHFG is monitoring closely – productivity trends, energy and other commodity prices and rising wages.

#### IV. **Asset Allocation**

##### **Equities – Value in Growth**

The equity-only component of Smith & Howard Financial Group client portfolios performed very well in 2006. International stock exposure once again helped boost returns. For the third straight year the EAFE International Index (up 26%) outperformed U.S. stocks.

The slight overweighting to equities that we have had in client portfolios since the beginning of 2003 once again helped performance.

Amazingly, large-cap value stocks outperformed large-cap growth stocks for the seventh straight year – a complete flip-flop from what happened in the mid-to-late 90s. While it is possible that value will continue to outperform growth, we think the tide will turn soon. We are currently overweighted towards the growth sector because, in our opinion, there is value in growth.

##### **Fixed Income**

During 2006, the Lehman Aggregate Bond Index rose only 4.3%. As we have stated since 2003, we believe that bonds will underperform stocks in the year ahead. With interest rates relatively low and a partially inverted yield curve, it will be difficult for bonds to achieve returns, even in-line with their historical averages. We continue to maintain bond portfolios tilted toward shorter durations and this has served our clients well. The risk/reward characteristics are commensurate with this strategy.

##### **Alternative Investments**

Led once again by Real Estate Investment Trusts, the returns for the portion of client portfolios invested in alternative investments were attractive for the quarter and for the year.

Opportunities in alternative investments have expanded dramatically over the last few years. Some clients are invested in the MLM Managed Futures fund and we are in the process of replacing it with a strategy that will result in less paperwork and lower fees. During 2006 we established positions in a long/short equity fund and a convertible arbitrage bond fund in the alternative investments area.

We hope that you will be able to attend our annual Investment Forum on February 1<sup>st</sup> at 4:30. It will be enlightening and a celebration of the success that you have helped make possible. We look forward to seeing you. If you have not registered but would like to, please call Misty Olive at 404-874-6244 by January 29<sup>th</sup>.

Sincerely yours,

Frederick S. Wright, CFA, MBA  
Chief Investment Officer