

OUTLOOK 2007: TACTICAL ASSET ALLOCATION ISSUES

Investment Policy & Strategy Group



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TABLE OF CONTENTS

Outlook 2007	3
Economy in 2007	4
Tactical Asset Allocation	
2007 Decision Tree	6
Equities vs. Bonds	8
The Index's "Right Calls"	10
Income Producing and Defensive Assets in 2007	
• Treasuries	11
• Corporate Bonds	12
• Real Estate Investment Trusts	13
Equity Investor 2007	
• Foreign Investment	14
• Size Investing	18
• Style Investing	21
Summary Allocation by Investor Type	24



While there is clearly higher risk of growth rates falling short of economists' forecasts, financial markets could generate better-than-expected returns in 2007. Equity markets are generally well supported by valuations and cash flow, available sources of credit, and cash balances remain in ample supply throughout the global economy.

Right Up Front

The challenges laid out last year, including an inverted curve, deteriorating outlook for residential investment and high energy prices, are still with us and there are significantly greater near-term risks to the economy today than there were a year ago. In addition, these risks seem to be underappreciated by economists.

OUTLOOK 2007

Where to Profit in 2007

Consider the stock market's strong performance of late or, better yet, look at the recent *Survey of Professional Forecasters* conducted by the Philadelphia Federal Reserve. This group of almost 50 forecasters expects the odds of a recession in 2007 to be about one in seven, up from one in ten a year ago. At one in seven odds, the forecasters are assuming that there is no greater risk today than under ordinary circumstances. However, there are undeniable signs of weakness in manufacturing, inventories, automobile sales and residential construction. In addition, a model based on the shape of the yield curve created by the New York Federal Reserve¹ puts recession odds closer to one in three. We think that the data and the bond market are closer to reality than the economists' survey. Therefore, we have temporarily placed a heavier emphasis on the "risk case" for the economy in our asset allocation models.

A Stable & Supportive Environment

Now that we have discussed the risks, we can look at what is going right. The environment is conducive to wealth creation in financial markets because inflation remains low and, by raising interest rates, the Federal Reserve is again demonstrating its commitment to maintaining price stability. An outbreak of inflation would erode the value of money and discourage productive investment. By maintaining vigilance, low and stable inflation engenders confidence, allows for better planning and encourages investment. Restoring appropriate levels of real interest rates that raise the cost of money has been an important contributor to the success of the economy over time. Temporary dislocations caused by higher rates will be accepted by markets as necessary "growing pains," rather than a terminal event for the economy.

At the same time, the private sector continues to create more jobs, income and wealth. According to the latest data from the Federal Reserve, households have added \$2.6 trillion in disposable income, \$11 trillion in net equity, and 4.7 million net jobs since March 2000. Businesses, excluding financials, are generating an additional \$760 billion in additional income and net equity has expanded by \$4.6 trillion over the same period. Coupled with ample credit, the deep

pools of wealth available to the private sector remain a powerful engine of growth moving into 2007.

Working the Earnings Math

We estimate that S&P 500 earnings could reach \$91 next year versus an expectation of \$87 in 2006. These figures are based on a blending of our "good case" estimate of \$96 in earnings coupled with our "risk case" assessment of \$79 in the event of a marked slowdown or recession. In a sign of sober thinking on Wall Street that reflects a more conservative culture since 2000, we note that the consensus among strategists is also close to our \$91 forecast, although analyst surveys are somewhat higher. Using our \$91 earnings figure, we note that the stock market trades with an earnings yield of about 6¹/₂%, 2% more than the yield on long-term Treasuries. This gap suggests more conservative investor attitudes regarding risk and hints at the possibility of lessened risk and better returns for equity investors looking further out.

Conclusion

Although the risk of growth rates falling short of consensus next year are real, financial markets can still generate better-than-expected returns in 2007 for two main reasons. First, many markets are well supported by reasonable assumptions. Second, and more importantly, cash flows, available sources of credit, and cash balances remain in ample supply; that supports a stable outlook for the consumer, economy and markets over our time horizon. While our risk scenario could envision a modest decline in equity markets in the event of a recession, our valuation and economic models suggest the more likely outcome is for the S&P 500 to trade higher from today's levels. Under our risk adjusted and good case scenarios described above, the S&P 500 could reach 1,510 with an outside chance of achieving 1,600 if the recession scenario recedes.

Our recommended mix of assets for a growth portfolio remains 65% in equities and 35% in fixed income. The equity portfolio favors large capitalization, growth stocks. The pages that follow explore tactical portfolio issues for each asset class in greater detail.

ECONOMIC OUTLOOK

While growth could be negatively impacted by housing and inventory corrections, trade, business investment and government spending remain favorable. More important are ongoing gains in jobs and average wages. Our full year forecast expects more modest growth near 2½% in real terms with inflation moving to just over 2%.

Before we dive into the details of our forecast, let's look at how far the economy has come in recent years. Since March 2000, the U.S. economy has added 4.7 million jobs, generated an additional \$2.6 trillion in disposable personal income and seen after-tax profits grow by \$850 billion to \$1.36 trillion. In the past year alone, incomes were driven higher by \$450 billion thanks to higher average wages and the addition of another 1.6 million workers. Core measures of inflation have risen slightly to 2.7% compared to 2.4% in 2000 and the 10-year Treasury bond yield has dropped to 4.6% versus 6.0% in 2000. The household sector has enjoyed an \$11.1 trillion, or 25%, gain in net worth. Of this \$11.1 trillion amount, \$6.6 trillion is directly attributable to investment in (and appreciation of) real estate, net of accumulated mortgage and home equity debt that now stands at \$9.5 trillion.

In contrast to the boom in real estate, stock market gains have been more muted, although much improved from their lows. Multiples of earnings for the large-cap stocks contained in the S&P 500 have contracted from 30 times trailing earnings in March 2000 to just over 17 times today, despite the lower bond yields. Equity markets turned in a strong performance in 2006 driven largely by 14% growth in profits. Profits as a percent of economic output are at multi-decade highs and corporate tax rates have already been cut. Cash flow continued at a slower pace and growth in cash balances appears to be slowing as companies spend more on capital expenditures, wages and stock buybacks.

Consumer in 2007

The number of jobs created in the past year, 1.6 million, is a slower pace than the prior 12 months, but robust enough to drive \$450 billion of additional disposable income. Next year should produce more of the same. The downturn in real estate may temporarily slow purchases of large-ticket items and higher money fund and CD rates have created incentives for savings and disincentives for debt accumulation. These changes should affect spending patterns on the margin, but as long as job growth and wage gains continue, and financing sources remain available, 2-2½% growth in consumption is likely again next year.

Investment in 2007

Efforts to rebuild productive capacity damaged by hurricane Katrina in the Gulf of Mexico added to an already strong investment environment for commercial, or non-residential, construction. This category surged ahead by almost 30% in 2006. We expect this surge to give way to solid, but more modest, growth of 10-15% in 2007-2008. At the same time, business spending on equipment and technology that drove the 1990s capital spending cycle has been slower in recovering from the technology downturn of 2000-2002, but modest and consistent growth is evident. Another year of 10-15% growth in 2007 looks reasonable, especially if the release of a new operating system for computers enlivens sales. The problem areas in investment remain residential real-estate and inventories, which represent over a third of the entire investment category. As in past housing cycles, we expect residential investment spending to trough around 3-4% of GDP versus recent cycle highs of 6.3% of GDP. This process will not occur overnight, but over several years. Because spending remains at elevated levels despite some initial signs of weakening, we anticipate a 10-20% decline in spending in 2007 as builders look to balance inventories with demand. Separately, we expect overall inventories in the U.S. to be cut in half. These correction will drag on output, especially in the first few months of the year.

OUTLOOK 2007

Taking the good with the bad, the overall investment climate next year should be mixed with 5% overall growth expected in 2007. Adjustments to investment trends in 2007 should give way to an improving outlook that can carry on into 2008 and beyond thus making second half growth more robust than the first half.

Government and Trade in 2007

We expect another year of trendline growth in government spending as gridlock in Congress keeps spending plans

on track. Budget deficits are benefiting from higher than expected tax receipts. The trade deficit is falling, as well. A decline in imports is the primary culprit, raising some concerns about consumer spending's strength. However, declining consumption of imports translates into higher stated rates of growth, due to the way we account for trade in the economy. The trade deficit can decline further next year if current consumption trends continue and the dollar drifts lower, as expected. In 2007, we envision a trade deficit closer to 4% of GDP compared with 6% earlier this year.

Summary of Economic Assumptions for 2007

Assumption	<i>Actual</i>		<i>Estimate</i>		2006 to 2007
	2005	2006	2005 to 2006	2007	
Real GDP	11,049	11,410	3.3%	11,691	2.5%
Inflation	3.0%		2.0%		2.07%
Consumption	7,841	8,088	3.1%	8,270	2.3%
Non-residential Investment	1,224	1,319	7.8%	1,484	12.5%
Residential Investment	608	587	-3.5%	469	-20.0%
Change in Inventories	20	45		0	
Federal Government	728	742	1.9%	756	2.0%
State Government	1,230	1,256	2.1%	1,282	2.0%
Net Exports	-619	-634	2.4%	-571	-10.0%
Payroll Employment (<i>Millions</i>)	133.4	135.3	1.4%	136.7	1.0%
Domestic Profits After Taxes (<i>\$ Billion</i>)	931	1,119	20.2%	1,175	5.0%

TACTICAL ASSET ALLOCATION

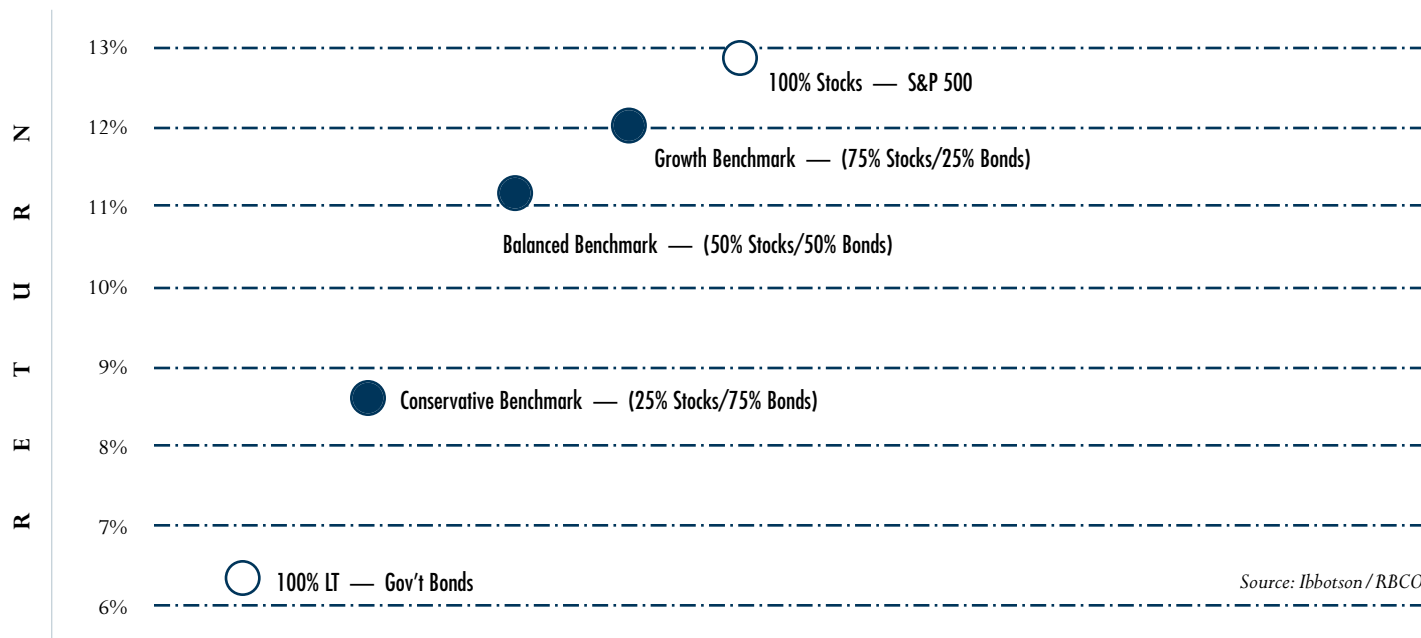
2007 Decision Tree

The first step in allocation, of course, starts with the investor. In general, we recognize that issues regarding financial flexibility, future funding requirements for planned purchases or multi-generational planning, personal attitudes regarding risk, and time horizon all weigh on the basic portfolio strategy applied to portfolio structure over time. In short, a more conservative investor will generally prefer less volatile assets that produce greater income than the growth investor who has a greater appetite for risk, can withstand market volatility and has a lesser need for current income. The performance between income oriented securities and growth oriented securities over long periods of time can be demonstrated by looking at

the average annual returns and historical volatilities of three different mixes of stocks versus long term Treasury bonds. The chart below graphically illustrates the tradeoff between return and risk when we blend stocks and bonds together in the portfolio. The portfolios range from a pure Treasury portfolio in the lower left corner to 100% stocks in the upper right hand corner of the chart. In between are various “target” mixes of stocks and bonds ranging from 25% stocks/75% bonds for the conservative investor, 50% stocks/50% bonds for the balanced investor, and 75% stocks/25% bonds for the growth investor. We believe that the vast majority of portfolios fall close to one of these three long run strategies.

Portfolio Benchmarks

(Historical Average Annual Returns 1926-2006)



Source: Ibbotson/RBCO

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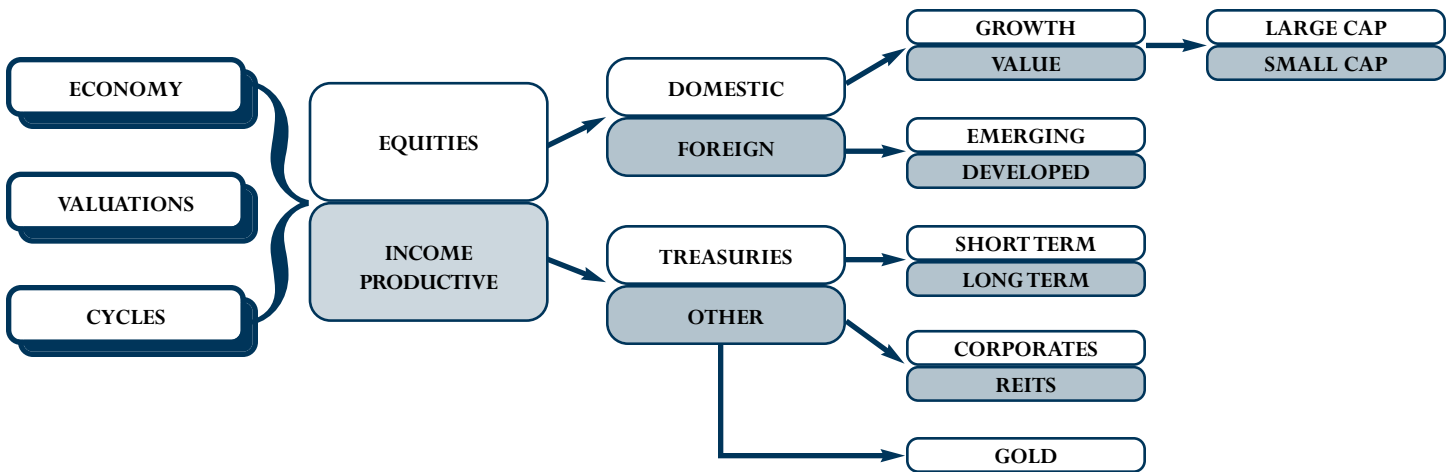
TACTICAL ASSET ALLOCATION

2007 Decision Tree

Implementation of a long-run strategy for asset allocation should not ignore the realities of the current environment and prevent implementing changes to take advantage of opportunities or avoid excess risk. Each market cycle affords investors opportunities to buy certain assets at valuations that are compelling relative to other asset allocation choices and sell those assets that appear overvalued or do not reward the investor for taking on the risk of owning that asset. This ongoing process which seeks to tilt portfolio weights toward undervalued assets is commonly referred to as “Tactical Asset Allocation.”

Our ongoing analysis of the economy, asset valuations, cycle dynamics within asset classes and through special considerations (such as the direction of oil prices or the dollar) provides one such framework for tactical asset allocation. In the pages that follow we will examine each of the “decision points” along the “decision tree” and recommend appropriate portfolio actions for the three basic types of portfolios (growth, balanced and conservative).

Decision Tree for Tactical Asset Allocation



EQUITIES VS. BONDS

The Basic Question for Every Investor

Equities

Although an outright recession or unanticipated geopolitical shock would produce a divergence between the equity and bond markets, we believe both can produce positive real returns in 2007. We expect the Federal Reserve to move away from further rate increases and may provide some relief in the form of gradual rate cuts in store in 2007, depending upon the severity of a slow down in residential housing.

Our year-end target for the S&P 500 index is 1510, which translates into an 8% total return on the year from the time of this writing, December 2006. Using estimated earnings of \$91 in 2007, the market would then trade near

17 times trailing earnings at year-end, not far from today's multiple. We expect most of the return for the index to come through aggregate earnings growth, more modest share repurchases, and dividends. We expect leadership in the areas of technology, telecommunications, healthcare, utilities, and staples. Cyclical areas, including energy and materials, are expected to lag. We also expect foreign earnings to grow more rapidly than domestic earnings. On balance, we see the equity markets generating positive returns for the year, with an increasing divergence between the various sub-segments of the equity market by geography, size, style, and industry.

Interest Rates and Multiple Paid For Stocks Are Related



Source: First Call/RBCO

EQUITIES VS. BONDS

The Basic Question for Every Investor

Bonds

We expect the bond markets will produce positive returns. We are experiencing higher rates on the short-end of the yield curve while longer-term rates have moved lower. In 2007, we expect the yield curve to shift lower with long bond yields ranging between 4-4³/₄% as the economy and inflation cool. We also expect gradual cuts to the Fed Funds rate that moves the yield curve from its currently inverted shape to a more properly sloped orientation. Cuts in short-term rates are expected to happen only gradually unless a more significant dislocation in the economy emerges.

It is important to recognize that our bond markets are increasingly dominated by foreigners as the result of years of globalization which has tied the United States' economy inextricably to the rest of the world. Our trade deficit, as seen from the point of view of our trading partners, represents excess "savings" of those countries. Savings in this case does not mean savings in the traditional sense, but represents the amount of goods and services that are produced by those countries in excess of what they consume in their own economy. This surplus tends to be reinvested in the U.S. bond market which, has helped keep interest rates low and demand strong.

China and OPEC are extreme examples of this, and they account for more than 50% of the ownership in publicly held Treasuries. Net foreign purchases of Treasury bonds and notes are now near \$450-500 billion compared to being net sellers in 2000. Foreigners are attracted to U.S. bond markets because our yields are better than those offered in other countries, our currency is considered stable, existing trade relationships and the United States remains a high-quality creditor. All of this demand helps to keep long-term interest rates low and allows for maintaining inexpensive and available credit for borrowers. In this light, topical issues regarding trade and protectionism with China and other countries remain important debates. The outcomes of these discussions are critical for the future of the global economy.

Equity vs. Bonds – Relative Valuations

One way of comparing the relative attractiveness of equities compared to bonds is to calculate the earnings multiple for the stock market (represented by the S&P 500) and compare that to the valuation of a risk-free 10-year Treasury bond. To compute the earnings multiple, we divide the S&P 500 index by the earnings expected for the index over the next 12 months. With \$91 in expected earnings coming into the year and a current price of the S&P 500 (as of the time of this writing on December 15, 2006) at 1,429, the multiple paid for stocks is 16 times forward earnings. Meanwhile, the 10-year Treasury bond yields approximately 4.6% (to simplify comparisons with stocks, we must turn that yield into a multiple by calculating the yield's inverse). The result is that bonds trade at 22 times the underlying coupon. With stocks trading at 16 times earnings compared with 22 times coupon for bonds, the market for equities appears less expensive. We have seen in the past, when there are significant divergences in valuation between the equity and bond markets, value-driven investors who sell the more expensive asset in favor of the more attractively valued asset were often able to take advantage of opportunities and mitigate some risk. The chart on the next page demonstrates this relationship by creating a ratio of the two markets' multiples and tracking that ratio over time.

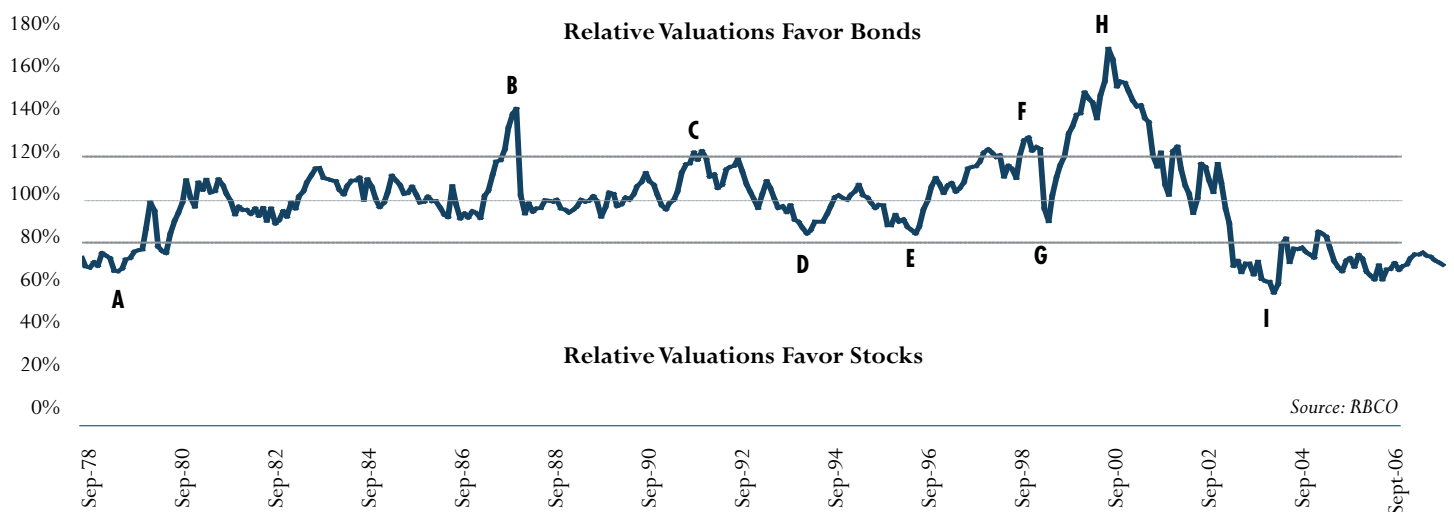
How to Read The Chart

The chart at the bottom of the next page shows the ratio of stock market multiple to bond market multiple, using the process described above. At 100%, for example, the stock market and bond market multiples are equal and suggest that markets are fairly valued on a comparable basis. If the ratio is significantly higher than 100%, that suggests that equities may be overvalued compared to bonds and investors need to exercise caution and be particularly careful about overpaying for stocks. If the ratio is significantly lower than 100%, bond market investors should exercise caution lest they not be well compensated in terms of yield for risks of future inflation.

THE INDEX'S "RIGHT CALLS"

<i>Point on Graph</i>	<i>The Index Suggested</i>	<i>What Happened In The Period That Followed</i>
Point A	Stocks Favored	Marked beginning of 20-year bull market in equities.
Point B	Bonds Favored	In the following month, the S&P 500 fell by 20% in the 1987 "crash."
Point C	Bonds Favored	The Fed's efforts to raise rates to stabilize the economy during the Savings and Loan crisis, coupled with higher oil prices and the start of the Iraq war, created a recession and bonds outperformed.
Point D	Stocks Favored	During 1994 stocks held their value while bonds experienced their worst year in a generation as the Fed doubled overnight rates.
Point E	Stocks Favored	From 1995–1997, equities enjoyed strong performance primarily by technology and networking companies.
Point F	Bonds Favored	By late 1997 bonds had become relatively cheap compared to stocks. Investors who held bonds going into the fall of 1997 avoided much of the pain that followed the emerging market crisis of that year.
Point G	Stocks Favored	In classic form, the panic that resulted from the emerging market crisis, coupled with the collapse of hedge fund Long Term Capital Management and Russian debt defaults, created a buying opportunity for stocks which rallied straight through to year 2000.
Point H	Bonds Favored	By 2000, internet frenzy got the better of many investors and drove valuations out of sight despite the Fed's best efforts to raise rates and contain "irrational exuberance." Prudent investors scaled back positions in favor of greater bond exposure to provide income and limit downside risk.
Point I	Stocks Favored	Equities rose strongly in 2003 as recession fears subsided and investors came to terms with war in Iraq.

Stocks Are Relatively More Attractive Than Bonds



INCOME
PRODUCING
AND
DEFENSIVE ASSETS
IN 2007

The Treasury Market

We came into 2006 with recommended exposure on the yield curve very short. Emerging signs of weakness in the economy last spring led us to extend our recommended maturities. By fall, the yield curve inversion had been sustained for over 90 days, suggesting that the bond market had become convinced that the economy would slow further. Inverted yield curves, historically, have been highly accurate predictors of recessions. What also makes this indicator special is that it does not rely on government data and is, instead, a byproduct of financial markets. In November, we looked at the historic track record to examine the performance of long-term bonds versus equity markets following such a sustained inversion (see table). The results were that long-term Treasuries performed well in each case and tended to exceed equity returns for at least a year following 90-day inversions (excluding the recession induced by Paul Volker's Federal Reserve in 1970-1980). The weight of evidence from this study suggests that a greater emphasis on a longer-maturity bond portfolio is appropriate at this time.

Relative Performance of Long-Term Bonds Compared to Stocks Following 90-Day Inversions

Date of 90-Day Inversion	# Months Bonds Outperform	Underperformance Following 90-Day
October 8, 1973	15 Months	34.2%
March 3, 1981	19 Months	27.3%
September 18, 1989	14 Months	13.6%
December 8, 2000	22 Months	46.7%

The expectation for lower inflation can also be seen in the market for Treasury Inflation Protected Securities, also known as TIPS. TIPS are a United States Treasury bond whose principal increases at the same rate as the Consumer Price Index (CPI). The interest payment is then calculated off that inflated principal and repaid at maturity. These bonds have lagged non-inflation protected Treasuries by 5% since May 2006, which has caused the spread, or difference in yield, between these and non-inflation protected Treasuries to contract. This lower spread can be interpreted as the market's assessment of long-run inflation expectations. Presently, the inflation expectation priced into the market is near the lowest level of the year at approximately 2.3% and well below the 2¾% expectation seen last spring. TIPS, therefore, appear to be priced better today compared to long-term Treasuries. While they may lag non-inflation protected bonds if the economy continues to cool, the valuation is becoming more compelling from a risk/reward standpoint.

At this time, we recommend a laddered portfolio of non-inflation protected Treasuries with an average maturity of approximately eight years. Our current expected yield on the 10-year Treasury by year's end is 4¾%. Our expected yield for short-term interest rates (Federal Funds) is also 4¼%.

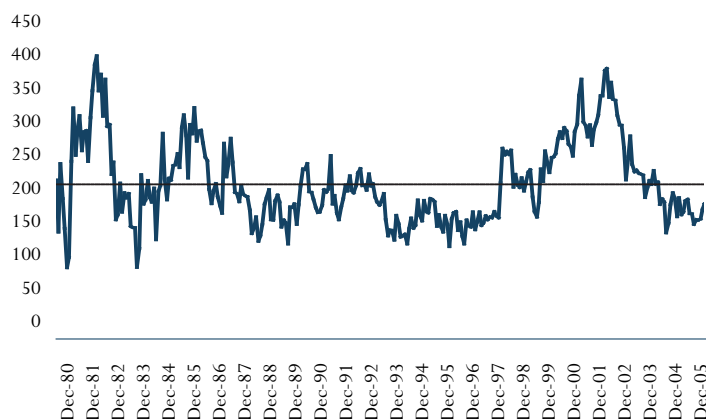
Corporate Bonds

The most dramatic example of behavior in the corporate market can be seen in the most risky bonds. Investors seeking yield continue to pour money into the corporate bond market, driven by the allure of yields that are higher than Treasuries or government agencies. Actively traded investment grade corporate bonds are currently yielding about 5.6%, about 1.0% (or 100 basis points) above 10-year Treasury bonds. Medium-grade, long-term corporate bonds yield close to 6.4%, about 1.8% (or 180 basis points) above similar duration Treasury bonds. At the farthest end of the domestic corporate bond risk spectrum, actively traded speculative grade corporate bonds now yield close to 8.2%, about 2.6% (or 260 basis points) over the 10-year Treasury bond. In general, the incremental additional yield, or spread, over Treasury bonds has contracted in recent

years. At first glance, one might conclude that investors are not being paid well enough to take on the risk of ownership. However, a longer term point of view suggests that spreads are about in line with longer-run historic averages and that corporate bonds are neither excessively cheap nor expensive (see chart below). Moreover, the tighter spreads among speculative-grade issuers is supported by low default rates near 2% and better coverage ratios. Based on data from the S&P Analysts Handbook, the debt to cash flow ratio for the S&P Industrial companies², for example, has fallen from two times EBITDA (earnings before interest taxes depreciation and amortization) to 1¼ times EBITDA between 2001 and 2005, providing an additional buffer of protection for creditors. The improved coverage ratio is the result of a 12% improvement in cash flow and a 37% reduction in net debt between 2001 and 2005. Barring a deeper downturn in the economy, our conclusion for corporate bonds at this time is that they remain appropriately priced given the improved fundamentals.

The combined recommended model bond portfolio, including both corporate and Treasury bonds, has an average maturity between 7-8 years heading into 2007.

Credit Spread Slightly Below Average
Moody's Long Term Baa Rated Corporate Bond – LT Treasury Yield



Source: RBCO/Bloomberg

INCOME PRODUCING AND DEFENSIVE ASSETS IN 2007

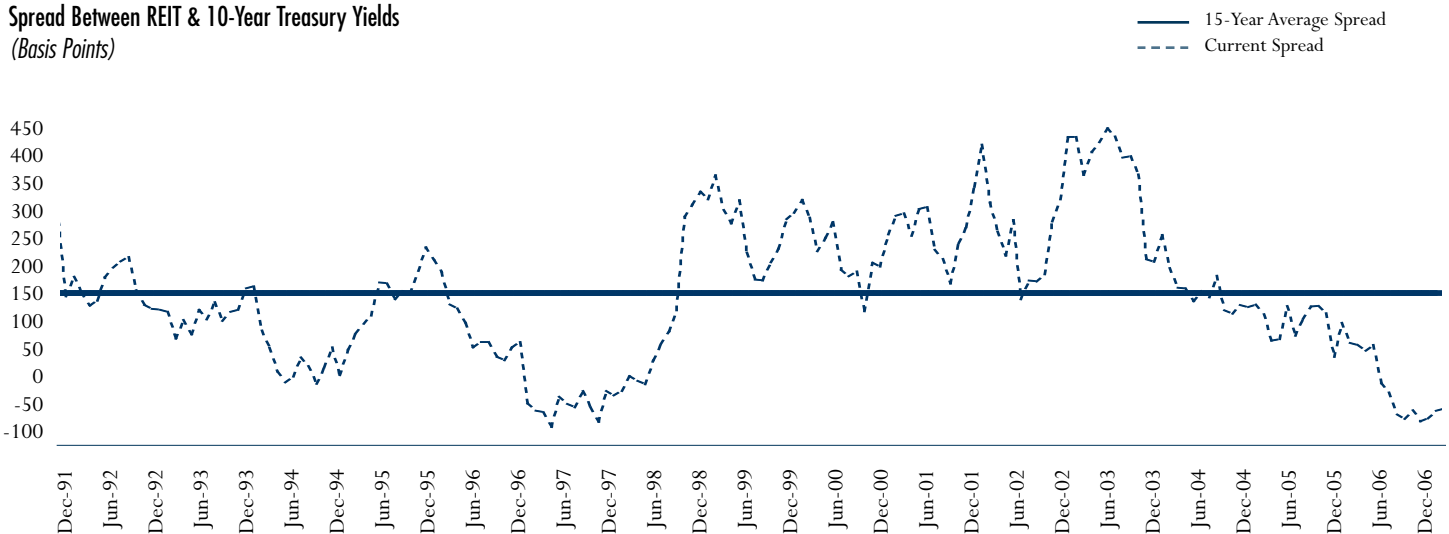
REITs

Real estate investment trusts, also known as REITs, generally hold commercial properties and benefit when vacancy rates are falling and lease rates are rising. Special tax provisions allow REITs to generate and pass along income to shareholders largely free of corporate income tax (REIT dividends are still taxable to the individual, however). Because REITs pay out the vast majority of their income as dividends, REITs tend to produce a modestly growing income stream with yields that are competitive with bond coupons and utility yields. REITs, however, remain equity instruments and are sensitive to both the performance of the economy and the direction of interest rates. Rising rates detract from REITs' appeal much the same way utility and bank stocks tend to move inversely to the direction of interest rates. A stable or falling interest rate environment coupled with modest growth in employment is the ideal environment for REIT performance. Given talk about the current "Goldilocks" economic environment, it is easy to see why REITs had another strong year in 2006. Our only

concern at this time is that yields offered on the broad REIT indices have become too low, in general, to justify us raising our allocation to REITs at this time.

Based on the current yield for the National Association of Real Estate Investment Trusts' Index, REITs have fallen to their lowest yields ever and are now less than 4%. This 4% yield is half the level seen in 2001, and now stands 60 basis points below 10-year Treasury bond yields (see chart on page 12). The yields have been driven lower by a six year bull market. The bull market has been prompted by economic recovery and low interest rates that began to take root in 2001-2002, helped along by some favorable tax law changes in 2003, and carried on by the momentum that has followed up until today. A similar cycle existed from the start of the expansion in 1991 through 1997, when REITs initially rallied over 200%, before the Federal Reserve raised interest rates in '99-00 thereby snuffing out the economic expansion. With a powerful six-year bull run for REITs already on the books, and REIT index yields at record low levels, we remain cautious in our near-term outlook for the group.

Spread Between REIT & 10-Year Treasury Yields
(Basis Points)



Source: National Association of Real Estate Investment Trusts/Bloomberg

EQUITY
INVESTOR
2007

Foreign Investment

International investing possesses special risks, including currency, political, information, and liquidity risks. Still, international investment holds a host of opportunities that are not fully appreciated by investors. Consider for a moment the fact that 95% of the world's population lives outside the United States; that 72% of gross domestic product comes from outside the United States; and that 61% of the value of the world's stock markets lie outside our borders. Perhaps the most critical challenges for the global economy's future are to bring emerging economies into the fold of wealth creation and further strengthen ties between developing nations. This is the future. Now ask yourself: "is foreign investing getting enough attention in my own portfolio and thought process?" If you are like most others, the answer is "probably not."

Key Statistics

<i>2005 Year-End Data</i>	<i>World</i>	<i>Within U.S. Borders</i>	<i>Outside U.S. Borders</i>	<i>% Outside U.S. Borders</i>
Population³ (Millions)	6,430	296.5	6,133	95%
Gross Domestic Product³ (\$ Trillions)	44.3	12.4	31.9	72%
Equity Capitalization of Stock Markets⁴ (\$ Trillions)	44.4	17	27.4	61%

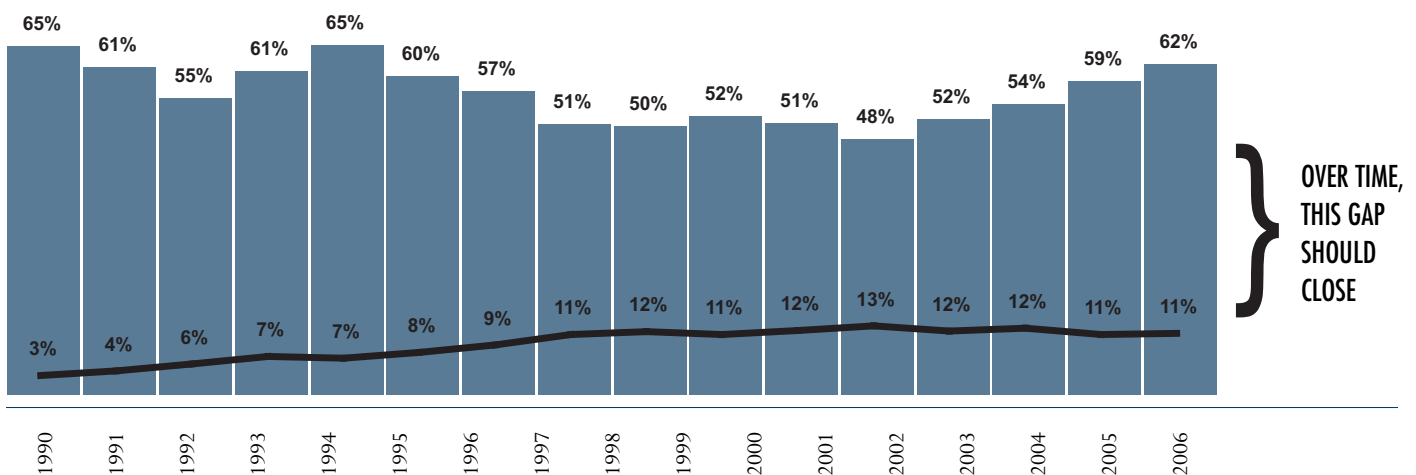
If your portfolio holds about 11% in foreign assets, you are roughly in line with the average portfolio. Financial theory suggests that capital will move to markets that maximize risk-adjusted returns over time, assuming there are no artificial barriers to the free flow of capital. As the chart below shows, this has not yet happened. Only 11% of U.S. portfolios are currently invested in the foreign assets that account for more than 61% of global equity market capitalization. Over time, this “opportunity gap” should evolve to become a relic of history. We believe the current gap is too large, given rapid developments in trade, several decades of free market reforms, and the creation of global exchanges and an improved risk profile for foreign and emerging market economies relative to our own. The recent flurry of cross border mergers involving exchanges suggest that market structures themselves are soon to shift, much the way that

the introduction of American Depository Receipts (ADRs) boosted ownership rates. Just as the listing of ADRs lowered costs removed institutional barriers and prejudices toward overseas investing, and boosted foreign ownership rates, the vision of an integrated network of global exchanges can transform the way Americans invest. Thus, for U.S. investors, we envision an accelerating and secular movement towards greater exposure to assets outside the United States than ever before.

Risks to Foreign Investing

There are, of course, very real barriers and special risk factors involved in international investing. We are reminded of these risks from time to time. On December 18th, 2006, for example, Thailand initiated currency controls that locked up large amounts of foreign currency deposits

Percentage of Equity Market Value Outside United States Compared with Percentage of United States' Portfolio Invested Overseas



Source: World Federation of Exchanges, Bureau of Economic Analysts

as their way of thwarting “speculation” in their markets. The action was met with an immediate 9% plunge in stock prices and a sharp slide in the Thai Baht. The new government immediately reversed their decision to institute currency controls, bowing instead to pressures of the global free market system. The decision by the Thai government to reverse their decision on currency controls may prove beneficial in the long run because currency controls raise the cost of capital to those economies, inhibit the use of policy tools to tame business cycle gyrations, and can create any variety of economic and social ills. Hence, while the idea of closing the “opportunity gap” is an appealing one, the practical reality is that it will take time for the market economy to develop to a point of full transparency that fully supports flows of capital, especially to the level of an individual investors’ equity portfolio. Until then, capital and portfolio flows will tend to move toward those countries that demonstrate a commitment to developing robust, stable and free-flowing financial markets. The coming development of robust cross-border exchanges is a significant next step in this process.

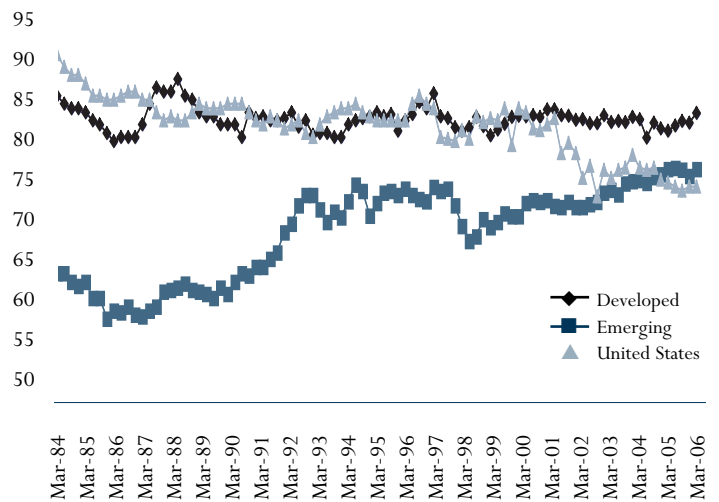
A more immediate and familiar risk for international investors is currency. During periods of dollar strength, the total return to a U.S. investor will be diminished by the rise in the currency. However, if the dollar were to weaken over time, the weaker dollar would translate into higher total returns to the U.S. investor. It is a fact that over the past 25 years, the dollar has moved substantially higher versus most currencies (see chart on page 17); this has created a persistent drag on the performance of foreign assets held in the United States. This persistent drag against returns may have contributed to an ingrained perception of risk, among American investors that foreign investing was a low return/high risk endeavor. If the dollar’s 25-year advance has ended, or if it should drift lower over time, the softer dollar could create additional returns to investors.

Emerging Markets

It is important to remember that the riskiest of markets continue to be tied strongly to the performance of commodity markets (see chart on next page). Emerging market

economies are highly dependent on resource development for income. There is a long and well-chronicled history of investors making, and losing, money as the result of emerging market booms and busts tied to the commodities cycle. The recent commodities boom, coupled with years of reform, has helped improve the risk profile of many foreign markets relative to our own. We attempt to quantify this using data from the PRS group who attempt to quantify the various risk factors (political, economic, financial) relating to individual countries (see chart below). The group publishes a quantitative composite “risk score” for most countries that can be measured over time. Here, we take the average risk score for a group of major emerging markets (Taiwan, South Korea, China, Mexico, South Africa and Brazil) compared to developing foreign economies (Switzerland, Japan, Germany, Australia, United Kingdom and France). These groups are also compared to the risk score of the United States. It is important to note that the perceived risks of

Emerging Markets Risk Profile Has Improved
ICRG Composite Risk Rating for the 6 Major Emerging vs. Developed Foreign Economies



Source: RBCO/International Country Risk Guide

developed foreign markets are not shared by the researchers who conducted this study, and that the perceived risks in emerging markets have diminished relative to developed markets and U.S. markets. While any measure of risk is subject to critique, market-based reform in countries such as India, Bolivia, Peru and Russia has led to a difficult, but positive, process of economic change that is slowly shifting the risk/return profile of many of these economies for the better. We believe that the cumulative effect of 20-years of reform is being fairly captured in the ICRG data.

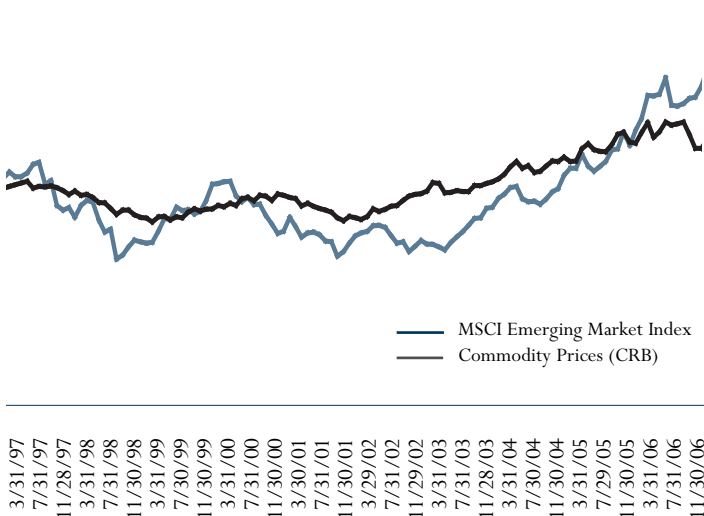
We do not imagine that emerging markets will be devoid of risk. Last spring's 25% drop in the MSCI Emerging Market Index was a painful reminder of that fact. We do, however, believe that investors will be compensated for the risk over time. Many of these economies depend heavily on revenue from sales of basic resources and commodities. In the past 10 years, there has been a strong (approximately 85%) correlation between the emerging markets' stock

markets and commodity prices (see chart below). We recognize that a sudden, severe drop in commodity prices could expose hidden risks and weaknesses within these emerging markets.

Conclusion

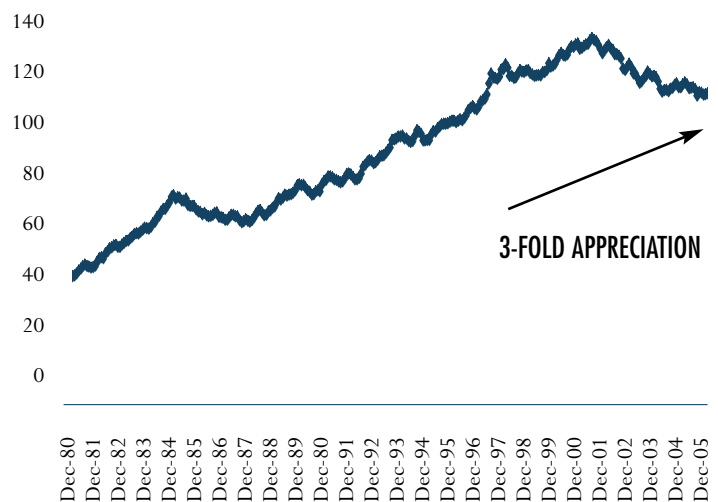
While a sharp dollar appreciation or commodity price collapse would negatively impact returns, we are maintaining a higher-than average recommended allocation to foreign equities. We believe that structural changes in the market, reduced risks, and a softer dollar will allow foreign assets to increase as a percentage of portfolios over time. This is an important long-run emerging secular trend that warrants special consideration within portfolios. Our current recommended allocation for a growth investor is 15% exposure to foreign equity markets as a percent of overall equity exposure. Foreign assets are evenly divided at this time with a 50/50% split between emerging and developing markets.

Emerging Markets and Commodity Prices Are Linked
85% Correlation Over Past 10 Years



Source: PRS Group Raw Data; RBCO Calculation

Trade Weighted Value of \$1



Source: Bloomberg

Size Investing

In last year’s Outlook, we posited that large capitalization stocks (generally defined as companies with a market capitalization over \$5 billion) would perform better than small. In 2006, the Russell 1000 index, which tracks the performance of the 1000 largest companies in the United States, provided a total return slightly below the smaller capitalization Russell 2000 index (see chart on next page bottom left). Besides that modest underperformance, the volatility of the small cap index rose (see chart on next page bottom right), thus making the risk-adjusted performance of the small capitalization index slightly less positive.

Over long periods, small caps have handily outperformed large-cap stocks. Based on data published by Ibbotson Associates, small-to-micro capitalization stocks returned an average 12.6% annualized rate of return for the 80 years through 2005. This return was considerably higher than the 10.4% return posted by large cap stocks, but was

also accompanied by higher volatility. The higher return is partly the result of markets behaving efficiently over the long run and pricing assets in such a way to provide higher rates of return to the riskier asset classes. Of course, results over shorter time periods can be very different. A better measure of the performance of small to mid capitalization stocks is seen in the 28 year performance of the Russell 2000 total return index. This index is a market capitalization weighted index comprised of the 1000th to 3000th largest companies traded in the United States. The Russell 2000 total return index has provided an annualized total return of 13.3% since its inception in 1978 which is slightly less than a 13.3% total return for the larger capitalization, less volatile Russell 1000 total return index. This higher return for the “safer” large capitalization stocks is inconsistent with the longer term Ibbotson data and existing ideas about efficient markets and may reflect the effects of a strong dollar and globalization that has significantly changed equity markets over the past

Relative Performance of Large vs. Small Capitalization Stocks (Long View)



Source: RBCO/Bloomberg

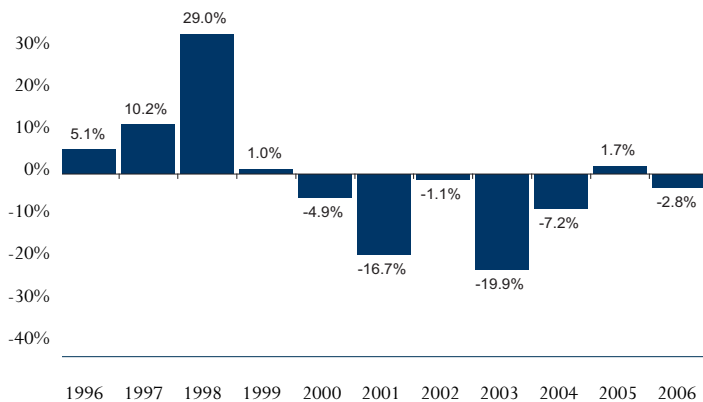
20 years. Looking well down the road, we expect that investors will be compensated for the added risk in smaller capitalization stocks although that adjustment may take many years to play out and will not unfold neatly each and every year.

The year 2007 may be one of those interruptions in the long-run trend. It is a fact, that a slowing economy places greater pressure on smaller companies as markets come under risk of slower earnings growth rates and potentially less liquidity in the market. The recent pattern of weakness in the economy is, therefore, an added risk factor especially for the smallest end of the market-cap spectrum. The softening economy may also be having an impact on earnings. We have seen expected growth rates slip recently and earnings growth for small caps has recently slipped below expected growth rates for the large-cap S&P 500 index. This marks an important change in a key driver of relative performance between size categories. Our current valuation models (see “size graphs”) also indicate a more favorable

short-run valuation for large caps over small. For these reasons, we remain focused on the mid-to-large segments of the equity markets in our recommended tactical asset allocation at this time.

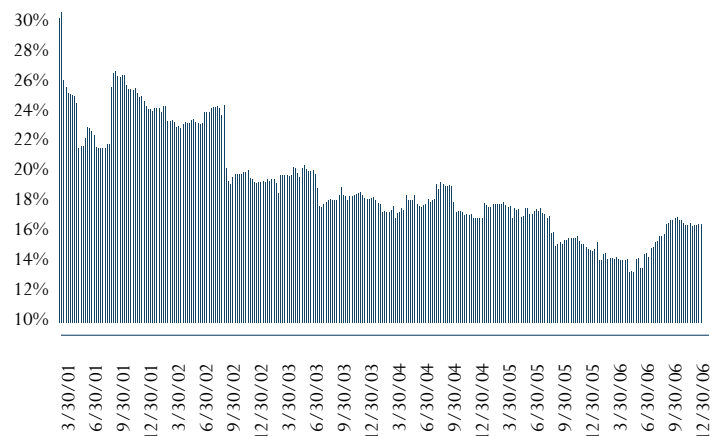
Today, we conclude that smaller capitalization stocks have become relatively expensive given the current earnings outlook, prevailing bond yields, inflation forecasts and other adjustments that must be made to compensate for greater risks in the small-cap arena. While the large-cap bull market of the late 1990s created an opportunity for a multi-year cycle favoring small capitalization stocks, we favor a more conservative posture today which emphasizes mid-to-large capitalization stocks. We further acknowledge that the large, and, to a lesser extent, “mid” cap segment of the market have broad institutional and international appeal principally because these stocks are more easily traded than smaller companies. The largest multinational companies also have broader exposure to international markets where profit

Large Cap Performance Compared to Small Caps
Russell 1000 vs. Russell 2000



Source: Bloomberg

Small Cap Stock Volatility Declined In Recent Years, But Has Increased Of Late
12-Month Moving Avg Relative Volatility For Russell Growth/Russell Value



Source: RBCO/Bloomberg

growth has accelerated recently and is now more robust than domestic profit growth. According to the Bureau of Economic Analysis, profits from foreign sources rose at a 20% annualized rate in the most recently reported quarter (Q3, 2005) compared with 15% domestic profit growth. We believe that multinational firms' exposure to a diversified set of foreign markets provides some additional support to the case for large and mid-caps.

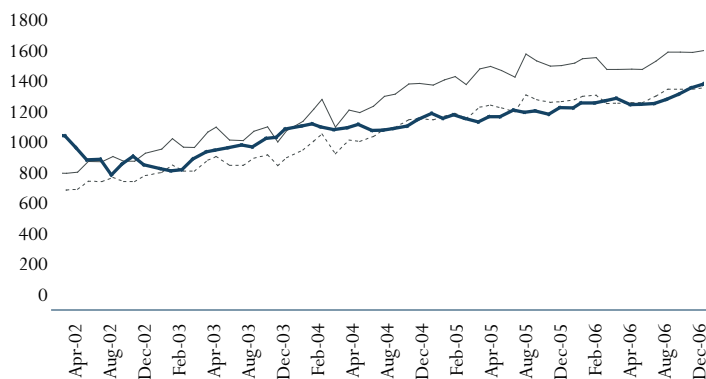
This analysis does not preclude investment in small-caps entirely. We recognize that the small-cap universe is vast with the great majority of publicly traded companies in the U.S. falling within the category of "small-cap." What we are saying is that, in aggregate, the smallest companies appear to be expensive which can create additional risks above and beyond the normal risks associated with these smaller companies. We would wait, then, for a correction in relative valuations to occur before re-committing capital to this segment of the market.

"Fair Value" Ranges in Size

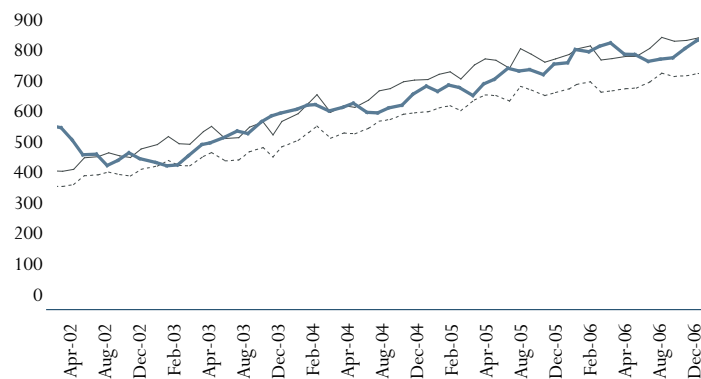
We regularly update these "fair value ranges" to track the relative attractiveness of each class of equities by market capitalization size. These ranges quantify the approximate valuations that we consider reasonable given expected earnings, inflation, interest rates and appropriate size premiums. The lower the index (heavy line) is relative to this range, the more attractive the valuation of that asset class all else being equal. At present, we see that small capitalization stocks are somewhat overvalued, mid-caps are fairly valued and large capitalization stocks are somewhat undervalued. By contrast, these valuations pointed toward opportunity in small-caps during the late 1990s. Today, that same opportunity is not apparent.

----- "Fair Value" Range Using 3.5% ERP & 90BP Size Prem
 - - - - - "Fair Value" Range Using 4.5% ERP & 90BP Size Prem
 _____ S&P Index Value

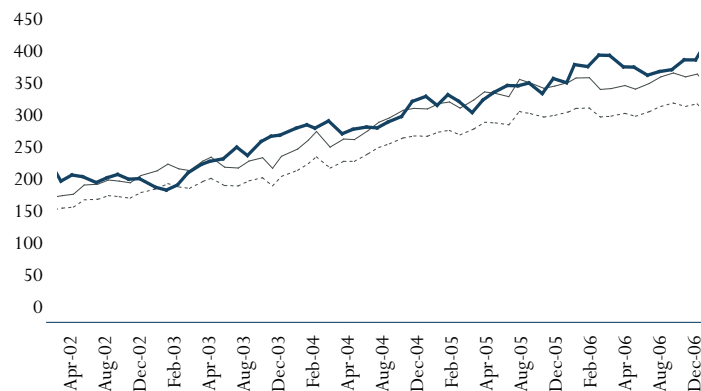
S&P 500 Large Cap Index vs. "Fair Value" Range



S&P 400 Mid Cap Index vs. "Fair Value" Range



S&P 600 Small Cap Index vs. "Fair Value" Range



Source: RBCO/Thomson Financial

Style Investing

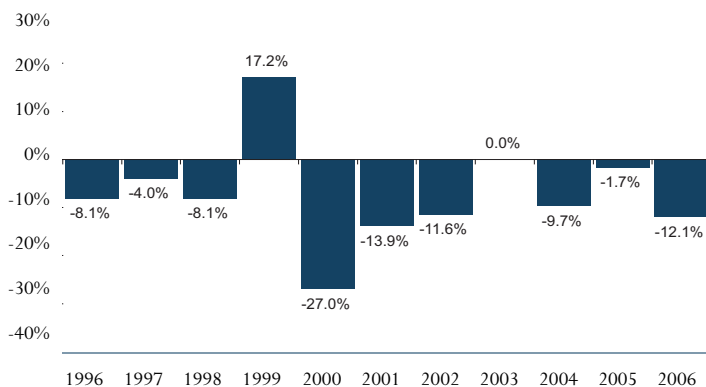
Last year, we felt that growth would outperform value. Instead, growth underperformed value by 12% for the year and by 5% compared to the broad market averages. The underperformance was primarily attributable to the strong performance by financial companies and expectations for future interest rate cuts. Utilities provided a secondary source of strong performance as that group continues to restructure, consolidates and benefits from falling interest rates.

We remain cautious about outlook for the value style over the near term because this segment of the market has received much attention and no longer trades at a discounted multiple compared to growth stocks whose multiples have come down to earth in recent years. Risks could also rise sharply in the value arena in the event of any adverse “spillover” effects from a deflating housing bubble impacting lenders; should tax relief for dividends be called into question by the newly elected Congress; or by an unexpected rise in inflation or short-term interest rates. Remember,

also, that value stocks have already run well ahead of growth stocks in terms of performance over the past seven years in what has been one of the longest running value cycles on record. Growth and value have run in cycles in the past and we expect that these cycles will continue on into the future. The table on the next page highlights recent cycles between growth and value. Note that this particular value cycle is not only long in duration but has generated excess returns over growth stocks greater than 170%. While much of that may have been warranted given the late-90s technology boom, we are concerned that another meaningful percentage is tied to the more recent boom in real-estate and commodity prices.

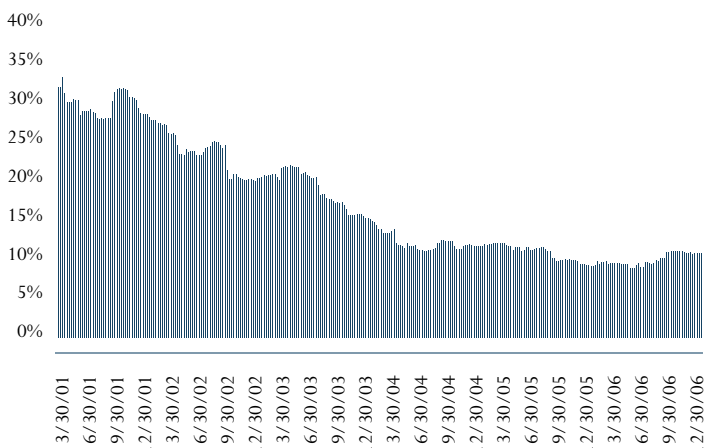
There are potential for significant headwinds affecting large portions of the value complex emerging as housing and construction activities cool. At the same time, technology spending is improving gradually with pent-up demand for computing and telecom equipment emerging as the installed base ages and as a new operating system for personal computers is prepared for launch.

Growth Performance Compared to Value Performance
Russell Growth vs. Value



Source: Bloomberg

Volatility of Growth Stocks Has Declined Compared to Value Stocks
12-Month Moving Avg Relative Volatility For Russell Growth/Russell Value



Source: RBCO/Bloomberg

Pharmaceuticals and healthcare are also generally attractive in terms of balance sheet integrity and valuations. A large-and-aging baby boomer population also strengthens the long-run secular growth story for medical device companies, services, and products of all kinds. While it is impossible to perfectly predict the “tipping point” between growth and value investing styles, we believe we are getting much closer to that point.

At the present time, we remain slightly more exposed to growth stocks over value stocks in our tactical model portfolio.

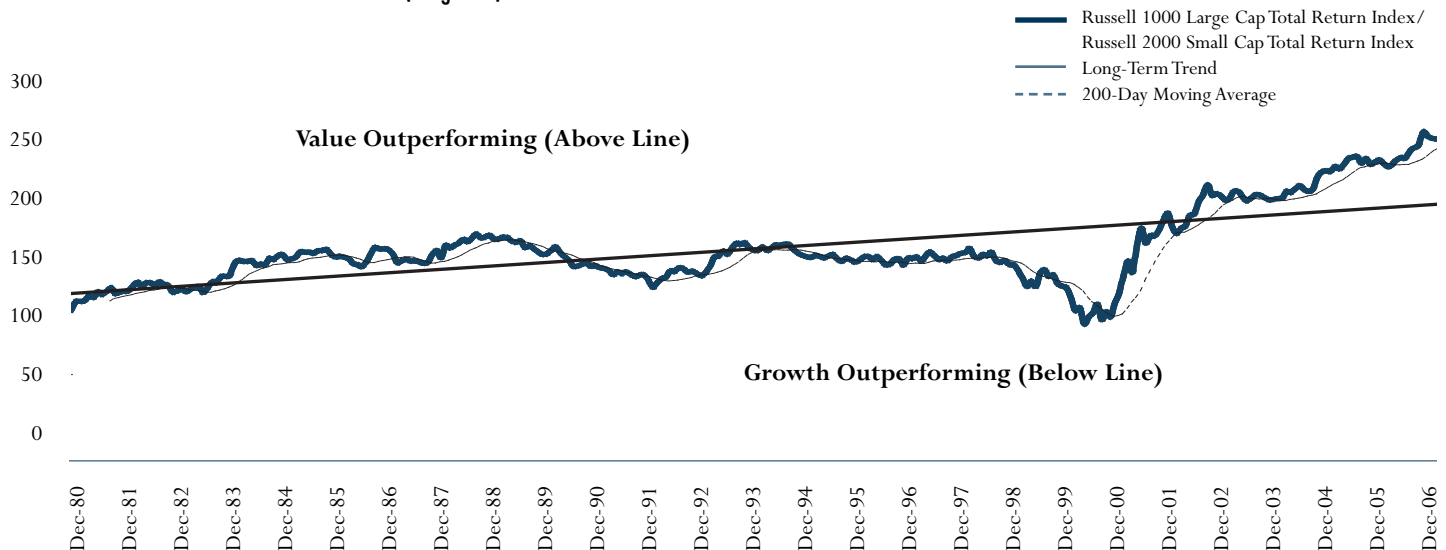
Note: This data is based upon the Russell 3000 Growth and Value Indices From 1980–December 19, 2005. Cycles start and end dates are estimated based on significant turning points in the relative performance of the two indices. Source: RBCO/Bloomberg >

25 Years of Style Cycles

Russell 3000 Value vs Growth Total Return Indices

Cycle Start	Cycle End	Length (Years)	Outperformance	
			Total	Annualized
Value Cycles				
Nov-99	Dec-06	7.0	171.1%	15.2%
Mar-96	Dec-97	1.8	4.4%	2.5%
Jun-91	Sep-93	2.3	18.1%	7.7%
Sep-86	Aug-88	1.9	7.1%	3.6%
Nov-82	Nov-84	2.0	24.8%	11.7%
Growth Cycles				
Dec-97	Feb-00	2.2	67.5%	26.9%
Sep-93	Mar-96	2.5	7.7%	3.0%
Aug-88	Jun-91	2.8	23.4%	7.7%
Nov-84	Sep-86	1.8	-4.1%	-2.3%

Relative Performance of Value vs. Growth Stocks (Long View)



Source: RBCO/Bloomberg

Style Fundamentals

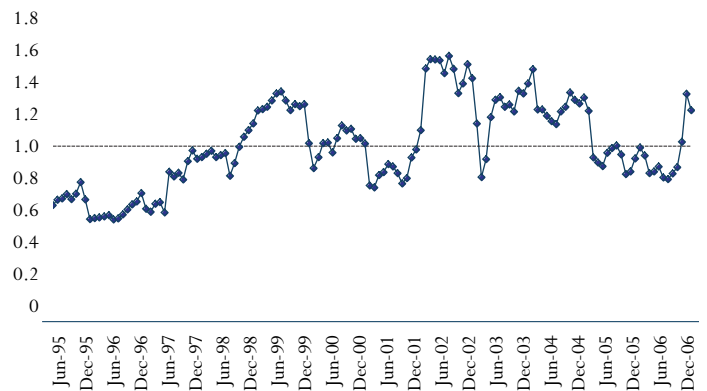
As you can see in the charts to the right, value investors are paying about 20% more for each percentage point return on equity today than on average over the past decade. Growth investors, on the other hand, are paying about 20% less than the historic average on the basis. The valuation gap between growth and value is near the widest it has been over the past decade excluding the 2000-2002 technology downturn.

Currently, the price-to-earnings (P/E) ratio divided by return on equity is .95 for growth and 1.23 for value. Our P/E ratios are adjusted for inflation to allow us to compare multiples over time. The ratios are designed to measure changes in how much investors are willing to pay for profitability in each style category. Any deterioration in earnings power in value-oriented sectors, relative to growth sectors, would suggest that allocations should be further tilted toward growth.

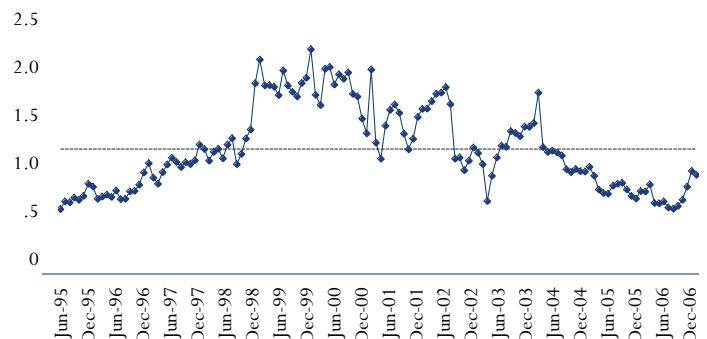
Relative Value Index
Growth vs. Value



S&P/Citigroup Value Index
Inflation Adjusted P/E Divided by ROE



S&P/Citigroup Growth Index
Inflation Adjusted P/E Divided by ROE



1 Bloomberg Active Investment Grade US Corporate Bond Index Average Yield to Maturity
 2 S&P Industrial companies include the S&P 500 companies but exclude financials, utilities and transportation companies
 3 World Bank, 2005 Data
 4 World Federation of Exchanges

Source: Standard & Poors/RBCO

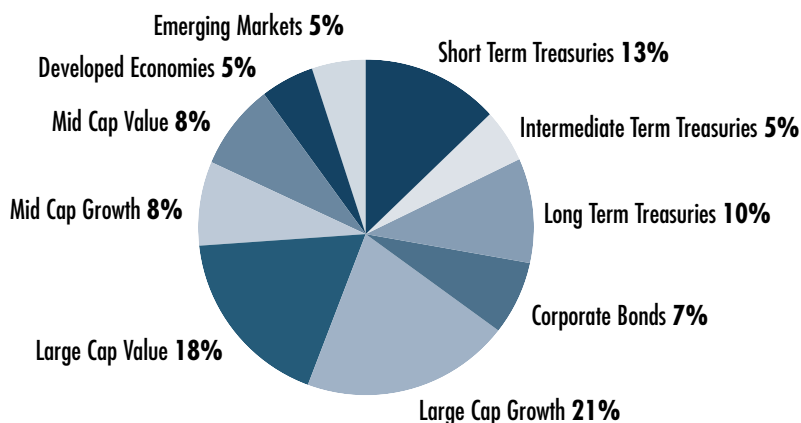
SUMMARY ALLOCATION BY INVESTOR TYPE

Having walked through the “decision tree,” our three basic portfolio allocations headed into 2007 are as follows. Throughout the coming year, we may update these allocations in response to market changes and economic events.

The Growth Portfolio



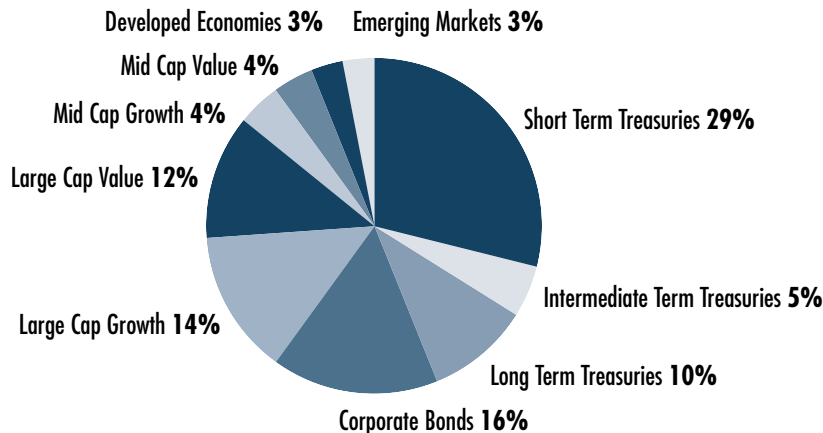
*Primarily equities (usually 50-100%).
Appropriate for investors with a long time
horizon and higher tolerance for risk.*



The Balanced Portfolio



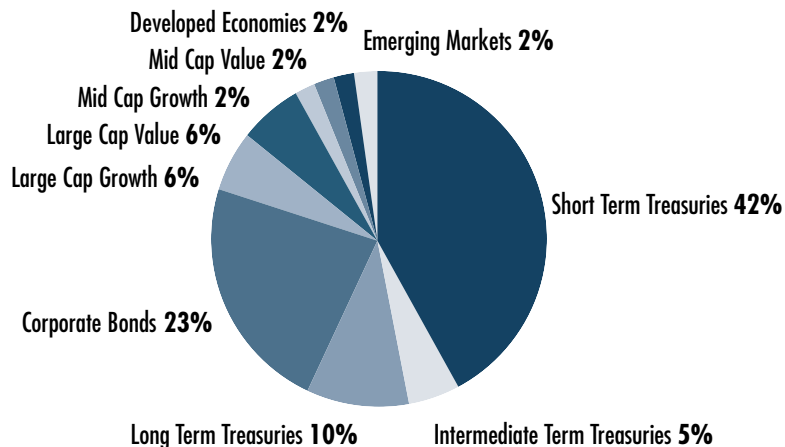
*Mix of equity (usually 25-75%), fixed
income investments and REITs.*



The Conservative Portfolio



*More conservative mix of equities (usually
0-50%), bonds and REITs. Appropriate
for lower risk tolerance, but still desire some
modest growth.*



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