EMPIRICAL
WEALTH MANAGEMENT

January 05, 2007 Fourth Quarter 2006 Client Letter

Introduction

We hope that 2006 was a great year for you and you have our wishes for prosperity and good health in 2007. In this letter we offer support for our belief in efficient markets. In our last letter we provided an overview of the investment process used to manage your portfolio along with the promise to provide more detail in subsequent letters. It was stated that the belief in efficient capital markets serves as a foundation for our investment philosophy. Call us if you would like to receive another copy of last quarter's letter or simply visit the "About Empirical" section of our website to obtain a copy, look under the "Documents and Research" sub tab. We are planning to post more papers and research on our website. Separately, you will find a performance review of the various asset classes used in your portfolio. We felt it fitting to review considerations on tracking performance and benchmarking your portfolio.

Efficient Markets

In our last letter we provided an overview of our investment philosophy. We touched on market efficiency, structured asset class investing, capital market expectations and investment selection. We stated that over the next few letters we would delve into each of these topics to provide more insight into our approach. With this letter we continue the discussion on market efficiency as it relates to Empirical's portfolio construction.

When we discussed the Efficient Market Hypothesis (EMH) we stated that we apply it in relation to market timing and stock selection. While we believe the markets are too efficient to consistently profit from either endeavor, it does not mean that we believe every aspect of market efficiency holds true. The real issue is a practical matter of how to manage your portfolio to get the best net returns.

There are three forms of the Efficient Market Hypothesis

1. The **"Weak" form** asserts that all past market prices and data are fully reflected in securities prices. In other words, technical analysis is of no use.
2. The **"Semistrong" form** asserts that all publicly available information is fully reflected in securities prices. In other words, fundamental analysis is of no use.
3. The **"Strong" form** asserts that all information is fully reflected in securities prices. In other words, even insider information is of no use.

The author of the Efficient Market Hypothesis and Nobel Prize candidate, Eugene Fama of the University of Chicago has stated that "the extreme version of the market efficiency is false." Most of the research we have seen supports our decision to focus on the first two forms of EMH. With this in mind we find that it is more useful to direct resources toward assuring that you continue to have the proper asset allocation given your goals, return objectives and circumstances, and that you have a globally diversified portfolio. We therefore focus on finding the most efficient investment vehicles available in the world to capture asset class returns.

By recognizing that markets are efficient we open ourselves up to some great benefits. The following are a few of the benefits:

- Eliminate the uncertainty of not reaching return objectives caused by poor stock picking.
- Enhanced tax efficiency and tax reduction strategies.
- Reduced portfolio costs.
- Elimination of style drift that frequently occurs with active managers. This leads to greater control of risk/return characteristics.
- Potential to reduce permanent losses through broader diversification.

Consider the statement you may have heard before that goes something like this, "equities have provided investors with better returns than most other investment vehicles available such as bonds, collectables, gold and so on." Although this is generally true, what is interesting about it is that you did not have to own the "right stocks" or "time the market" to receive the superior returns that equities have provided over the last eighty years or so. Instead, the required action was to maintain diversified exposure to the market and possess the discipline to stay invested through the down markets. It is ironic that this statement is often used by investment companies who go on to make individual stock recommendations or recommend mutual funds that are actively engaged in market timing and stock selection in hopes of beating market rates of return.

We hold a passionate belief that you deserve to capture the returns of investable capital markets around the globe. There is value to be added by going beyond the purchase of a US market index and we will address this notion further in future letters. Suffice it to say, that is the reason we continue to research and monitor various asset classes and make decisions about how much to include in your portfolio. Coming back to our discussion on EMH, we won't attempt to add value by doing what has been proven to be statistically futile.

The ultimate test of whether market timing and stock selection works is to examine the published results of professional stock pickers. Within the actively managed mutual fund industry we have a group of professional investors that consist of some of the best and brightest in the field. If any one should be able to beat the market it is this group of investors and thus most published research has focused on the track records of mutual fund managers. The table included at the end of this letter presents only a few of the studies on manager performance covering performance data back to 1955. Many other studies have been done and for the most part the overall conclusions have been the same. Active managers as a whole have not been able to consistently beat the market indices and there is little consistency among winners. They do even worse when you adjust for the costs associated with their management fees, trading costs and taxes.

Author, Larry Swedroe in his book "Rational Investing in Irrational Times" (a book that we recommend investors read) presents an interesting study done on active managers. The results of the study showed that at the end of the ten year period ending in the year 2000 only a single manager was able to beat the S&P 500 index each individual year. He showed that over another ten year period the number of stock pickers outperforming the S&P 500 each year was less then would be expected by simply flipping a coin. Basically, the number of managers outperforming the market was less then we would expect to occur by pure chance. It's not that some managers don't outperform because some do, the problem is that it is impossible to predict the winning managers in advance. Some proponents of stock picking argue that certain markets like the emerging markets or small company stocks are inefficient and active managers can offer more value there. However, partially because of the extra costs of active management in these asset classes active stock pickers have not been able to dominant index funds in these areas.

Efficient Markets Verses Rational Markets

Sometimes investors confuse the idea of the market being rationale with markets being efficient. For example, during the technology bubble most of us with the benefit of hindsight can agree that the market was not rationally priced. This does not mean the market was not efficient. The market as a whole decided on the valuations of these securities and while the market eventually concluded that prices were over-blown, no market participant had an advantage in determining when and how much the market would correct. It was impossible to predict when it would occur and that is the sign of an efficient market. It is important to understand that markets can be irrationally priced and remain so for long periods of time. While prices can be proven to be wrong, efficiency as we think of it has more to do with the ability to exploit these price inaccuracies when they do occur. This is why some of the top performing mutual funds heading into the year 2000 became the worst performing funds in subsequent years.

The main conclusion one may draw from the empirical studies done is that professional money managers (stock pickers) have not been able to demonstrate that they can consistently outperform the market for long periods of time. When they do out perform it typically has been a function of style or momentum, not skill. This is why we will continue to focus on an approach that is broadly diversified and disciplined rather than attempting to time in and out of markets or pick stocks. We will stay focused on structuring your portfolio to your preferences so that when markets decline you will be comfortable enough to stay invested.

Tax Reporting Note

We are sending our tax reports to you in a separate mailing this year. Please be on the look out for your tax information and call us if you do not receive it within a few weeks. There will be a letter accompanying the tax reports explaining our tax information and how it coincides with the reports you will receive from your account custodian.

Sincerely,

The Empirical Wealth Management Team
Kenneth R. Smith, CFP®, MS
Chief Executive Officer

Summary Characteristics for Empirical Performance Studies

Study	Main Results
Jensen (1969)	Funds don't cover costs, on average. There is very little evidence that any individual fund has been able to earn significantly higher returns than those that could have been expected by random chance.
Grinblatt and Titman (1992)	Five-year returns exhibit persistence. Losers show stronger persistence.
Lakonishok, Shleifer and Vishny (1992)	Before fees, pension funds underperform the S&P 500 index by 1.3% per year on an equally weighted basis, and by 2.6% per year on a value-weighted basis. There is very little evidence of persistence in annual returns, but some persistence is seen at two-year and three-year horizons.
Hendricks, Patel and Zeckhauser (1993)	Last year's winners continue to perform well for one to eight more quarters. Last year's losers continue to perform poorly. Persistence in poor performance is stronger than persistence in good performance.
Elton, Gruber, Das and Hlavka (1993)	Funds underperform passive benchmarks on average. Funds with high fees and turnover underperformed funds with low fees and turnover.
Goetzmann and Ibbotson (1994)	Both winners and losers repeat over horizons from one month to three years.
Brown and Goetzmann (1995)	The level of observed persistence depends on the time period under study, and is mostly due to poor performers.
Malkiel (1995)	Most funds underperform both the S&P 500 Index and the CAPM. There is evidence of performance persistence, but it is due entirely to the 1970s.
Elton, Gruber and Blake (1996)	Both one-year and three-year returns exhibit persistence, for both winners and losers. Strong persistence among losers is driven largely by high expenses.
Carhart (1997)	There is some evidence of persistence among winners, but this appears to be due to momentum in their underlying stocks instead of skill. Losers exhibit strong persistence, and high expenses account for much of this persistent poor performance.
Quigley and Sinquefield (2000)	UK equity unit trusts underperform the Fama/French three-factor benchmark, on average. Unit trusts that are focused primarily on small companies have especially poor performance. Bad performance persists, but good performance does not.
Davis (2001)	Some short-run persistence is observed among the best-performing growth funds and the worst-performing small cap funds.

This table was taken from a paper done by James L. Davis in March of 2006 titled "The Informational Efficiency of Stock Prices: A Review" we include it to show you some of the academic work done on this topic.