February 2007

Dear Client,

Enclosed are the 2006 returns for your account(s). Where applicable three and five-year results are included as well.

The stock market as measured by the S&P 500 returned 15.79% with dividends for 2006. Seven years into the new millennium, cumulative results for the index and many mutual fund holders have finally turned positive. Most major broad indices- with the exception of the NASDAQ- are finally approaching their previous highs set in 1999. It's been a real test of patience for the buy & hold index investor. Overall results for the average retail investor have almost certainly been even worse.

Our account composite returned 15.48% (individual results may vary) in 2006. Net returns for the composite vs. the S&P 500 index over the past seven years are as follows: 84.13% total return and 9.11% compounded annually against 8.10% and 1.12% respectively. Although we find the S&P 500 a useful benchmark of sales and profit growth for American industry, we make no effort to closely mimic its quarterly or annual performance. Our efforts are directed towards providing clients with attractive absolute returns over time. In the process, our returns may vary considerably on an annual basis from those of the index. Long-term however, we believe our disciplined investment approach will continue to generate superior returns.

In last year's letter, we touched on two interesting features of the then-present investment landscape. One was the relative bargain valuations of American "blue-chip" companies and also, the reasonably compelling short-term bond yields of approximately five percent. The three "blue-chip" bargains mentioned in last years letter, Coca-Cola, Anheuser-Busch and Johnson & Johnson all performed well (+22.77%, +17.16% and +12.35%, respectively). On the interest rate front, nothing much has changed. The yield curve is slightly inverted with short-term rates yielding just fraction more than long-term rates. We continue to look favorably upon short-term, high quality bonds.

In our letters over the past few years, we've spent a fair amount of time reviewing our investment methodology and approach (for those interested, they can be accessed at www.highlandercapital.com/commentary.php). One aspect of investing where we haven't focused much attention and perhaps the one which bedevils most investors is that of investor psychology.

The most sensible investment plan or approach can be rendered virtually worthless if the necessary patience isn’t exhibited on the part of the investor. This is not to imply that a regular review of investments isn’t a good idea, or even that some sort of periodic rebalancing of asset classes- especially after very large price run-ups- isn’t merited. What it does imply is that investors ought to think twice before abandoning sensible, time-tested investment approaches, in favor of what is currently in vogue. One would think that such advice is unnecessary, or even self-evident, but in many cases investors are their own worst enemy.

History is a fairly good guide to understanding why it is that investors often make the same mistakes repeatedly. The pattern is a familiar one. First, after a long period of under-performance, prices for certain industries or sectors begin a sharp advance with many doubling and some tripling. Investors take note and impulsively exit their existing investments that may, at the moment, be stagnant, in favor of those that are, at the moment, showing good price action. Wall Street firms and their marketing departments are only too happy to accommodate the new demand with a host of new sector-specific mutual funds or ETFs, all showing excellent short-term performance. With exquisite timing and usually at near-peak prices, investors pour even more money into these new funds until prices begin to retreat and performance takes a turn towards the negative. To add insult to injury and in what appears to be a cruel twist, it’s likely that the investments that were sold earlier are probably showing strong gains. This cycle has occurred so frequently that it often seems as if the stars are aligned against the investor ever making any money in the markets. Of course the reality is that it is hyperactivity that is the real enemy of investment success. Patience truly is a virtue when it comes to investing.

Since their 2002 lows, stock prices have rallied steadily for four years. And as mentioned earlier, many of the broad indices are approaching their old highs. Earnings have also risen materially since 1999 and thus from a valuation standpoint, the overall market is priced much more reasonably than it was seven years ago. The increase in corporate earnings has truly been remarkable. More than just a rebound off their recession lows, corporate earnings are now at an all time historic high when measured against GDP. For some perspective, after-tax corporate profits have fluctuated between 4%-7% of GDP since World War II. They are currently over 9% of GDP and for those who believe that abnormal trends are ultimately mean reverting, this represents an area of concern.

We tend not to spend much time thinking about macroeconomics or making economic forecasts. The best use of our time has typically been spent analyzing companies and looking for good businesses available at good prices. As long as we can successfully identify a sufficient number of candidates, returns will take care of themselves.

Please feel free to contact us with any questions or comments. As always, thank you for your trust and patience.

Very truly yours,

Eckart A. Weeck
Managing Director