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INSTITUTIONAL INVESTMENT RESEARCH, LLC

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<u>What is AlphaReturns and why does the world need another investment newsletter?</u>

Welcome to the inaugural issue of AlphaReturns™. This newsletter and the soon to be launched online counterpart, AlphaReturns.com™, are a subsidiary of Institutional Investment Research LLC. Institutional Investment Research LLC was founded as a vehicle to provide relative asset class valuation analysis for institutional investors as well as for the Alphareturns newsletter. Institutional Investment Research LLC also attempts to research the current portfolio allocations of the most successful institutional investors so as to better understand where the best minds in the business are investing their money. Our research has shown that asset allocation is the primary determinant of investment performance. Furthermore, we find that the best institutional investors have moved away from basing allocations upon Markowitz' "*Beta-Centric*" Modern Portfolio Theory and are now basing allocation decisions upon relative asset valuation analysis. The AlphaReturns portfolio recommendations will condense this research each quarter into a simple to implement portfolio allocation for the small investor where the allocations among asset classes are based upon the relative valuation fundamentals of these assets. Using relative valuation analysis among diversified asset classes instead of beta, the AlphaReturns portfolio has the potential to produce market-beating returns (the industry term for this is *"alpha returns"*) with lower risk than the broad market.

Over the years, friends and family have witnessed the market beating success of this relative valuation investment methodology and have asked for advice with their own investments. Instead of explaining the philosophy and current investment allocations over and over again in person, we decided to start this newsletter and website to more efficiently share our investment ideas. We are providing this service free of charge to friends and family but will also make it available for an annual subscription fee of $200 to the general public.

As far as we know, AlphaReturns is the first newsletter to offer institutional level advice and portfolio allocations based upon relative fundamental valuation to the general investing public. In the past, it was difficult if not impossible for the small investor to achieve the same types of portfolio allocations that large institutional investors were using for private trusts, endowments, pension plans, etc. This is because institutional investors have historically been very diversified into commodities, real estate, domestic and international stocks and bonds. Mutual funds for small investors provided some of this diversification in stocks and bonds, but commodities and real estate have not been covered well by the mutual fund industry. Now with the launch of the ETF (exchange traded fund) industry, small investors have the ability to achieve institutional quality allocations into commodities, real estate, and even more specific international stock and bond sectors than ever before.

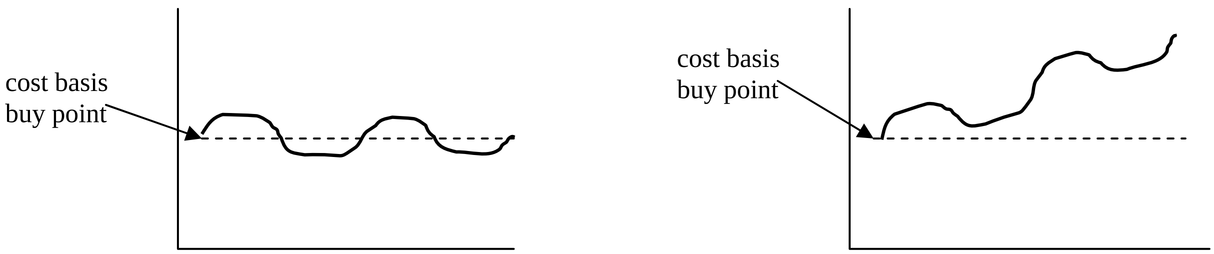
<u>How are Alphareturns' ideas different from those found in thousands of other investment newsletters?</u>

1. ***<u>We use fundamental economic valuation analysis to determine how much of which asset class should be in your portfolio at any given time. Most brokerage firms use one measure: the historical volatility "beta" of each asset class to determine allocation percentages.</u>***

At Alphareturns we believe in using fundamental economic analysis on each asset class to determine it's value, risk, and potential for growth relative to other asset classes. We then adjust the percentage allocation of each asset class based upon this analysis. Unlike most Wall Street investment analysts, we do not believe that the measure of historical standard deviation or ***"beta"*** volatility alone is an accurate indicator of future investment performance. Therefore, we do not use beta in our analysis. We do use fundamental valuation techniques like price to book, price to earnings, price to sales, price to cash flow, return on equity, debt to equity, GDP growth of major market economies, interest rate levels, credit quality, commodity supply and demand and currency strength. We take all of these factors into account and many more when analyzing the relative valuation of various investment asset classes.

Therefore, we increase the allocation to the asset classes that our research shows to be undervalued and avoid the asset classes that we believe are overvalued. Again, this has nothing to do with standard deviation, beta, or volatility of the various asset classes. Wall Street's Modern Portfolio Theory pioneered by Harry Markowitz in 1952 says that higher beta (more volatile) asset classes must always produce higher investment returns. While there are sectors of the US stock market that exhibit this behavior, it is just not proven out by fact when international stocks, real estate, and commodities are considered. In a study conducted by Morgan Stanley Capital from 1972 to 1997 they actually found that the most volatile asset class, commodities, actually produced the lowest return on investment and the least volatile asset class, commercial real estate, actually produced the highest return on investment! (see Chart C below) This is just the opposite of the Markowitz Modern Portfolio Theory that most brokerage firms use to construct asset allocations for clients. Academic research has proven that volatility in and of itself is not necessarily a risky thing and is a poor indicator of future investment performance. After all, volatility on the upside above our cost basis can be a very good thing. Likewise, we strive to avoid any kind of downside volatility if possible. Consider two investments: Investment A is very volatile and bounces around quite a lot both above and below your cost basis where you purchased this investment. Investment B is just as volatile but its gyrations occur above your buy point cost basis as it goes up and up and up. (see Chart A below) Clearly the volatility of Investment B is not as damaging to your portfolio as the volatility of Investment A. However, most Wall Street brokerages focus on standard volatility around the mean (like investment A) and therefore fail to recognize that volatility above your cost basis (like investment B) is not as unfavorable as volatility below your cost basis. So in a sense we are market timers in that we strive to avoid asset classes that are overvalued and we favor assets that are undervalued. Overvalued asset classes tend to have a higher tendency to be volatile both above and below the cost where you buy into the investment. Undervalued investments have more upside potential and are much more likely to have volatility above your cost basis buy point. Remember, the first step in selling high is buying low! The point at which you buy into the asset class investment determines your ultimate return on investment.

Chart A: A Look at Two Different Types of Volatility Around the Mean



Investment A where the volatility is above and below the cost basis.

Investment B with the same volatility as A, but with its volatility above the cost basis.

2. ***Most financial advisors and investment newsletters today advocate frequent trading into and out of a "hot list" of stocks or mutual funds. Alphareturns advocates only changing investments if the valuation fundamentals significantly change.***

Most newsletters today advocate frequent trading in and out of the newsletters' recent list of "hot stock tips". In some cases some popular newsletters are entirely dedicated to a particular commodity like silver or a particular stock sector like micro-cap biotech. While following the hot tip of the month may result in success from time to time, institutional investors who are charged with managing large pools of money have found that frequent trading in the most recent "hot" investments will not produce market-beating results over the long term. This is because the recent "hot" investments have usually been bid up in price to over-valued levels and investors then can only hope for a "greater fool" to come along and pay a more over-valued, inflated (and unreasonable) price. Successful institutional investors do the opposite – they search for under-valued, over-looked investments to buy and hold for a longer period of time until the true higher value of these investments can be recognized by the market. Consider the study below done by DALBAR (an industry research group) regarding the investment returns achieved by the average mutual fund investor from 1985 to 2004: (see Chart B below)

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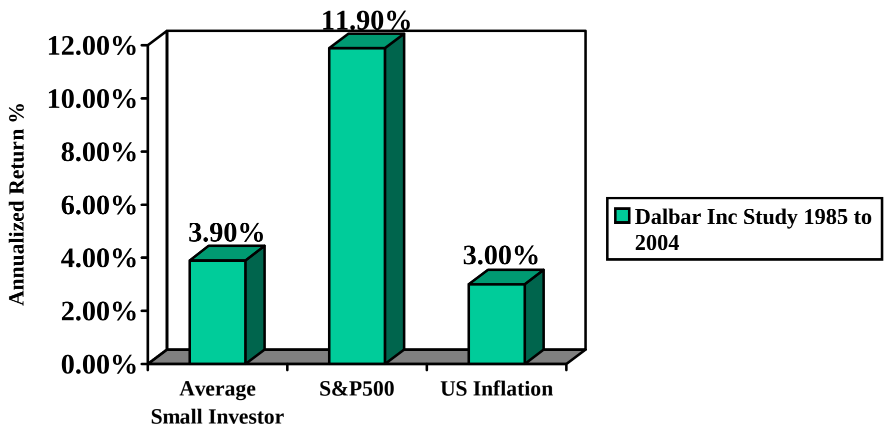
Chart B: DALBAR Study of Small Investor Returns vs the Market and Inflation

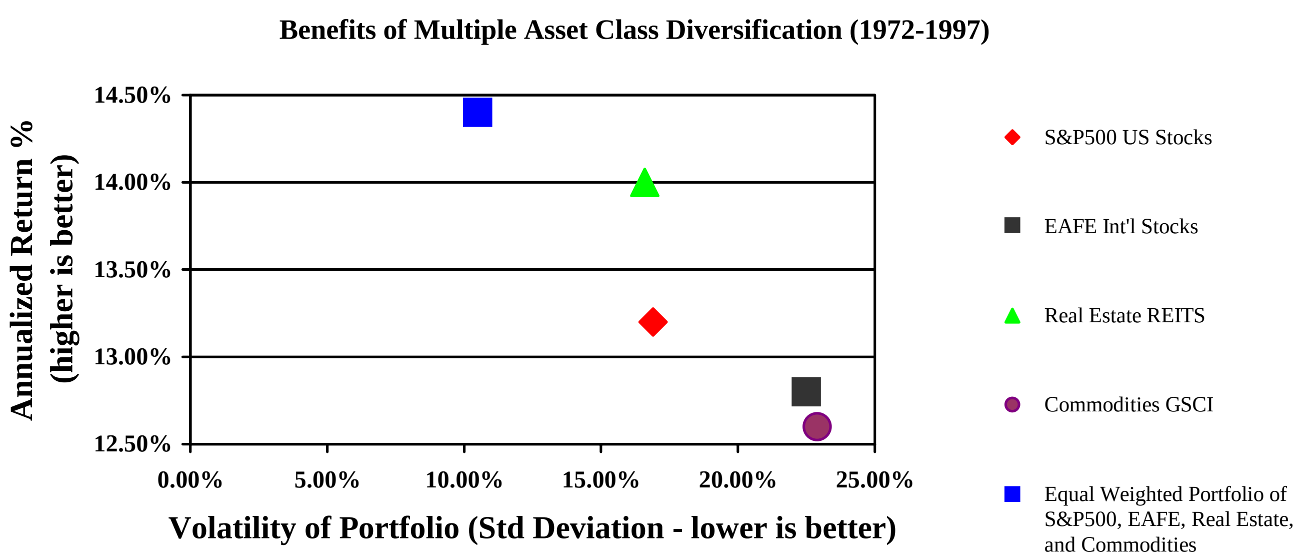


The study concluded that the average mutual fund investor achieved an annualized return of only 3.9% compared to the S&P500 return of 11.90% because the average mutual fund investor took money out of the market at the bottom of bear markets and put more money into the market at the top of bull markets. Also, some of this poor return was the result of the average mutual fund investor chasing the latest "hot" mutual fund (for example tech stock funds in the late 1990's) and therefore not having enough diversification into other asset classes like bonds, commodities, etc.

3. ***Many advisors and newsletters do not provide enough diversification for their clients because they do not include commodities and real estate in portfolio allocations.***

How important is diversification? Consider the following study done Morgan Stanley Capital from 1972 to 1997:

Chart C: Benefits of Multi-Asset Class Diversification



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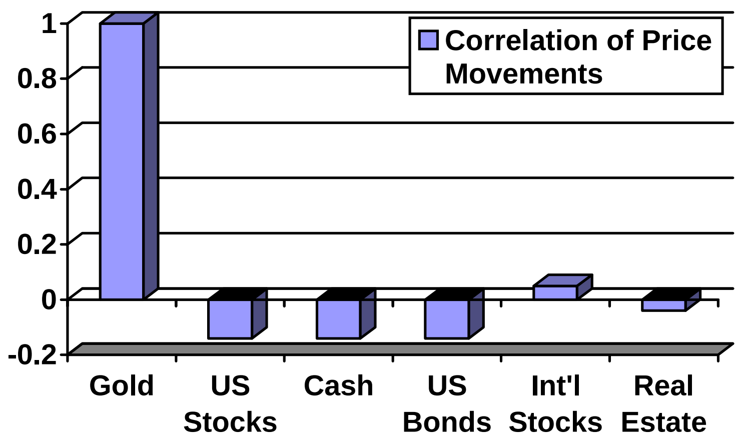
This study found that by adding diversification to a portfolio (in this case equal weights of commodities, real estate, US stocks, and International stocks), the return of the diversified portfolio produced higher returns while the risk (volatility measured in standard deviation) was lower. *So the sum of the parts has a higher return and less volatility than any one of the parts on its own! How can this be? It has to do with a powerful mathematical principle that benefits from low correlation among the various asset classes. When your portfolio consists of various assets that are not highly correlated mathematically, the entire portfolio can outperform even the highest performing asset inside the portfolio. In layman terms, when one asset is zigging another asset is zagging and the sum of the parts has a higher return with less volatility!* One note regarding real estate: you will see later in this newsletter that we are not currently recommending an allocation to commercial real estate in the Alphareturns portfolios. This is because we view both the residential and commercial real estate markets to be overvalued relative to other asset classes at this time. Therefore, we are not recommending an allocation to real estate at this time, but will soon bring real estate back into the portfolio when it becomes fairly or undervalued again. We do have a position in gold, which is our favorite undervalued commodity at this time.

Chart D: Mathematical Correlation Among Various Asset Classes



Source: Zephyr Style ADVISOR, SsgA Advisor Consulting Services Research October 1984 through September 2004.

Global Economic Overview and Outlook:

On a macro economic level, we view the U.S. economy biased toward slowing GDP growth, stable to lower short-term interest rates, and stable to higher inflation for the next 6 quarters. The risk of a deep and prolonged residential construction and real estate industry downturn persists with the possibility of 1 million or more U.S. jobs at risk in these sectors over the next 6 quarters. Many of these U.S. construction workers left jobs in the manufacturing sector during the real estate and construction boom over the past 4 years. The risk to U.S. consumer spending is that these redundant construction workers may try to return to manufacturing jobs that no longer exist. Furthermore, mortgage equity withdrawals added close to 5% to the disposable income of U.S. workers over the past 3 years. With housing prices falling, mortgage equity withdrawals will not be able to support consumer spending going forward. These factors combined with an inverted

U.S. yield curve create a risk of mild recession in the U.S. over the next 6 quarters. Our forecast of stable to increasing US inflation is based upon the likelihood of oil staying above $60 per barrel, persistently high gas prices, and a falling US Dollar. These are all inflation triggers.

In terms of global economic growth, our view is that the eurozone economies will continue with above trend growth through the next 2 years with expanding earnings and spending. Eurozone rates are forecasted to increase moderately as the European Central Bank endeavors to keep core inflation stable and within the EC target range. Our view is that Asian economies will continue to grow with China leading the way. Japan should continue with its recovery and trend toward re-inflation as it benefits from China's growth. At this time we believe China is likely to suppress the value of the Renminbi for a number of years into the future. China is very much aware of the damage caused to the Japanese economy as a result of the Plaza Accord Agreement in the late 1980's. The Chinese also have state mandated controls within their economy that allow manipulation of prices and wages so as to limit inflation and overheating caused by an undervalued currency. Therefore, at the moment we do not see a large risk to the global economy of a sudden "unwinding" of these imbalances. We currently see the Chinese allowing a very slow and deliberate rise in the Renminbi (around 2% to 3% per year). The risk to this forecast is a bursting of the Chinese stock market bubble (see Chart H below) or a global financial event (like a major hedge fund collapse or bond default) causing these currency imbalances to unwind suddenly.

Oil:

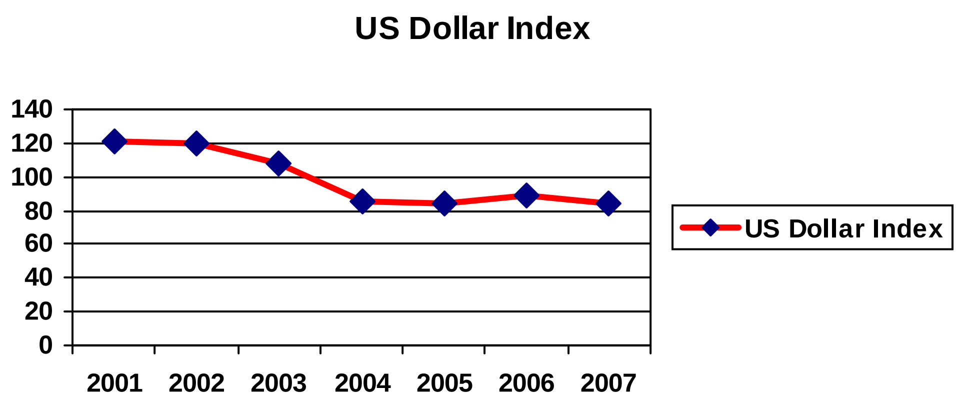
What do we see the future of oil and energy to be? Our research shows that OPEC is desperately trying to hold a lid on supply to set a floor under crude of around $60 per barrel. However, our research also shows that global demand is slowing with the global economic slowdown and therefore the true supply/demand equilibrium price for crude oil should be somewhere around $45 to $50 per barrel. So we look for crude to possibly pull back to the $45 to $50 range from time to time during 2007 but rebound back above $60 per barrel as OPEC adjusts production in their attempt to keep oil above $60 per barrel. Another factor that may keep oil higher than its free market equilibrium price is the Iranian nuke situation. Our view is that this geopolitical crisis with Iran is far from being resolved and may result in a severe geopolitical crisis in the Middle East during 2007. This could also force oil higher and add to its price volatility. Therefore, we believe that the risks on crude oil are tilted to prices being higher and hovering above $60 per barrel during 2007. With regard to gasoline prices, our research shows a supply shortage in the refining industry that will likely keep gas prices high through 2007. Refiners are currently running at 93% capacity compared to a historical rate of 86% and new capacity will not be coming on line for a number of years into the future due to regulatory and environmental issues.

US Dollar in Decline:

The US Dollar lost approximately 9% of its value relative to other major currencies in 2006. The same fundamental factors behind this decline are still in effect, namely:

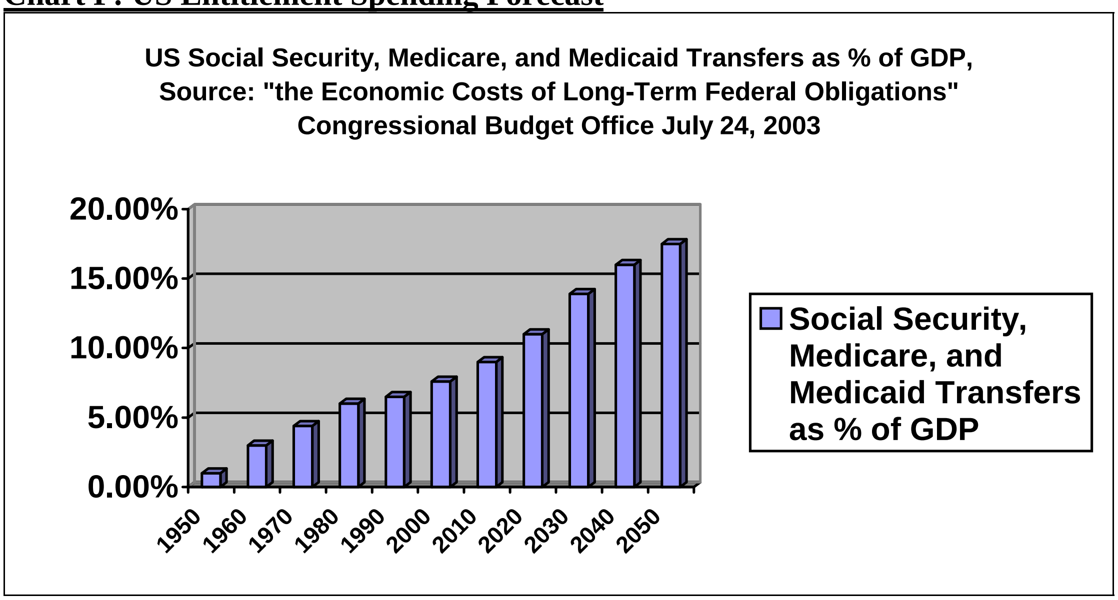
- Growing fiscal, entitlement, and consumer debt in the US
- Trade deficit and currency imbalances
- Peaking US interest rates in the short run through 2007.

Chart E: US Dollar Index



Source: Wall Street Journal

Chart F: US Entitlement Spending Forecast



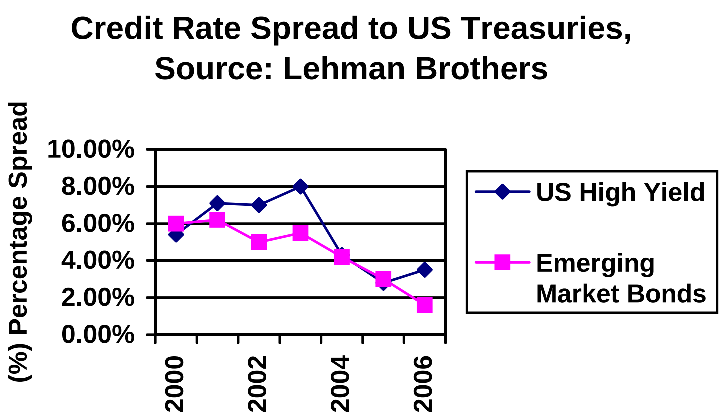
Source: Congressional Budget Office

This decline in the US Dollar's purchasing power is behind the continued bull market in many commodities such as gold, base metals, energy, and agricultural commodities. Since these commodities are priced and traded in US Dollar terms, their value will increase as the US Dollar declines. This is another reason for our belief that crude oil and gasoline prices are more likely to hold at current levels or go up through 2007.

Global Credit Bubble and Inflation Outlook:

The lowest interest rates in a generation combined with tame inflation are causing a global bubble in credit and debt issuance. We have the lowest spread ever between high-risk junk debt and high-grade government debt. (see Chart G below) Debt investors are taking on risk with little or no reward for credit or maturity risk (as evidenced by the inverted yield curve in US Treasuries) as if there is no longer any risk in the debt markets. We strongly disagree with this assumption and believe that credit spreads will widen back to historical norms and much of the junk and emerging market debt that is being issued will go into default. This will lead to higher interest rates on longer maturity, lower credit quality debt securities. This also may lead to a re-pricing of risk in general for longer maturity fixed income securities. A re-pricing of risk more than likely will lead to higher rates on 10 and 30 year US Treasuries and a much steeper yield curve for Treasuries.

Chart G: Credit Spreads



A high appetite for credit risk combined with over-zealous lending in the US mortgage debt market, may lead to a global liquidity crunch as rates on risky assets rise, lending standards are tightened, and defaults increase. This avalanche of global liquidity and cheap, easy money has been providing the fuel for the bull market in global equities. In fact, emerging stock markets like those in China, India, and Russia are experiencing "*bubble-like*" speculative growth that is disconnected from underlying economic strength. While stock markets in developed countries do not appear to be as grossly overvalued as they were in 2000, a liquidity crunch combined with a slowing global economy will provide headwinds to the entire equity bull market.

China runs flat-out toward its global "coming out party"… the 2008 Olympic Games:

Growth in China continues at an extraordinary pace. Anyone who has been to China lately will remember the unbelievable number of construction cranes and projects in the major cities. Industrial activity is also booming with annual GDP recently growing in excess of 10% (see Chinese GDP chart I below). With its low labor costs and currency still heavily tied to the US Dollar and our relatively low interest rates, China's growth does not look like it will slow anytime soon. However, with over $1 Trillion in foreign reserves and a growing middle class, the Chinese Communist Government will come under increased pressure from its trading partners and its middle class to behave responsibly on the trade front and improve human rights on the domestic front. The more pressing concern is a bubble situation developing in the Chinese stock market with this market up over 70% in calendar 2006 on the heels of a blistering 140% gain in 2005. Speculation among small investors in China and "hot" foreign investment flows from speculative hedge funds will increase the likelihood of an unsustainable bubble in Chinese stocks (see Chinese stock market chart below). We remain cautious on Chinese equities along with other emerging markets such as India, Brazil, and Russia, which have had speculative "bubble-like growth" of over 40% in 2006 alone.

Chart H: Chinese Stock Market Bubble

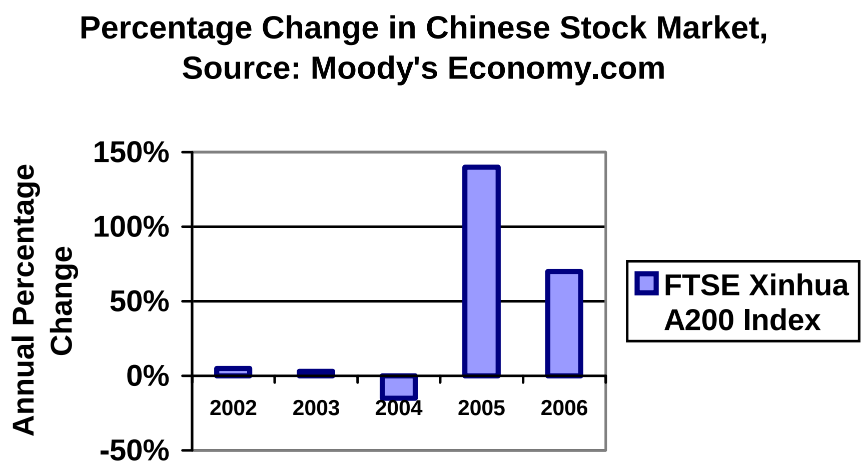
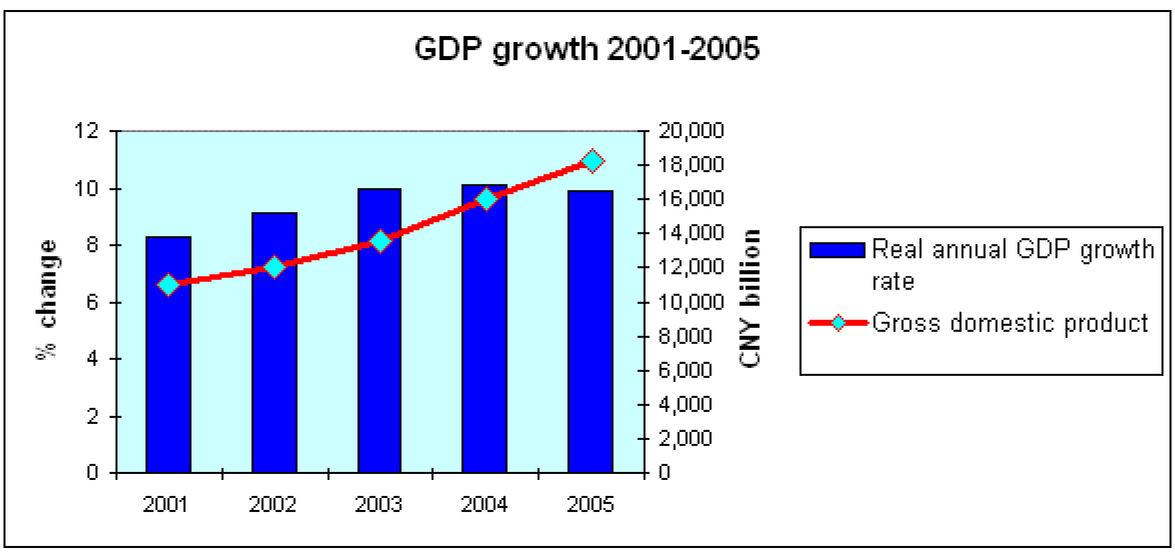


Chart I: Chinese GDP Growth



Chinese GDP Growth (CNY- Chinese Yuan), Source: Chinability.com

The Alphareturns Portfolios:

The table below details the current portfolio allocations in the Alphareturns portfolios. We will briefly touch on the rationale behind the various asset class choices:

Gold: An investment thesis built upon the falling dollar, diversification, and the undervalued situation with gold. Our view is that gold is the most undervalued and attractive commodity to own at this time. We believe that central banks will diversify back into gold to escape losses due to the falling US Dollar. We also believe that gold's very low correlation with stocks will provide a hedge against volatility in stock markets. (See chart D again)

US Value Stocks: Large Value looks more attractive than Small-Cap and Mid-Cap Value at this time due to valuation fundamentals. Even though US Value stocks have outperformed US Growth stocks over the past few years, they still have lower price to earnings, price to book, and price to sales ratios and higher earnings growth. Traditional US Growth category stocks will also be hit harder by the expected slowing in GDP growth this year.

Foreign Large Value: Large International Value again looks attractive from a valuation standpoint and foreign stocks will also gain from the falling dollar trend. European stock markets look especially attractive due to lower price to earnings ratios and higher yields than US stocks. European GDP growth is still accelerating where US growth is now slowing.

Asia Pacific excluding Japan: The Pan-Asian economies except for Japan are very attractive from a price to earnings and dividend yield standpoint. We look for the commodity bull market and growth in Chinese commercial construction to continue to support extraordinary growth in the Australian stock market which also has low price to earnings and high dividend yields.

Fixed Income: We believe that a re-pricing of risk in the credit markets will likely lead to a steeper yield curve. Therefore we have a higher allocation in Short Term Treasuries and a lower allocation in the Lehman Aggregate Bond Index. We forecast short-term rates to stay steady or fall as US GDP growth slows in 2007. However, as credit risk is re-priced in junk and emerging market bonds, we also expect longer-term bond rates to increase to more adequately reward investors for maturity risk.

Alphareturns Portfolio Allocations For First Quarter Calendar 2007:

Symbol	Asset Class	Conservative Risk 1-3 year horizon	Moderate Risk 3-5 year horizon	Aggressive Risk 5 + year horizon
GLD	**Gold ETF**	5%	4%	3%
VTV	**US Large Value Stock ETF**	12%	15%	19%
VOE	**US Mid-Cap Value Stock ETF**	3%	5%	7%
VBR	**US Small Cap Value Stock ETF**	3%	5%	7%
EFV	**International Value Stock ETF**	12%	17%	22%
EPP	**Asia Pacific ex-Japan Stock ETF**	5%	7%	8%
EEM	**Emerging Market Stock ETF**	5%	6%	7%
IEV	**European Stock ETF**	5%	6%	7%
EWA	**Australian Stock ETF**	4%	5%	6%
AGG	**Lehman Aggregate Bond ETF**	16%	10%	4%
SHY	**Short Term US Treasury ETF**	30%	20%	10%

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