ALTER ASSET MANAGEMENT, INC.

Excess generally causes reaction, and produces a change in the opposite direction, whether it be in the seasons, or individuals, or in governments.
- Plato-

July 26, 2006

Dear Friends of AAM,

We hope you are having a good summer.

As we write to you, the general level of pessimism (disgust) toward the U.S. equity asset class is high. Your Advisor has had its greatest success buying securities that possess a margin of safety during periods of disdain and trimming holdings during periods of optimism (euphoria). The 2006 AAM mid-year letter examines factors that we believe have materially improved investment conditions for the U.S. equity and fixed income asset classes generally and your investment program specifically.

- Your Advisor highlights the impact of Fed policy on common stocks (highlight for us is at least 500 words).
- We are very mindful of mean reversion and its impact on the long-term risk/reward framework of key asset classes. As a result, we are enthused by the prospects for high-quality, blue-chip companies. They are trading at their best relative and absolute valuations of the decade.
- We conclude with a review of Warren Buffett's long-term plan for his Berkshire Hathaway shares. The plan is great news for the world as well as a subset of the world — Berkshire Hathaway shareholders.

If you are not confused, you are not paying attention.
- Tom Peters-

FED UP

G. William Miller served as Chairman of the Federal Reserve from 1978 to 1979. During his tenure, the Fed was unable to turnaround a weak economy ravaged by rising inflation and growing unemployment. Reflecting the low esteem and visibility of the Fed during this period, Miller is said to have glumly observed that, "23 percent of the U.S. population thinks that the Federal Reserve is an Indian reservation, 26 percent thinks it is a wild life preserve, and 51 percent thinks it is a brand of whiskey."

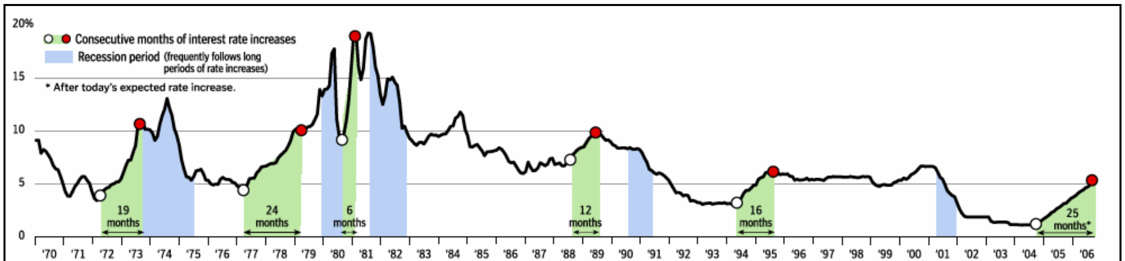
No one thinks the Federal Reserve is a brand of whiskey anymore.

In contrast, newly retired Fed Chairman Alan Greenspan presided over one of the strongest periods of economic growth during his 18 years in office. Greenspan's popularity is reflected by a reported $8 million advance from publisher Penguin Press for his memoirs. This led late-night comic Conan O'Brien to quip, "Finally — a book that captures the romance and excitement of an old man talking about interest rates!"

Now all eyes are on rookie Chairman Ben Bernanke who has weathered some minor slip-ups. In April, for example, he observed that the Fed might take a pause in its tightening. The markets rose on this news. Days later, at the White House Correspondents Dinner in Washington, D.C., he mentioned to CNBC's Maria Bartiromo that the markets had misinterpreted his remarks. The market tumbled when Bartiromo reported Bernanke's comments. Bernanke quickly apologized by saying that his remarks represented "a lapse in judgment."

Though Bernanke has suffered some communication malfunctions, much of the market's recent volatility reflects concerns about commodity-based inflation, geopolitical risk, and economic growth beyond 2006. We have some strong convictions on all of these matters and believe that the so called "Perfect Storm II" will die at sea.

After suffering a recession in 2001, the U.S. economy has experienced four and a half years of solid growth. In 2004, the Federal Reserve was confident that economic expansion was on track and accordingly initiated a series of 17 successive quarter point rate hikes. This tightening campaign has lifted the overnight bank lending rate, also known as the federal funds rate, from 1.00% to 5.25%.



SOURCE: Federal Reserve; GRAPHIC: By Karen Yourish , The Washington Post - June 29, 2006

Bernanke must be careful not to slow the economy too much through his efforts to combat inflationary pressures. The Federal Reserve is very much like a man in a dark room trying to walk from one side to the other. His first few steps are easy, but as he gets closer to the other side, he must be careful that he doesn't hit the wall and hurt himself.

Unfortunately, the Fed is not omniscient. Even Alan Greenspan made notable mistakes during his tenure. One week before the peak of the Nasdaq in 2000, Greenspan observed at a conference held at Boston College, "The fact that the capital spending boom is still going strong indicates that businesses continue to find a wide array of potential high-rate-of-return, productivity-enhancing investments. And I see nothing to suggest that these opportunities will peter out any time soon."

With a mid-term election on the horizon and bond traders protesting in the form of an inverted yield curve, we believe the Fed is prepared to stop raising interest rates after its August meeting. A move to 5.5% on the fed funds rate will likely complete the current tightening cycle. There is tremendous pressure for a new Fed Chairman to demonstrate his inflation fighting credentials at the risk of allowing economic growth to sputter. We believe the Fed will need to reverse course by the 4th quarter of 2007 as it becomes increasingly clear that monetary policy became too restrictive this summer.

With this is mind, Professor Jeremy Siegel of The Wharton School has researched equity returns following directional changes in the fed funds rate. His conclusion: following increases in the fed funds rate, stock returns are significantly less than average. Conversely, when the fed funds rate is lowered, stock returns are significantly higher than average. Siegel cautions that increased Federal Reserve transparency over time may lessen the market impact of rate decisions. Nevertheless, it is easy to see why stocks would benefit from decreases in the fed funds rate:

1. Lower rates spur investment and provide system liquidity.

2. Lower yields increase the discounted value cash flow provided by common stocks.

S&P 500 Performance After Increases and Decreases in the Federal Funds Rate

	3-Month Performance	6-Month Performance	9-Month Performance	12-Month Performance
Increases	1.2%	2.9%	5.9%	7.4%
Decreases	5.3%	9.7%	12.4%	16.6%

Source: Stocks for the Long Run

The anticipation of lower future rates also bodes well for fixed income investments which have stagnated over the past couple years. In the first six months of 2006, long-term and intermediate-term U.S. treasuries declined 6.5% and 2.6% as measured by Lehman Brothers indices. We believe that high-quality five to ten year bonds now offer the opportunity to earn both their coupon and generate underlying price appreciation as rates decline.

NOT GOING ANYWHERE FOR AWHILE?

I will prepare myself and the opportunity will come.
– Abraham Lincoln –

In 1999, Snickers ran a commercial where a professional athlete was showing off a tattoo of his team logo that covered his entire back. His coach walked in and the athlete screamed, “Hey coach, check this out” while turning to show off his tattoo. The coach replied, “That’s great, but you’ve been traded to Miami.” The next shot showed the athlete grimacing in pain as his tattoo was being removed. A voice then commented, “Not going anywhere for awhile? Grab a Snickers.”

In 2000, many common stock investors would have been well-advised to grab a Snickers and avoid the pain associated with the speculative flurry in technology stocks. From the top in 2000 to June 30, 2006, the stock market as measured by the price of the S&P 500 declined in price by 18%. The NASDAQ is still more than 60% below its peak. Over this period, your Advisor has generated gains by avoiding the Hail Mary while sticking with a solid running game.

WHY BIGGER IS BETTER

Pure Mathematics, in its way, is the poetry of logical ideas.
-Albert Einstein-

Sir Isaac Newton enlightened future generations with the simple insight that in the physical universe 'What goes up must come down'. Yet many investors believe they are in a "Newton Free Zone". In the universe of asset classes, two simple rules are observable:

1. What goes up too far must come down.

2. What goes down too far must come up.

3. Over time, markets will deviate from their long-term relationship between price and value but inevitably they seem to be drawn like a tractor beam to their intrinsic valuation.

Jeremy Grantham and Ben Inker, of investment firm *Grantham, Mayo, Van Otterloo (GMO)*, conducted a study that demonstrated the mean-reversion tendencies of markets. They collected data for all asset classes they could find from commodities, currencies, stocks, and bonds. They defined a bubble as a two standard deviation event or a 1 in 40-year upside move. Data was available to calculate the trend in long-term prices and to determine the volatility of each series. They found 28 examples where prices deviated from their long-term trends. How many asset classes deviated without a reversion to the mean? **NONE**.

Grantham and Inker found that most deviations from trend start to revert within three years. Unfortunately, many do not. They concluded that it is impossible to predict the timing and extent of market deviations. Accordingly, we must live with the paradox that when we throw up feathers in the storm, we know nothing about their flight path, how high they will go, or when or where they will land, but still we have complete confidence in one outcome — they will touch down eventually.

The GMO study supports our own conclusions about where to best allocate capital.

- The stock market is reasonably priced: Historically, the S&P 500 has had an average price-to-earning ratio (PE) of between 15-18. The S&P 500 hit a high of 1,527 in 2000. This price was based on underlying earnings of $50.95 per share which means investors paid about **30** times earnings (1,527/$50.95).

  In 2007, the S&P 500 is expected to earn $84. At a current level of 1,240, the price-to-earnings ratio is below 16. Going forward, most stock market investors should expect reasonable rates of return over time.

- High-quality U.S. stocks are selling well below their intrinsic value: Blue-chip U.S. companies are now as attractive as we've seen them in some time.

  This represents a significant change from our observations in February 1999. In our 1998 year-end client letter we noted that large-capitalization companies were significantly overvalued relative to their smaller brethren.

AAM's portfolio structure currently emphasizes smaller businesses and those with lower than average price to book and price to earnings values. Our attraction to this area combines the most compelling long-term business opportunities with the greatest probability for long-term outsized performance.

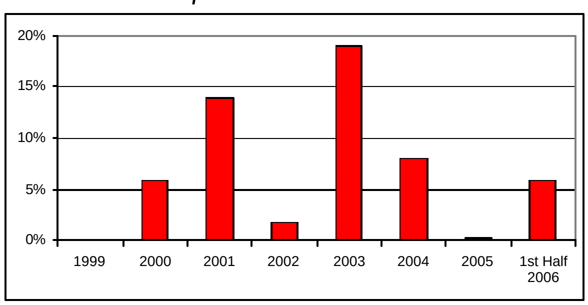
As 1998 came to an end, we noted that the top fifty stocks in the Standard & Poor's 500 (S&P 500) returned 34.9% while the remaining 90% of securities in the popular average were held to a gain of 8.4%. The divergence in performance between large and small capitalization businesses — as measured by the S&P 500 and Russell 2000 respectively — established several notable records.

1. The five-year period from 1994 to 1998 represented that longest number of consecutive years where the S&P 500 outperformed the Russell 2000.

2. 1998 experienced the greatest yearly divergence between the S&P 500 and Russell 2000: 30.8%.

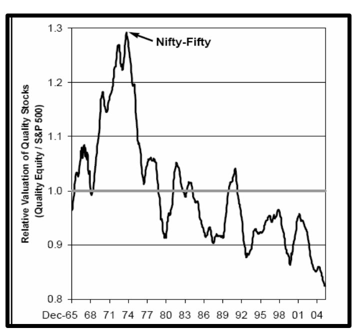
By the end of 1999, small capitalization companies began to rally. Amazingly, this trend is now entering an unprecedented eighth year as shown in the following chart which depicts the outperformance of the Russell 2000 vis-à-vis the S&P 500.

Russell 2000 Performance Relative to the S&P 500



The attractiveness of blue chip stocks can be better understood by examining the valuation of the top quartile of companies within the S&P 500 vis-à-vis the entire index. This exercise demonstrates that blue chip stocks are at their most undervalued levels since 1965.

Relative Value of High Quality Stocks
Compared to the S&P 500



Source: GMO

MUD SLIDE

Real Estate Redux: In our mid-year 2005 letter, your Advisor pointed out that the value of any asset is determined by the discounted free cash-flow it is expected to generate over its useful life. With this in mind, one of the most useful ways to gauge housing valuations is to compare them to rental income. This produces a ratio similar to the price-to-earnings ratio that we use to gauge stock valuation. Courtesy of the Federal Reserve Bank of San Francisco, we included the following chart that illustrates the U.S. price-to-rent ratio since 1982.

Source: Federal Reserve Bank of San Francisco

It was evident to the most novice chart reader that something had to give and your Advisor further pontificated:

These prices may be justified if long-term interest rates continue to fall dramatically in tandem with a strong economic backdrop. In our view this is the lowest probability scenario. When will the music stop? As in every speculative period, it will only be clear in retrospect.

Since our observation in the year-end 2005 client letter, real estate markets across the country have softened as rising interest rates serve as the catalyst for mean reversion.

WHAT DID THE SECOND RICHEST MAN SAY TO THE RICHEST MAN?

I resolved to stop accumulating and begin the infinitely more serious and difficult task of wise distribution.
- Andrew Carnegie-

In June, Warren Buffett, the world's second richest man, promised to give away the bulk of his estate to Bill Gates, the world's richest man. What is remarkable about the donation is that it is structured to simultaneously benefit Berkshire Hathaway shareholders and the efforts of the Gates Foundation.

Buffett has pledged to gradually give away 85% of his Berkshire Hathaway stock to five foundations. Five-sixths of the shares will go to the $30 billion Gates Foundation which is focused on world health and literacy. Beginning in July and every year thereafter while he is alive, Buffett will give a predetermined, annually declining number of Berkshire B shares – starting with 602,500 in 2006. The foundations will be required to annually spend the dollar amount of the contributions.

How does the gift benefit Berkshire shareholders? Buffett has long said that his wealth would go to charity, but has always maintained that it would be donated upon his death. Many investors feared that when he died, the charities would sell Berkshire shares in large blocks that would push the price down. The Gates Foundation currently has $30 billion in other assets so it will not have to sell its Berkshire shares right away. In addition, Bill Gates is a Berkshire Hathaway board member, owns Berkshire stock personally, and would likely be very comfortably holding on to the shares the foundation receives for an extended period.

As part of Buffett's plan, he will convert his Berkshire Hathaway Class A shares into Class B shares (1 A share is convertible into 30 B shares) before he donates them. This will keep Buffett firmly in control of the company as his current voting stake of 38 percent will drop far less rapidly than his ownership stake of 32 percent. Each A share has one vote, while a B share has only 1/200th of a vote. In addition, B shares are much more liquid than the A shares.

This increase in B shares has led some to predict (including Buffett) that Berkshire stock could be added to the S&P 500. Berkshire is the largest public company not in the S&P 500 because there are so few shares outstanding and Buffett's stake is so large. With Buffett's large scale conversion of his A shares, the increased float of B shares would likely make the company liquid enough for addition to the S&P 500. Adding Berkshire to the S&P 500 would require many indexes to purchase large quantities of stock absorbing much of what the foundations could potentially sell .

Buffett's donation to someone else's foundation is unique. He is not seeking to immortalize himself through an institution that would go on to spend lavish sums on administration and fund raising. The Gates Foundation, the world's largest charity, has already built an infrastructure to effectively give away large amounts of money. Buffett will simply piggy-back on what Gates has done. Also, Buffett insists that the money be given away as it is donated and during the lifetimes of Bill and Melinda Gates so that he avoids the problems associated with most family foundations — maintaining focus after its founders are gone.

Buffett's approach to philanthropy is very much in line with his investment style — rational, strategic, and free of emotion and ego. How does this gift compare to others? The earmarked shares currently have a value of $37 billion. In today's dollars, Andrew Carnegie gave $7.2 billion and John D. Rockefeller $7.1 billion.

IN CONCLUSION

Plans fail for lack of counsel, but with many advisers they succeed.
-Proverbs 15:22-

Your Advisor strives to serve as your family's CFO. Accordingly, we are happy to review and to serve as a sounding board for any investments or opportunities that you are considering. A second opinion is often helpful in better understanding the risks and rewards in any new venture — a fact that was highlighted by a recent study by the Securities and Exchange Commission (SEC).

The SEC just released a study about people who fall prey to investment scams. The research found that when compared to non-victims, victims of fraud are typically:

1. **Less likely than non-victims to seek the help of a financial advisor, or even a family member, before making investment decisions.**
2. Better-educated
3. More financially acute
4. More likely to be men
5. Less likely to be living alone and more likely to be married
6. More likely to have a college degree or more

At first glance, the findings seemed counterintuitive. Why would victims of financial fraud be more educated and more financially sophisticated?

Anthony Pratkanis, a psychology professor at the University of California, Santa Cruz, led the study and offered insight into this question. He observed, "In a robbery, the weapon is a knife or gun. In a fraud crime, the weapon is social influence which is more difficult to recognize."

Social influence can be extremely powerful. When we see friends making money in whatever is the flavor of the day — dot-com stocks, real estate, commodities — we want to emulate without consideration of the rational underpinning of the "opportunity". Doug Shadel of AARP participated in the research and described a typical victim who despite being "sharp as a tack" was "persuaded to invest more than $500,000 in an oil-and-gas scam that he believed was guaranteed to bring in thousands of dollars a month in income."

As in medicine, getting another opinion allows you to benefit from different perspectives and to better understand your options. AAM even makes house calls.

We look forward to speaking with all of you to discuss your investment program and any other issues or opportunities that impact your financial health.

We recently signed a new lease on our existing location at 731 Alexander Road and exercised an opportunity to assume additional space.

In the Fall, we will refresh our web site. As always, we welcome your thoughts and ideas on the functionality that adds value for our clients.

We have revisited our custodial relationship with Charles Schwab and have compared the value and execution they provide vis-à-vis other institutional options. We believe their value proposition is extremely competitive. In the course of our review, we once again negotiated lower costs and commissions that will benefit many of our client families.

Included in your 2006 mid-year report, please find a copy of AAM's Form ADV II, Privacy Notice, and Proxy Voting Policy.

The 2006 Annual Report will be mailed to you in early March of 2007. We will also begin offering you the opportunity to receive reports on CD-ROM in 2007 in place of paper copies.

Have a safe and enjoyable summer!

Very truly yours,

Howard Steve George