ALTER ASSET
MANAGEMENT, INC.

March 19, 2007

"A pessimist is one who feels bad when he feels good for fear he'll feel worse when he feels better."

Dear Friends of AAM,

We hope that the AAM 2006 year-end report finds you in good health. As we write to you in mid-March, the engine of the global equity markets — which was in high gear during the second half of 2006 — has seized into reverse. Is this a pit stop to refuel or has the recent advance put too much wear on the transmission? Your Advisor offers a quick road trip (less than 2000 words) to stress test our thesis that high quality U.S. equities continue to provide value relative to other investments.

Our three-part checklist to get under the hood of the U.S stock market is highlighted below:

- Risk vs. Reward
- Investor Psychology
- Valuation

Before your Advisor examines the investment framework for U.S. equities – we provide a macro analysis of liquidity in the capital markets and its effect on the equilibrium of financial assets.

## A YEN FOR RISK – RISK & REWARD

"Surprises are foolish things. The pleasure is not enhanced, and the inconvenience is often considerable."
-Jane Austen-

Over the past several years, the world has become awash in a sea of liquidity resulting from historically low global interest rates and aggressive banking practices. As an example, with Japanese borrowing costs at close to 0% and the yen weakening against alternative currencies, large investors have tapped funds where money is extremely cheap and invested their newfound capital around the world. Relaxed credit standards have also added to the liquidity tide as some U.S. banks, for example, allowed marginal homeowners to borrow in excess of 100% of the value of their residence and have provided aggressive loans to private equity firms enabling highly leveraged buyouts. The abundance of capital looking for investment opportunities has fueled demand for nontraditional assets such as emerging market securities and a variety of commodities.

## A YEN FOR RISK – RISK & REWARD

In a world awash in liquidity, the prices of many assets do not appear to reflect their associated risk. This is demonstrated by compressed risk premiums. As an example, the yields on the lowest rated bonds (CCC) are at spreads of under 5 percentage points over AAA United States Treasuries. This is significant. Although investors are getting paid more to hold a riskier asset, it does not appear to be enough when one factors in a probability of permanent impairment or default associated with the underlying security. This compares with spreads for similar securities that historically provided investors with 7 to 9 percentage points in incremental yield. A well accepted indicator of the appetite for risk, the distress ratio, which measures the number of high-yield bonds that provide 10 percentage points or more in additional yield above Treasury bonds, is at its lowest, most speculative reading, in over a decade.

During a period of compressed risk premiums, your Advisor finds it unacceptable to chase marginally higher short-term returns in assets that fail to reward the associated risk. Instead, we prefer to upgrade the quality of client portfolios with the understanding that we are trading off incremental near-term expected yield in favor of dramatically reduced expected risk.

## BUYING THE BIGGEST AND THE BEST AT DISCOUNT

In contrast to what your Advisor views as excess across a number of asset classes and geographies, global large capitalization companies in the U.S. equity market offer a margin of safety. Characterized by strong balance sheets, global brands, and steady growth prospects, these Park Avenue businesses appear to be selling at Bowery prices.

The managers at the Clipper Fund, Christopher Davis and Kenneth Feinberg, observed that in 1999 the largest 50 companies in the S&P 500 traded at a 168% premium to the next 450 companies. Seven years later these top 50 companies are trading at a 5% discount to the next 450!

How can one make sense of such changes? Your Advisor is continually reminded that human behavior creates opportunity for the patient investor. In fact, a single day of activity in the stock market affords us all front row seats to a Greek Play called "Capitalism" with three main characters, Hope, Fear, and Greed.

As we have communicated over the years, we find that buying when Fear takes the stage, selling when Greed re-enters, and retaining Hope as a constant companion, is the most effective method for creating long-term wealth. Such an approach invariably guides us to buy low, sell high, and remain mindful that purchasing well-managed companies at reasonable prices for long-term ownership is the clearest path to investment success.

## PICK A NUMBER 1929 OR 2000? – INVESTOR PSYCHOLOGY

One's feelings for the future are rooted in how they've been treated in the past. This is particularly true with an investment program.

We offer a rather stunning illustration to explain why the biggest companies in the U.S. currently trade at such favorable valuations.

If an investor had placed their capital in a basket of common stocks, the S&P 500, during the first 86 months (7 years and 2 months) of the 21st century, the total return after reinvesting dividends averaged 1% per annum.

If one had invested their capital in the S&P 500 at the end of 1929 (as the Great Depression gripped the country), using the same 86 month time horizon, the average annual return was approximately 1% per year with reinvested dividends.

Therefore, it is of little surprise that many investors continue to view large U.S. public companies with suspicion. If one harkens back to the beginning of 2000, the favorable psychology associated with large businesses was overwhelming. The value of what one was holding was of little consideration as long as the prices were ascending. These winds of emotion have reversed course as Great Depression type of returns in high quality U.S. businesses have created great discomfort.

Your Advisor believes the caution and favorable valuations surrounding quality companies such as Wal-Mart, AIG, and Coke, provide your Advisor with a starting point for incorporation into a successful investment program. Now, more on the valuation paradigm.

## PRICE IS WHAT YOU PAY AND VALUE IS WHAT YOU GET - VALUATION

"A pinch of probability is worth a pound of perhaps."
-James Thurber-

According to a study by Thompson Proprietary Research, investors have generally paid between fifteen to twenty times earnings for business in the S&P 500. The research concludes that valuations outside this band have been "rejected by investors over time." As we write to you today, the S&P 500 sells for approximately fifteen times anticipated 2007 profits or the low end of this band.

What has happened? Over a significant period of time, share prices have been flat while earnings have grown tremendously. In fact, we have entered the fifth straight year where profits have risen at a faster pace than share prices. To your Advisor's knowledge, if this trend were to continue in 2007 it would represent an unprecedented occurrence in the modern era.

## PRICE IS WHAT YOU PAY AND VALUE IS WHAT YOU GET - VALUATION

In the past, we have often referenced the Fed Model to assess the relative attractiveness of common stocks vs. high grade U.S. bonds. This is a simple and effective analytical tool comparing the yield on the ten year Treasury note, currently 4.6%, against the earnings yield of the S&P 500, which is now 6.5%. What does the current data communicate to investors? Either Treasury yields are extremely low or equity prices are undervalued relative to bonds by as much as 40%.

The table below highlights a sampling of large U.S. businesses, their earnings growth per share since 2000, and their price to earnings in ratios in 2000 and 2007.

| Company | Annualized Return (2000-2007) | Earnings Growth (2000-2007) | 2000 – PE | 2007 - PE |
|---|---|---|---|---|
| Dell | -11% | 110% | 59 | 20 |
| Microsoft | -8% | 77% | 60 | 20 |
| Wal-Mart | -4% | 130% | 43 | 16 |
| AIG | -1% | 182% | 34 | 11 |
| Coke | -1% | 106% | 39 | 18 |
| McDonalds | +2% | 86% | 32 | 17 |
| Disney | +3% | 168% | 39 | 19 |
| American Express | +3% | 94% | 27 | 16 |

Earnings have clearly grown significantly over the last seven years. Yet the prices of these superior businesses have stagnated as valuations have compressed. In retrospect, they were overvalued and over-loved in 2000. In 2007, these and other similar businesses appear much more reasonably priced and offer good entry points for long-term investors.

## EVERYTHING ELSE

Those who make the best choices in life tend to understand risk, manage it, but not let themselves be controlled by it. There are both wonderful and horrible things that carry low probabilities of occurring. The good stuff tends to take care of itself so we will address a few dark thoughts.

The threat of terrorism on U.S. soil is real and remains of significant concern both personally and with regard to the short-term effect on share prices. Oil may spike to over $100 a barrel. Global warming may doom many coastal communities around the world.

As a Nation, we savor the good times - adapt and find wisdom and strength in our mistakes and unforeseen calamities. The fundamental point is that we make our highest quality decisions based on the most probable outcomes. When it comes to our investment process, the road marked high probability points your Advisor toward the type of large capitalization U.S. stocks we have highlighted in this letter. We look forward to taking the journey together.

## IN CONCLUSION

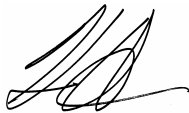
Two thousand six was a notable year for your Advisor. We completed the build out of additional office space at our current location at 731 Alexander Road. Space is nice, (especially as we enter our sixteenth year together), but the dedicated team at AAM is what breathes life into the halls every day. In fact, we are all breathing a little more to get from one side of the office to the other.

We look forward to meeting and speaking with many of you this spring and we strongly encourage you meet with us proactively as life happens and your financial needs evolve. Please make us aware of any changes in your personal and financial situation or investment objectives for the purpose of reviewing, evaluating, or revising our previous recommendations and or services.

Included in your year-end report are profit and loss statements for your current holdings, return information, tax data, a breakdown of fees, and other information that we hope you find helpful. In addition, please find a copy of AAM's Form ADV II, Privacy Notice, and Proxy Voting Policy, which highlight your Advisor's operating procedures.

Have an outstanding spring and hopefully an early summer!

Very truly yours,



Howard Steve George