

Capital Market Review • Third Quarter 2006

The third quarter of 2006 saw many of the major stock market indices near new highs and levels not seen in six years. After a pull back toward the end of the second quarter for many of the hot, high risk sectors of the market, mainly commodities and emerging market equities, the broader market trended higher. The Federal Reserve finally stopped its two year rate hike campaign and the market seemed to react positively to that.

The dramatic fall of oil prices was another contributing factor to the stock market gains with oil falling 17% from \$73.93/barrel at the end of June to \$62.91/barrel at the end of September.

The Dow Jones Industrial Average came close to a new high finishing the quarter at 11,679.07, up 4.7% for the quarter and 9.0% year to date. The S&P had a strong quarter gaining an impressive 5.7% to finish at 1335.85, and the Nasdaq finished at 2258.43, well off its high reached in 2001. Could we be finally seeing what many in the investment community have been calling for, a rotation from smaller companies to larger companies?

The S&P trounced the Russell 2000 for the quarter by over 5% with the Russell only up 0.4%. The third quarter was strong for the bond market with the long end of the market leading the way. The Lehman Brothers Long Government Index was up 6.5% for the quarter. Bond yields pulled back sharply from its high levels in the second quarter. The Lehman Brothers Aggregate Bond index rebounded from its losses in the second quarter with a 3.8% gain.

The quarter provided some important highlights. The Federal Reserve paused leaving the fed funds rate at 5.25% with signs of a slowdown in earnings growth, the cooling of the housing market, and inflation in check. The drop in oil prices ultimately made their job easier. The yield on the 10 year treasury dropped 11% or 51 basis points to close at 4.64% on September 30th. The housing market may be cooling

somewhat, but the other sectors of the real estate market have propelled the Dow Jones REIT Index up 9.2% for the quarter and 24.9% year to date. Commodities were the biggest loser of the third quarter declining 6.5% and are now in negative territory for the year.

The fourth quarter should provide some excitement to see if the stock averages can continue to build on impressive gains in the third quarter, if oil prices will continue to fall, if the Federal Reserve will continue its pause of the fed funds rate, if large company stocks continue to outperform small company stocks, and if real estate can continue its unbelievable run.

STOCK MARKET

The major benchmarks were mostly higher for the quarter with real estate again leading the way. After leading the way in the second quarter, The Dow Jones AIG Commodity Index fell 6.5%. Also after falling in the second quarter The Dow Jones Wilshire REIT Index got back on track gaining 9.2% and up 24.9% year to date. The Russell 2000 fared the worse with a gain of merely 0.4%. It's too early to say if the rotation from small stocks to large stocks is underway, but the S&P 500 had a strong showing returning 5.7%. The Russell 2000 and the S&P are even year to date. For the twelve month period the S&P is up 10.8% beating the Russell's 9.9% return. The MSCI EAFE, major index of international stocks, improved since last quarter to return 3.9% this quarter and 14.5% year to date.

Market Returns

	3 months ended 9/30	1 year ended 9/30
T-Bills	1.3%	4.8%
Lehman Bros. Aggregate Bond Index	3.8%	3.7%
S&P 500	5.7%	10.8%
Russell 2000	0.4%	9.9%
EAFE	3.9%	19.2%
Wilshire REIT	9.2%	28.1%

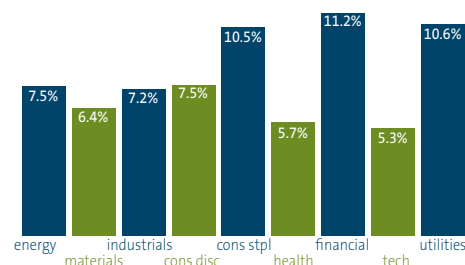
Returns by Equity Manager Style

	3 months ended 9/30	year-to-date ended 9/30
Large Value	5.2%	6.4%
Large Growth	2.6%	2.0%
Small Value	0.2%	7.9%
Small Growth	-2.5%	6.7%
International	3.6%	14.4%
Real Estate	8.3%	15.3%

The third quarter was an improvement across the board from last quarters dismal showing across the board. Every major equity style finished last quarter in the red with small growth dropping the most. This quarter saw five of the six in positive territory. It was more of the same on some fronts. Value continued to outperform growth and real estate lead the way. Just like last quarter large stocks beat small stocks again this quarter. Large value returned 5.2% compared to small value's 0.2%. Large growth trounced small growth 2.6% to -2.5%. International returned 3.6% for the quarter and 14.4% year to date. The Real Estate style continues to amaze returning 8.3% for the three months and remaining the best performing style for 2006 at 15.3%. All equity styles are positive for the year with large growth joining the group with its gain in the quarter.

Stocks by Sector

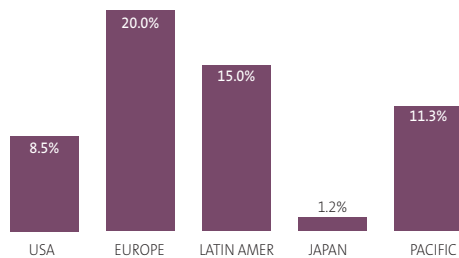
for the 3 months ended 09-30-06



Most of the major sectors were handily stronger in the third quarter with the one exception being energy. The Energy sector pulled back in a major way losing 5.3%

and easily being the worst sector of the quarter. The sector was hurt by the pullback in oil prices. The other two losing sectors were materials and industrials losing 0.6% and 1.0% respectively. The six sectors in positive territory had big returns showing the strength that the upward move for the major indices was broad based. The healthcare sector led the way at 10.1% with technology and financials next at 8.6% and 7.9%. Utilities gained 6.0% and consumer discretionary and consumer staples showing strength with upward moves of 4.9% and 5.5%. All sectors are now up for 2006 between 5.3% and 11.2%. Consumer staples, financials, and utilities are all up over ten percent with the other sectors up between five and eight percent. This is just another indication of the broad based move toward the indices new highs.

Stocks by Region for the 3 months ended 09-30-06

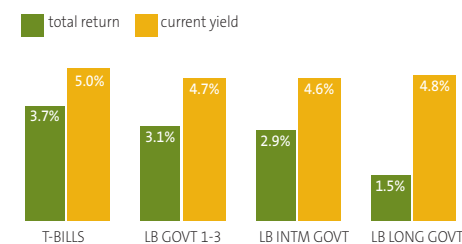


With Japan being the one exception, the other major regions of the world were positive for the quarter. May 2005 was the last time the S&P 500 beat the other regions for a three month period. The S&P barely beat out Europe to claim itself the best performing region this quarter. Japan could not bounce back from a 4.6% loss in the second quarter falling another 0.7% this quarter. Japan barely remains positive year to date with a 1.2% return. The S&P 500 returned a strong 5.7% bringing its total return for 2006 to 8.5%. Europe was up 5.6%, The Far East up 5.1%, and Latin America up 4.4% all had an impressive quarter but still trailed the United States. Europe remains the top region in world year to date with a 20.0% gain leading by 5% over Latin America.

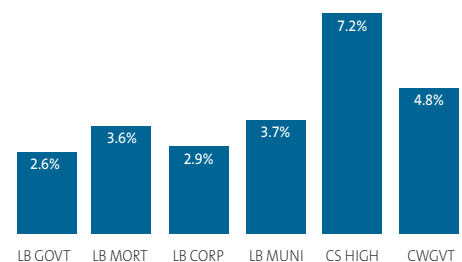
BOND MARKET

The Federal Reserve paused this quarter and kept the fed fund's rate at 5.25% after a two year rate hike period that saw the rate increase from an historical low of 1.0%. Inflation, the weakening of the housing market, falling oil, and a slowdown in the economy seemed to play a part in their decision. The bond market reacted strongly to the news and began looking forward to 2007 in anticipation of interest rate cuts. The yield on ten year treasury fell 51 basis points from 5.15% to 4.64%. The market may have already priced in two interest rate cuts next year. The bond market's returns were positive for the quarter from the shortest to the longest maturities. The Lehman Brothers Aggregate Bond Index gained 3.8% for the three month period bouncing back from a loss in the second quarter and is now up 3.1% year to date. T-bills returned 1.3% for the quarter with short and intermediate government bonds gaining 2.0% and 2.9% respectively. The long government was the best performer by far with a 6.5% advance but trails t-bills, short, and intermediate governments year to date.

Bonds by Maturity for the 3 months ended 09-30-06



Bonds by Sector for the 3 months ended 09-30-06



The third quarter provided gains for all sectors of the bond market propelling them into positive territory year to date. High yield bonds, tracked by the Credit Suisse High Yield Index, posted a 3.5% return for the quarter making it the best sector year to date at 7.2%. Improving on its strong return last quarter, World Government bonds returned another 0.9% this quarter behind junk bonds year to date with a 4.8% gain. Governments, Mortgages, Corporates, and Municipals all had strong quarters with the Corporate bond market leading the way with a 4.5% return. Governments at 3.5%, Mortgages at 3.6%, and Municipals at 3.4% trailed closely behind. As the numbers show the rally in the bond market was impressive and broad based

COMMODITIES MARKET

The quarter was anything but kind to the commodities market with Dow Jones AIG Commodity Index losing 6.5%. The index is now negative for the one, three, six, nine, and twelve month time periods. The returns are -6.0%, -6.5%, -0.8%, -3.2%, and -6.1% respectively. Commodities were hurt by a sharp decline in the price of oil in the quarter until it finally settled at \$62.91 per barrel. The price per barrel of oil topped out in July at \$78.40 and then fell 25% by quarter end. Natural gas also posted a loss of 8% during the quarter. Gold was down slightly and copper was unchanged and both had little impact on the index. Silver was one of the bright spots in the commodities market rising 5.7%.

CURRENCY MARKET

The U.S. dollar has remained strong against the Euro and Yen even after the rate increases which boosted its value stopped. The dollar gained 0.9% against the Euro for the quarter and 3.7% against the Yen. The Euro and Yen have been stronger year to date gaining 7.1% and 0.2% respectively. Many analysts on Wall Street believe that as the economy slows, the dollar will begin to lose ground to the Euro and Yen. ■

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