BERNARDI SECURITIES, INC.
105 West Adams Street, Suite 1900, Chicago, IL 60603
Office: 312-726-7324 Fax: 312-726-1431
www.BernardiSecurities.com

The Year In Review

The U.S. economy experienced events in 2005 that few people expected.

- **Oil prices reached a high of $70 per barrel; commodity prices soared.**
- **One of the most devastating natural disasters in our history occurred.**
- **The housing market cooled.**
- **The Dow Industrial Average ended the year with the smallest annual move in 79 years.**
- **The NASDAQ gained only 1.4%.**
- **The S & P 500 index rose a modest 4.8%.**
- **Our budget deficit ballooned**

Ronald P. Bernardi
President

And yet, in spite of all this negative news:

- **The unemployment rate hovered around 5%.**
- **The economy grew at an approximate 3.5%-4.0% annual rate.**
- **Inflation remained low as labor productivity continued to improve.**
- **A record number of new jobs were created in 2005; 200,000 per month on average.**

2005 was full of surprises. It was a trying year for bonds. The Federal Reserve Bank significantly increased the overnight interest rate it charges member banks. The Fed has increased its overnight lending rate 9 times since it reached its low point of 1% in 2004. Today, the rate stands at 4.50% making 2005's GNP growth rate of 3.5%-4.0% impressive. Short-term interest rates increased significantly as a result of the Fed increases, while the yield on the 10-year Treasury bond remained about the same in 2005. We are once again reminded that interest rates do not rise or fall equally across all parts of the yield curve. At year-end, there was an inverted yield curve: short term rates at higher levels than long-term rates. Normally, the yield on a 10-year Treasury bond is ¾ of 1% more than the 2-year yield. As of this writing, the 2-year bond yields 10 basis points more than the 10-year bond.

We do not see this phenomenon often and often it signals an economic slowdown; every post war recession was preceded by an inverted yield curve. A recession, of course, can lead to lower corporate profits, a stock market decline and lower interest rates. We will have to wait and see if this historically accurate indicator predicts our economic future correctly in 2006-2007.

WHY BONDS?

Here is data on various asset class performance from 1984-2004*:

- 5 Out Of 21 Years (24%), Bonds Ranked Number One Asset Class Returning Anywhere from 8.95%-15.15%
- 8 Times (38%) During This Period, Bonds Produced Double Digit Returns (10.27% - 22.13%).
- Only 2 Years (1994/ -2.92%, 1999/ -0.83) Produced Negative Bond Returns
- After Negative Return In 1994, Bonds Rebounded To Return 18.48% In 1995; After 1999 Negative Return Bonds Returned 11.63% In 2000.
- 13 Times (62%) Bond Returns Were 8% Or Greater.
- Only 3 Years (14%) produced bond returns of less than 3%
- Large Cap Growth Stocks LOST over 70% from 2000-2002.
- Large Cap Value stocks LOST 14% from 2000-2002.
- Small/Mid Cap stocks LOST 12% from 2000-2002.
- International Stocks LOST over 50% from 2000-2002.
- Bonds produced a cumulative return of 30.3% during 2000-2002 and an 18.7% return 2002-2004.

This data demonstrates the need for bonds in a diversified portfolio.

Investors own Bonds for:

- Income – Most bonds provide investors with income on a consistent basis. This income is usually greater than the average stock dividend. Fixed income investments must pay the interest payments due; equity investment dividends are discretionary.

- Diversification – The performance of equities and fixed income investments have a low correlation. When the equity sector is having negative returns, bonds can help offset the losses by stabilizing the portfolio and increasing total return. Usually when the stock indices are experiencing negative returns the fixed income markets produce positive returns.

- Protection – Typically, during periods when the economy is experiencing low or zero growth the stock market loses value. In those periods bonds continue to pay out income and might even appreciate.

  - Municipal bonds offer more stability to a portfolio. They typically hold their value better than taxable bonds when rates rise and bond prices fall.

- The standard deviation for the Lehman Brothers Aggregate Bond Index for a 20-year period ended 12-31-03 was 4.66%. The standard deviation for any equity segment was greater for the same time frame.

**Source: Zephr Associates Inc.; Bonds measured by Lehman Brothers Aggregate Index.*

There is less overall risk in losing your principal in bonds versus stocks and there is a low correlation between stock and bond returns.
As the data demonstrates, years 2000-2002 remind us all of this fact.

It was not a terribly exciting year for bond investors; nor was it a disaster. Fund managers willing to bet on longer maturities and lower credits generally produced the best bond returns in 2005. Long term, high yield (aka junk) funds posted the best returns, while the average short/intermediate municipal fund returned 1.06% per Lipper. Bond returns were generally low in 2005, but the anemic bond returns posted by the Lehman indices equaled the low returns of many stock indices.

Here are 2005 performance numbers for several bond indices:

- Lehman 10-year Taxable Government +2.74%
- Lehman Intermediate Taxable corporate +1.42
- Lipper General long-term municipal fund: + 3.00%
- Lipper short-intermediate municipal fund: + 1.06%
- Lehman 10-year Municipal +2.74%
- **Bernardi Intermediate municipal composite: + 3.46%**

We are pleased with the performance of the Bernardi composite portfolios. Please visit our website www.bernardisecurities.com for further details.

Where are we going?

The consensus view for interest rates in 2006 is that short/intermediate maturities will outperform longer maturity issues; yields on shorter maturity issues will decline (prices increase) as the Federal Reserve stops rising or even begins lowering it overnight lending rate. If this occurs, the current flatness in the yield curve will begin to reverse itself. We will have to wait and see about all of this, of course.

We believe, a reasonable non-taxable bond return target for a short/intermediate term portfolio in 2006 is 3.25% - 4%.

This translates into up to a 6% taxable equivalent yield for a top taxpayer.

Not too shabby when compared to major stock indices returns in 2005.

In the meantime, we will continue to manage client portfolios following several basic, time-tested principles:

- **Review your Investor Profile document; make any needed changes.**
- **Invest in quality bonds as these funds represent "mattress money".**
- **Understand the credits you own; receive updated financials.**
- **Ladder the portfolio with intermediate term maturities; forget timing the market.**
- **Invest in undervalued issues; focus on finding value in the right part of the yield curve.**
- **Keep upfront and ongoing costs low.**
- **Manage the portfolio actively and take advantage of market inefficiencies and opportunities to increase portfolio income.**

In our experience, if you follow these principles, you will succeed in the bond market. This has been our approach for many, many years.

It is an approach that works and one that has served our clients well as shown by the above average performance of Bernardi Securities composite portfolios over the years.

We thank you for your continued confidence in our portfolio research and management process.

As always, please call us with any questions or comments.

Ronald P. Bernardi
Bernardi Securities, Inc.
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The information herein has been taken from sources we believe to be reliable and is presented without representation as to accuracy or completeness. Past performance is no guarantee of future results. Our opinion constitutes our judgment as of the date a bond is placed into a client's portfolio and is subject to change without notice.