GV Financial Advisors E-Update

X-Factors
January 25, 2006

"Nothing is certain except death and taxes" goes the old maxim. We would add one more notion to this pantheon of certainties: at the beginning of any given year, we do not know what subset of all possible phenomena – call them X-factors – will have the biggest impact on the markets and the economy. We know, for example, that every year hurricanes batter the coastlines of Gulf and Southeastern states. We didn't know, at the outset of 2005, that (to the dismay of a number of eponymous females) "Katrina" would become a byword for massive devastation, acute social tensions and ham-handed governmental crisis management.

So here we are now at the beginning of 2006 and the markets decided to call me off the slopes of Aspen to remind us again of the perils of forecasting. Black Friday came not on the 13th, as superstition would have it, but exactly one week later as we witnessed the largest one-day market downturn for several years. The bellwether S&P 500 index lost 1.8%, the most since a 1.9% decrease on September 24, 2003. The NASDAQ index was off 2.35% - also the largest since losing 3.2% on that same September 24. The elusive 11,000 level seems to be for the Dow what the walls of the City of Vienna were to the Ottoman Empire in 1683 – not breachable for a sustained run, as the blue chips took a retreat to the 10,667 level on Friday before covering more positive ground again the ensuing Monday.

Notable among competing 2006 X-factors is an unsettling trend of developments in Iran under President Mahmoud Ahmadinejad. Since taking office in August 2005, Ahmadinejad has demonstrated a remarkable ignorance of the potential global consequences of statements and viewpoints he puts forward. During the course of the week preceding Friday's sell-off a succession of blustery assertions came out of Iran – threats to suspend oil exports, to transfer assets out of European banks that might freeze them, and to end compliance with international inspections of suspected nuclear facilities.

The reality of Iran's domestic situation, however, would argue for the logic that the country is too revenue-dependent on oil sales to follow through with all the tough talk. The country's population has more than doubled in the past 35 years, from 29 million in 1970 to 69 million in 2005 (according to the International Database of the US Census Bureau). Poor economic performance has produced rampant unemployment with estimates as high as 25% and chronic social problems including widespread drug abuse among young unemployed Iranians. We would not minimize the major foreign policy challenge posed by reactivated Iranian nuclear facilities – but short-term traders tend to throw the baby out with the bathwater on the basis of emotional reaction more than studied consideration.

We do, however, see the potential for more volatility than the markets have experienced in recent years, and this can produce a flight to quality in both equity and debt markets. High-quality mega-cap stocks have underperformed small- and mid-cap names for several years, a trend we think is due for a reversal both for cyclical reasons and because large high-quality securities with strong cash flow positions tend to become more desirable in periods of higher volatility. Our asset allocation strategy for 2006 reflects this thinking.

Indeed, the present market environment underscores the importance of our commitment to patience, discipline and diversification. Take the case of Japan, another story currently in the news. The Nikkei 225 index returned just over 50% for the full year 2005, but in the first 13 trading days of 2006 the market has suffered three one-day trading losses of 2% or more. That's why risk-adjusted returns mean so much more than simple returns, and why it pays to diversify away non-systematic risk through broader market exposure. We think of portfolios as being like well-constructed elevators – having six or seven support cables as opposed to just one can sometimes slow down the ride, but it certainly makes for a more comfortable landing when one cable snaps.

With warm personal regards,

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GVFA 2006 0004
DOFU: January 2006

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