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# FREDERIC T. KUTSCHER ASSOCIATES, INC.

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*Comprehensive financial counsel for individuals, families and trusts*

February 3, 2006

In December we sent you Parker Hall's article that provided a perspective on the economy's resilience through the decades. The year 2005 fits well within this context, as we've faced the high hurdles of rising interest rates, spiking energy costs, natural disasters (including Katrina and Rita), high trade and budget deficits, and military operations in Iraq and Afghanistan.

Despite these challenges, the US economy grew in 2005 at a rate about twice that of most of Europe, providing healthy corporate profits, adding nearly 200,000 jobs a month, and lifting hourly wages by 1.1% more than in the previous business cycle peak in early 2001 (after inflation).

Why, against this robust economic backdrop, did most US stock and bond markets deliver only mediocre returns? One explanation is that buyers of stocks and bonds try to anticipate future events, and concerns abide about the effects of the twin (fiscal and trade) deficits, the long-term unfunded liabilities of Social Security and Medicare, increasing global competition, lagging US education performance, the end of cheap oil and ongoing unrest in the Middle East. Most classes of US stocks failed to match the 70-year historical annual average of 11% return. However, your portfolio's positions in foreign stocks and small US stocks provided both diversification and enhanced investment returns.

The enclosed Capital Markets Review, our annual effort, illustrates how asset classes are far from homogeneous, how your asset classes have performed over the five and ten year periods and why we diversify. You may also notice by glancing at the charts that all asset classes had positive returns last year except for foreign bonds.

As always, we invite you to call us with questions and we look forward to working with you on your financial matters in the year to come.

Sincerely yours,

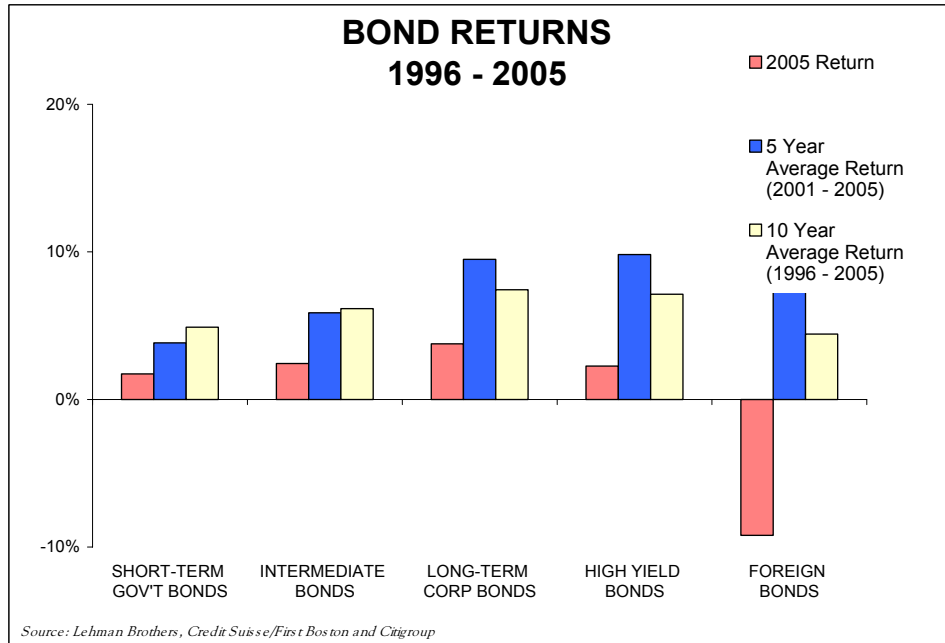
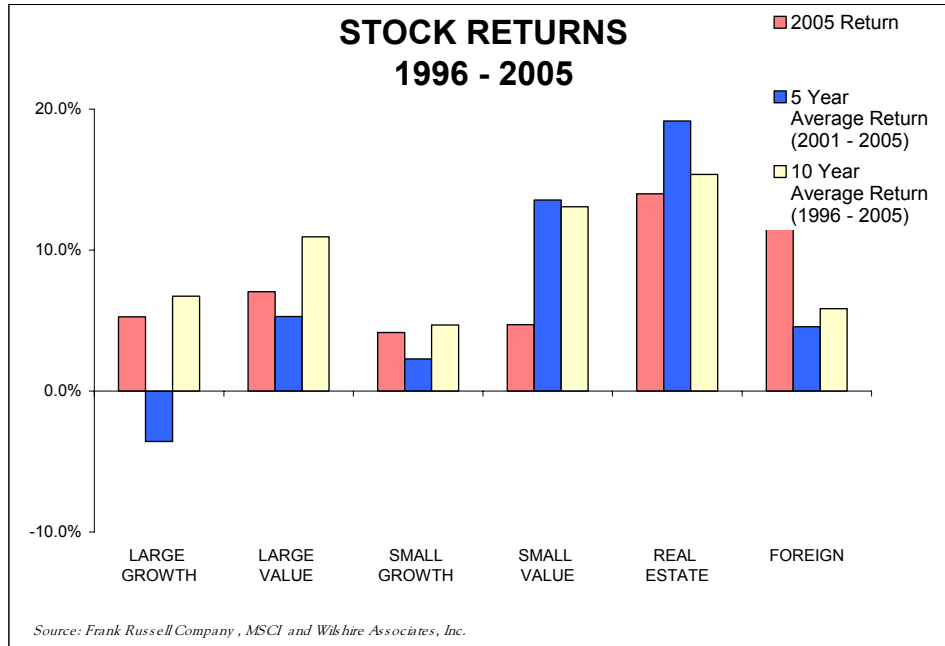


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P.S. As tax time approaches, a reminder: each year, we send to your tax accountant information that will be helpful for preparing your tax return. We'll send this information to you if you prepare your own tax return. Please let us know if anything has changed with respect to your tax preparation arrangements since last year.

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# CAPITAL MARKETS REVIEW



**TOTAL RETURNS  
(annualized)**

**1 year      5 years      10 years**  
(2005)      (2001-2005)      (1996-2005)

**COMMENTS**

<b>EQUITIES (Stocks &amp; Real Estate)</b>				
US LARGE-CAPITALIZED GROWTH COMPANIES	5.3%	-3.6%	6.7%	Large-cap growth stocks bested small-cap growth stocks in 2005 ending a six year run of small-cap stocks' outperformance. Notably, Google with its large capitalization had a starring role and strong influence on the index.
US LARGE-CAPITALIZED VALUE COMPANIES	7.1%	5.3%	10.9%	Large company value stocks' returns surpassed those of large growth stocks in 2005 and in the five and ten year periods. Despite accelerating results at the end of the year by growth stocks, value's early outperformance won the year.
US SMALL-CAPITALIZED GROWTH COMPANIES	4.2%	2.3%	4.7%	Small-cap growth stocks had the weakest performance of all major equity categories in 2005 and over the last ten years.
US SMALL-CAPITALIZED VALUE COMPANIES	4.7%	13.6%	13.1%	A negative return for December caused small-cap stocks to finish the year with a lower return than large-cap stocks; however, this year did not reverse the cumulative effect of exceptional returns over the last five and ten years.
REAL ESTATE EQUITIES	14.0%	19.2%	15.4%	While winning the beauty contest of the 2001-2005 period, securitized real estate had been an ugly duckling in the late 1990s. Returns in 2005 may have been twilight reflections of the low interest rate environment of the early 2000's when investors shunned large companies and technology stocks in favor of alternative classes like real estate. But this cyclical asset class's party may be over for now.
FOREIGN STOCKS	13.5%	4.6%	5.8%	In their local currencies, foreign stocks provided returns of over 30%, which a strengthening US dollar brought down to 13.5% - still an excellent showing, and this in spite of some tepid or weak foreign economies. Bright stars were Canada (natural resources and energy) and Japan.

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**COMMENTS**

**CASH EQUIVALENTS**

CASH – MONEY FUNDS	2.6%	1.8%	3.4%	Even though in 2004 and 2005 the Federal Reserve increased short-term interest rates 13 times successively, money market interest rates lagged behind inflation rates, making real returns negative.
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**BONDS**

SHORT-TERM GOVERNMENT BONDS	1.7%	3.8%	4.9%	The Fed's raising short-term interest rates damped bond prices because bond prices move inversely to interest rates. These price declines left the index with a total return that was about a third less than that cash (even after interest).
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INTERMEDIATE BONDS	2.4%	5.9%	6.2%	Although over the five and ten year periods intermediate bonds performed within historical norms, 2005 marked another year of low, but not negative, returns. Fluctuating opinions about inflation forecasts and the Fed's march toward higher short-term interest rates created an environment where intermediates finished slightly lower than the T-Bill Index of 3.1%.
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LONG-TERM CORPORATE BONDS	3.8%	9.5%	7.4%	In 2005 long-term corporates returned 3.8%, an unrewarding return considering the higher risks involved with corporate debt. However, for the ten-year period, this index still led the pack with a respectable average annual return of 7.4%
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HIGH-YIELD BONDS	2.3%	9.8%	7.1%	The high-yield index finished the year with a 2.3% return, another example of why 2005 was not a good environment for the riskier classes of bonds - as high yield bonds typically are issued by companies with a weak financial situation.
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FOREIGN BONDS	-9.2%	7.3%	4.4%	In local currency terms, foreign bonds would have produced positive returns, but the 15% strengthening of the US dollar left the foreign bond index with a -9.2% return in 2005. Conversely, over the five-year period foreign bonds benefited from a weaker US dollar.
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