THORNHILL SECURITIES, INC.

THE LONG VIEW

A periodic review of research, topics and performance for long-term investors

Asset Returns

October 2006

September 30, 2006	YTD	2005	2004	10 Year	20 Year
Domestic stocks					
Large	8.7	4.8	10.7	10.7	13.2
Large Value	13.4	6.9	16.1	11.9	13.6
Large Growth	3.0	5.1	6.1	9.6	12.6
Small	8.7	4.5	18.2	10.7	11.8
Small Value	13.2	4.4	22.1	14.4	14.1
Small Growth	4.2	4.0	14.1	7.4	9.5
Micro Cap	6.0	5.7	18.4	15.4	14.5
International stocks					
Large	14.0	13.3	19.0	7.9	12.2
Large Value	16.9	14.4	24.9	10.2	14.5
Large Growth	11.6	13.6	16.5	5.6	10.0
Small	10.9	22.0	30.9	11.5	-
Small Value	13.1	23.2	34.8	12.5	-
Emerg. Mtks.	9.7	32.6	24.6	11.3	-
EM Small	13.5	25.8	28.9	-	-
EM Value	16.1	30.8	39.5	-	-
Sectors					
U.S. REITs	23.3	8.9	30.2	16.7	12.3
Energy	7.3	40.2	33.9	16.8	14.9
Bonds					
Short Term	3.5	2.3	0.9	4.3	4.6
Five Year	2.8	1.7	2.9	6.2	7.5
Long Bond	1.2	6.6	7.1	7.9	10.3
Total Market	2.9	2.4	4.3	6.2	8.0
Other					
Inflation	-	3.4	3.3	2.5	3.0
Comm. RE	-	14.5	16.1	11.8	8.0
Residential RE	-	8.3	13.5	6.6	5.5
Hedge Funds	-	2.7	2.7	9.9	-
Commodities	-	18.9	12.5	5.6	5.9

SOURCES:
Large Cap data is based on S&P 500 returns.
Large Value and Growth returns are based on Russell 1000 Value and Growth data.
Small Cap, Small Value & Small Growth are based on Russell 2000, R2000 Value and R2000 Growth data.
Micro Cap returns are based on the CRSP 9-10 index of the smallest publicly traded stocks.
Int'l Large, Large Value and Large Growth are based on MSCI's EAFE Indexes.
International Small & Small Value returns are based on small company data in developed markets from DFA.
Emerging Markets data is from MSCI's Emerging Market.
Emerging Market Value and Small Cap data is based on Indexes maintained by DFA.
REITs are based on the Wilshire REIT index.
Energy data is from S&P's energy index.
Short term bonds are represented by Lehman's index.
Five year bonds are five year treasury returns and long term bonds are 20 year treasuries.
Total Bond market is the Lehman Aggregate Index.
Other data comes from the Federal Reserve, National Association of Realtors, HFRI & the CRB.

Thornhill Securities, Inc.
336 South Congress, Suite 200
Austin, TX 78704

Editor: Gabe Thornhill, CFA

Introduction

This is my first newsletter, so I thought I'd outline my mission and expectations in sitting down to write a regular piece for our clients. In the newsletter, I will examine the underlying principles of our investment management philosophy at Thornhill Securities, Inc. Additionally, I expect to review alternative strategies and keep you informed on research regarding the markets and the investment management business. If our strategies or market understanding change over time, I expect to explain the reasons for those changes and discuss the process and research leading to those changes.

The newsletter should help clients understand our process and philosophy. Additionally, it should serve as a point of reference during discussions with clients about our foundational beliefs. Examples of possible topics include Emerging Markets, Commodities, Hedge Funds, Fund Family comparisons, Prudent Investor Rules, an analysis of actual investor returns, and a discussion of "What is Indexing?"

Writing the newsletter will also help to clarify my thinking about our philosophy and ultimately be fun, in a financially geeky sort of way. New insights into the markets or investment strategies, can be shared with our client base as a whole.

I welcome any suggestions or feedback on the newsletter, especially topics you would find interesting. I've chosen to review active versus passive management in this first newsletter because passively managed funds are so central to our investment management philosophy.

Active vs. Passive Investing – A Home Study Guide

As a result of my research and my experience, I am convinced passive funds generally outperform active funds. Additionally, there is no reliable means to determine which active funds will outperform in the future. However, statistics suggest that funds with recent strong performance and large asset flows will almost certainly under-perform going forward.

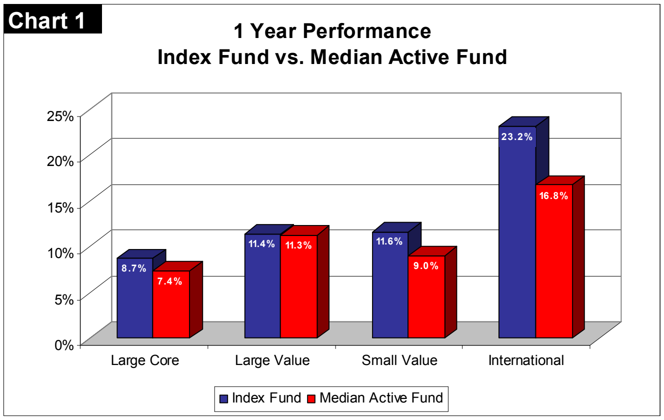
Despite this fundamental belief in the value of passive vs. active management, the media bombards us with a contradictory message on a daily basis. Every business publication has a list of hot funds and a discussion of their top picks and strategies for outperformance. Television and radio shows discuss stocks and ideas for profiting in the markets and often have strong numbers to support their cases.

How do you maintain your convictions when the daily barrage of information tells you otherwise? Why believe that passive investing is a better long-term strategy than active investing when the media tells you differently? Why not look at the data and see what the numbers reveal? I decided to do just that, using the tools and data available on the Yahoo! Finance website.

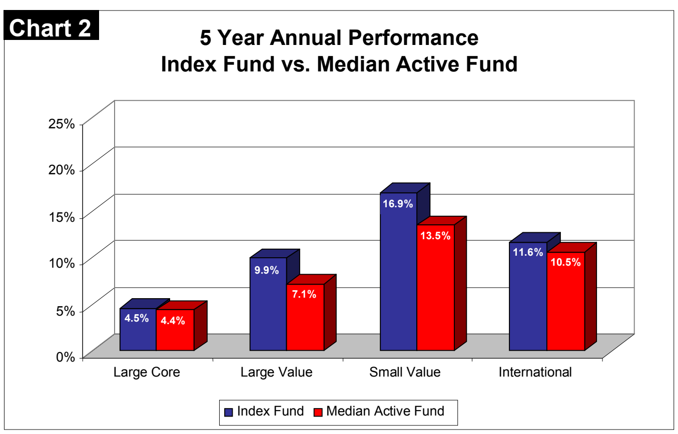
Yahoo! Finance[1] Fund Performance Review
The Yahoo! Finance website provides decent screening tools for mutual funds and a range of performance data. Although the site has some limitations (survivorship bias, limited screening options, possible style drift, incomplete list of funds, etc.), it can be used for a simple reality check for the active vs. passive debate.

continued on next page…

I used the site to screen for funds in 4 asset classes, large cap core/blend, large cap value, small cap value and international core. I pulled data on all the funds that met certain criteria (history, size, and asset class) and eliminated any duplicate funds or funds without 5 years of history. Charts 1 and 2 summarize the one and five year data.



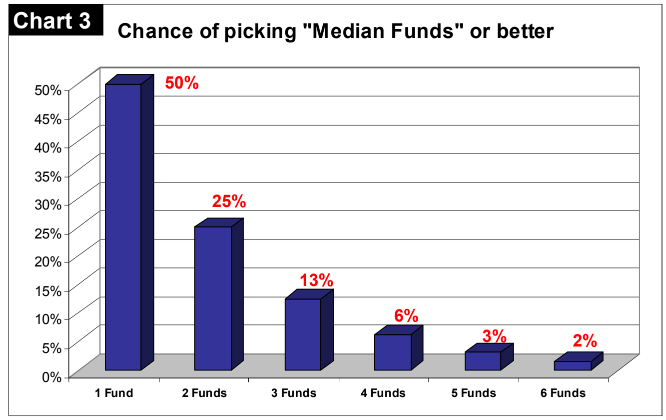
Even in this limited study, index funds outperform comparable median funds in every asset class across one, three and five years. Additionally, the study supports one of the observations I find most interesting in the active vs. passive debate, ***"When an asset class does relatively well, an index fund in that class usually does even better."***[2] International stocks were the best performing asset class over the last year, up 23.2% (based on their index.) However, the median fund trailed the index by 6.4%. Over 5 years, small value was the highest performing asset class, up 16.9% annually. The median small value fund underperformed its' benchmark fund by 3.4%.



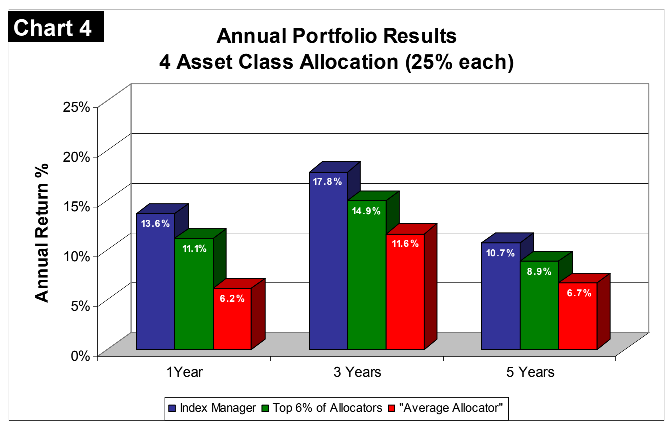
Why the large difference when an asset class performs well? The answer is style drift. Although funds typically have specific investment objectives and "Style Boxes," fund managers often drift out of their style box. This is helpful when the asset class is performing poorly, i.e. small cap value going into early 2000. However, it's a real problem if the asset does very well.

Multi-Asset Class Portfolio

This simple review of fund performance is also instructive if you consider the impact on a diversified portfolio with multiple asset classes. Effective diversification includes diversification within asset classes and across asset classes. Assuming you use mutual funds to achieve asset class diversification, the performance drag from active management becomes even more of an issue. Chart 3 shows the odds of picking median or better funds in each asset class as the number of asset classes increases.



We can use our study results to see the impact of active management on a diversified portfolio. Our theoretical portfolio includes 25% allocations across the asset classes we reviewed for this study and doesn't rebalance. Chart 4 shows the 1, 3, and 5 year results for an index portfolio, a theoretical portfolio put together by a very good fund picker, and a median portfolio. Since there is only a 6% change of being above median in all 4 categories, investors would have to be exceptional fund pickers to achieve median results in all 4 asset classes. This accomplishment would put them in the top 6% of the people randomly picking funds from this list. However, portfolio performance would still be 2-3% below the index portfolio in each time period.



A more likely scenario would be average fund picking skill across the 4 asset classes. In this case, an investor could achieve median performance by picking in the top 85% of funds across all 4 asset classes. However, since their funds are now likely to outperform only 15% of their peers, the combined performance suffers. Chart 4 shows this portfolio as the "Average Allocator."

In using index funds for our investment management strategies, we are applying the lessons from an extensive body of research over the last 20-25 years that proves the benefits of passive management. However, you don't have to be a PhD at the University of Chicago to do your own due diligence on the active vs. passive debate.

Gabe Thornhill

---

[1] http://finance.yahoo.com/, go to the "Investing" tab and then to the "Mutual Funds" tab. There is a fund screener tool that will allow you to pick funds by a range of criteria.

[2] *The Intelligent Asset Allocator* by William Bernstein is an excellent resource for those interested in an thorough discussion of asset allocation principles.