



January 22, 2007

To: Our Friends and Clients

From: Robert Bingham, CFA
SKY Investment Group LLC

Re: Fourth Quarter 2006 - Review and Outlook

“100 percent of the information you have about any business reflects the past, and 100 percent of the value of that business depends on the future.”

Bill Miller, CFA, Chairman and Chief Investment Officer, Legg Mason Capital Management, Inc.

Fourth Quarter 2006 Review

Equities closed the fourth quarter and year on a strong note with the S&P 500 advancing 6.7%, bringing full year returns to 15.8% (including dividends). Among major S&P 500 sectors, Energy and Materials led the market during the quarter, each advancing roughly 10.7%. Following closely was Consumer Discretionary which advanced 9.8% - a surprise given the rampant pessimism about the consumer that prevailed all year. For the year, the leading sectors were Telecommunications (+32.1%) and Energy (+22.2%). Laggards for the year were Healthcare (+5.8%) and Information Technology (+7.7%).

Prices of bonds were stable during the quarter. Consensus grew among investors that the economy was slowing and the Federal Reserve would begin to lower rates sometime in the middle of 2007. Reflecting this, the Lehman Brothers Intermediate Government / Corporate Index (LBIGC) advanced 1.0% during the quarter. Municipals advanced too, with the Merrill Lynch Intermediate Municipal Bond Index (MLIMBI) rising 0.75%. For the year, the LBIGC advanced 4.1% and the MLIMBI advanced 3.8%.

Commentary

Following 5 years of easy money by central bankers worldwide, 2006 is likely to be viewed as a transition year by economic historians. While the U.S. Federal Reserve had been raising rates for several years prior to 2006, excessive Asian liquidity thwarted the Fed's efforts to bring inflation under control. The Chinese policy of pegging the yuan to the U.S. Dollar and the Bank of Japan's aggressive promotion of liquidity to stave off deflation in Japan were major contributing factors. It wasn't until the Bank of Japan drained its banking system of excess money and started to raise interest rates and the Chinese allowed their currency to float higher relative to the U.S. Dollar that the "inflation genie" began to climb back into the bottle. Other central banks joined in with their own tight money policies, and the inflation fears and commodities boom finally appear to be coming under control.

It is ironic that, in a world where corporations and investors understand the potential risks and benefits of globalization, central bankers view their policy activities so parochially. If there is anything that should be learned from the rampant commodity inflation of the last few years, it is that monetary policy needs to be synchronized across major economies if it is to “move the needle” in a world of globalized financial markets. It was only after every major central bank worldwide started to raise interest rates that the asset bubbles started to recede. As of this writing, housing markets have begun to correct, oil prices have started to revert to more rational levels, and gold is down substantially. We would expect that other bubbles will start to recede too, especially if Japan makes headway in raising rates during 2007 and the Chinese allow the yuan to float higher in price versus the U.S. Dollar.

Outlook and Investment Strategy

Companies doing business globally are well positioned to prosper in the current investment environment...

Several factors are likely to drive the investment climate in 2007. The U.S. trade deficit is large relative to the size of the U.S. economy, and the dollar is likely to remain weak as politicians and their agents work to establish a sustainable framework for trade with China. This should benefit large, U.S.-based exporters selling into growing markets overseas. It should also have a positive effect on the earnings of global enterprises that conduct a large portion of their business in non-U.S. markets - their earnings will translate back into inexpensive U.S. Dollars and inflate their earnings from the perspective of U.S. investors. Companies doing business globally like United Technologies, Procter & Gamble and Coca-Cola should benefit from the weak U.S. Dollar.

...with companies selling services to the energy industry especially well positioned.

The world is awash in petrodollars stemming from the high price of oil in recent years. Petroleum producers are likely to continue to invest a sizable portion of their profits in new oil and gas production and infrastructure. As a result, oil service companies should continue to see growing demand for their services. The problems faced by British Petroleum in Alaska (pipeline failure) and Texas (refinery explosion) suggest that maintenance spending was inadequate during the oil industry's lean years and will need to be ramped up in the years ahead. Companies such as Halliburton should benefit from this increase in energy infrastructure spending.

Companies that facilitate the convergence and distribution of information on the Internet appear likely to benefit from the rapid growth and evolution of the worldwide Web ...

Digitization of information and media, and its convergence on the Web is moving forward at a torrid pace. We expect this to cause capacity constraints and necessitate the upgrade of hardware and software across the Internet. Distribution of media is also moving to the Internet, attracted by its disruptively lower cost structure. This migration is driving network capacity utilization higher and the transition of Internet access from slow speed to high speed. The success of phone and cable companies that offer bundled packages of wireless and wireline phone service, digital TV and high-speed Internet service is accelerating convergence. On the application side, the success of Apple's iPod and Google are driving otherwise conservative media companies (like newspapers) to accelerate their positioning on the Web. Not to be left out, traditional content producers like CBS, Viacom, NBC and Disney are refining their Web-based distribution models so as not to be left behind like the music industry was eight years ago. Microsoft's new operating system (Vista) should facilitate digital distribution because as users upgrade to Vista, they will be forced to invest

in new computer systems with the “horsepower” to take full advantage of the digital media feeds that will be piped into homes via the Internet. After seven years of underperformance, we expect Communications and Information Technology will again become a source of economic and stock market strength.

...and remarkably, growth stocks are still cheap relative to slower growth sectors of the financial markets.

During 2007, corporate earnings growth is likely to slow, as higher interest rates and weakness in housing work their way through the economy. High commodity prices have given a boost to corporate earnings, too, and as excess global liquidity recedes, we would expect earnings of commodity producers to stabilize or decline. Valuations of assets globally have converged, with little premium being paid for quality and growth. Looking forward, it is likely we will see Price / Earnings (P/E) multiples expand for higher-quality, faster-growing companies when corporate profit growth slows. It has been quite a few years since long-term, above-average corporate profit growth was rewarded by investors. We expect that 2007 may be the year that investors begin to pay special attention to above-trend growth and reward it with a premium valuation. P/E multiples have been contracting since 2000. We expect that with interest rates and inflation likely to fall, and corporate earnings growth slowing, these may be the catalysts to “jumpstart” a cycle of P/E expansion for quality growth.

With growth cheap and cash abundant globally, investors will unlock value where they find it.

With so much cash trolling the world looking for investment, private equity firms are able to raise substantial sums of debt at reasonable cost to pursue large acquisitions. Corporations are generating large amounts of cash from operations, and because of outsourcing, don't need to invest as much of that cash in production facilities. As a result, cash is piling up on the balance sheets of many corporations. With many companies underleveraged (and undervalued), private equity firms will continue to take firms private. This trend should continue until valuations on stocks move higher, liquidity in the hands of prospective buyers is reduced, or both. UBS, Citigroup and other investment banks should continue to benefit from the rapid pace of merger and acquisition activity we witnessed in 2006.

Recent changes to portfolios

In November we added Cisco Systems to growth-oriented client portfolios. After several years of rapid application growth and carrier consolidation, Internet capacity appears to be in need of upgrade. According to a recent Frost & Sullivan survey commissioned by Amdocs Corporation (August 2006), telecommunications service providers project a 33% increase in network infrastructure spending during 2007. Internet users are also likely to upgrade equipment in the months ahead as they seek to take advantage of new applications which facilitate the transmission of digital content.

Dividend increases

Dividends are an important source of return to stock investors, representing roughly 50% of equity returns over the last 60 + years. In recent years, dividend growth across many of our core holdings has been robust. 2006 was no exception. Cumulative and annualized dividend increases for the period from 1/1/1999 to 12/31/2006 for our 10 largest positions are listed below. Given companies' ample cash resources, we expect 2007 to be another good year for dividend growth.

Stock	1/22/07 Price	Annual Dividend 1999	2006	Current Yield	Cumulative Increase	Annual Increase
Altria	\$87.1	\$1.80	\$3.26	4.0%	81.1%	8.9%
Coca-Cola	\$48.0	\$0.64	\$1.24	2.6%	93.8%	9.9%
Exxon Mobil	\$72.9	\$0.84	\$1.28	1.8%	53.3%	6.3%
General Electric	\$36.8	\$0.47	\$1.00	3.1%	114.3%	11.5%
Hewlett Packard	\$42.0	\$0.32	\$0.32	0.8%	0%	0%
Johnson & Johnson	\$67.2	\$0.55	\$1.46	2.2%	167.0%	15.1%
PepsiCo	\$64.8	\$0.53	\$1.12	1.8%	111.3%	11.3%
Procter & Gamble	\$65.7	\$0.59	\$1.21	1.9%	106.0%	10.9%
T. Rowe Price	\$47.4	\$0.20	\$0.49	1.4%	145.0%	13.7%
United Technologies	\$64.1	\$0.38	\$1.01	1.7%	167.1%	15.0%
Average					96.5%	10.1%

(Source: Bloomberg)

As always, we welcome your questions and comments.

Apple Inc. (\$86.79, 1/22/07)
CBS Corp Cl. B. (\$31.34, 1/22/07)
The Coca-Cola Co. (\$48.03, 1/22/07)
Google Inc. Cl. A (\$480.84, 1/22/07)
Johnson & Johnson (\$67.18, 1/22/07)
Procter & Gamble Co. (\$65.72, 1/22/07)
United Technologies Corp. (\$64.09, 1/22/07)

Altria Group Inc. (\$87.07, 1/22/07)
Cisco Systems Inc. (\$26.53, 1/22/07)
Exxon Mobil Corp. (\$72.90, 1/22/07)
Halliburton Co. (\$29.32, 1/22/07)
Microsoft Corp. (\$30.72, 1/22/07)
T. Rowe Price Group Inc. (\$47.41, 1/22/07)
Viacom Inc. Cl. B. (\$41.40, 1/22/07)

BP PLC - ADR (\$63.91, 1/22/07)
Citigroup Inc. (\$54.68, 1/22/07)
General Electric Co. (\$36.75, 1/22/07)
Hewlett-Packard Co. (\$42.02, 1/22/07)
PepsiCo Inc. (\$64.81, 1/22/07)
UBS (\$60.72, 1/22/07)
The Walt Disney Co. (\$35.15, 1/22/07)

SKY Investment Group LLC
One Financial Plaza, Suite 2010
Hartford, CT 06103
(860) 761-9700