



MANCHESTER CAPITAL MANAGEMENT LLC

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be cautious, alert, and
flexible in the markets
of 2006.*

Market Outlook

By Ted Cronin, CIO

As we anticipated, a year-end rally should see the stock market positive. International equity markets are doing even better. The bond market hasn't helped portfolio performance much, but, importantly, it hasn't hurt either.

The current stock market rally is both seasonal and a relief rally. Gasoline and oil prices have backed off significantly, giving help to strained consumers and corporate energy budgets. The GDP numbers, a measure of economic activity, continue to be very strong at 3.8%. Productivity, a measure of output per worker, is equally robust. And after fears that the consumer was spent, the markets are buoyed by indications that the retail sectors will enjoy a good holiday season.

However, investors will need to be cautious, alert, and flexible in the markets of 2006. There are some alarms that draw attention. While interest rates remain low, inflation is palpable if not evident. The yield curve is almost flat – borrowers pay little more for long-term loans than short-term ones. Inventory surpluses from the prior recession are gone, and global demand for goods and commodities is unrelenting. Unemployment is low and labor costs are only held in check by productivity.

The government's economic models might not demonstrate much inflation, but if you rent a hotel room, pay an insurance bill, buy dinner at a restaurant, or go to a retail store, you can feel the pressure on prices beginning. Core inflation is more likely to increase than decrease in the coming year.

Indeed, there is too much money everywhere, confusing the pricing issue. Corporate coffers are full of cash. Consumers have borrowed beyond prudence. The housing market is clearly strained, with speculative ownership in the "hot" markets driving prices to levels that can't be supported by wages. Mortgage lenders have encouraged dangerous levels of debt by offering real estate buyers interest-only, no credit check,

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forget-about-the-future loans.

The excess supply of money is evident in the investment arena, as there is a similar speculative surge of “hot” money. There are now almost as many hedge funds as there are stocks! New funds seem to be created faster than IPO internet stocks were in 1999. They now constitute up to a third of the daily market activity. It is highly improbable that they will make the returns promised.

There is an underlying strength to the global economy that should make any observer optimistic about the future, despite problems here and there.

Venture capital and private equity is the flavor of the season. After several years of neglect, promoters are pitching illiquid efforts by teams with modest experience. Forgotten in the PowerPoint presentation are the rude facts that three quarters of all venture capital funds have sub-market performance. It is only a select group of experienced managers, those that don't want to take any new money, that have double digit returns. I am distressed to see hedge fund managers decide that now is the time to become private equity managers.

My concern is that there is a distortion in the relationship between risk and return. Many investors are seeking excess returns, and chasing opportunities in the most expensive asset classes while ignoring those that are better valued. Risk is not free. The markets have proven time and again that to get higher returns investors must be willing to suffer higher potential losses. What happens when hedge fund investors discover the returns are not there and ask to withdraw? What happens when real estate investors struggle with higher carrying costs and have to default?

There is no doubt that we live in an extraordinary time of prosperity. There is an underlying strength to the global economy that should make any observer optimistic about the future, despite problems here and there. The best scenario for 2006 is if the economy can slow modestly, inflation can accelerate gradually, and we avoid any abrupt adjustments in the markets caused by unappreciated risk. Fortunately, that is the most likely scenario, although we have our antennae tuned for other outcomes.

We Are Not a Wal-Mart Nation

By Vito Gioiello

It's time to dispel the notion that something is fundamentally wrong with our economic system.

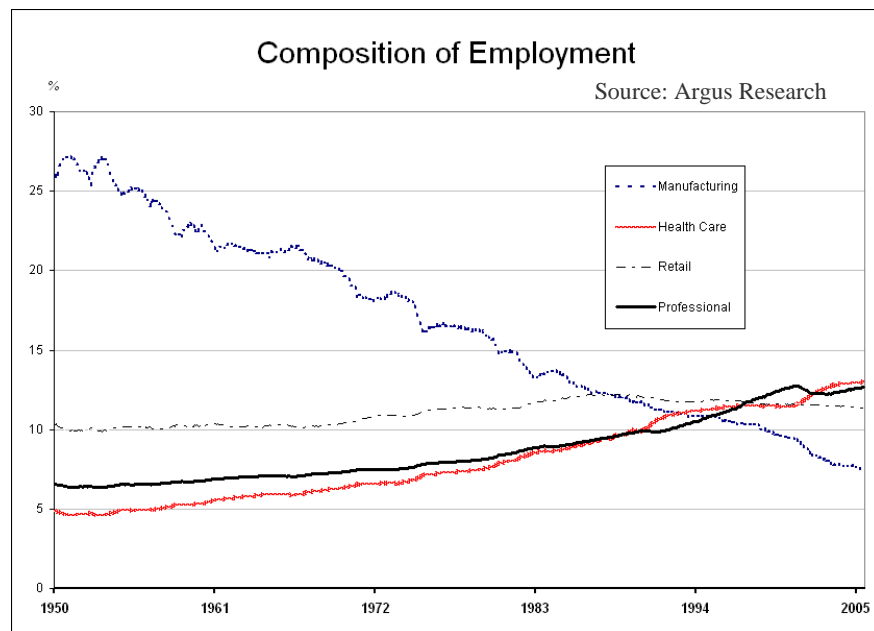
The United States economy and workforce has always been in transition. The story of our economic system has been one of tremendous productivity growth and that remains so today. This explains the growth of Wal-Mart and Home Depot versus the smaller chains and single stores they have replaced, but this does not imply that we have been relegated to a “nation of shopkeepers”. In 1950, the percentage of American workers employed in retailing was 10.3%. Today it is 11.4%, meaning there has been virtually no growth, yet we continue to be told that America is moving to a low paid, retail economy while all the great manufacturing jobs are

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Despite Wal-Mart's high visibility there has been virtually no growth in the retail sector over the past 50 years.

going overseas. We are also told that various foreign economies are either more stable or growing more quickly. While not wanting to gloss over our domestic problems, it's time to dispel the notion that something is fundamentally wrong with our economic system.

The reality is that the U.S. is a dynamo of productivity growth, but that very productivity exacts a human toll. Take the example of farming. In 1900, 35 percent of the workforce was employed in farming. Now, it's down to 2% and will probably be down to 1% by 2030. That fact is taken for granted in farming, but severe personal dislocation followed that transformation. The same goes for manufacturing. In 1950, about 26% of the workforce was employed in manufacturing. It's now 7.5%. You just don't need as many people to make a widget as you did back then. In that time, however, education and healthcare workers have tripled from 4.8% to 12.9% today.



At Manchester Capital, we diversify internationally not out of concern for our economy, but rather to lower portfolio risk.

Without question, we have a responsibility to those in need. As we write this, we read the news of major layoffs and plant closings at General Motors. We feel for a breadwinner who loses a secure, high benefit job and must start over. When a \$65 an hour job (including benefits) at Delphi Automotive is lost, it is true that an opportunity for a job with similar pay doesn't exist or the skills may not be transferable. If the worker has not done much in the way of gaining new job skills, the most likely alternative is to choose a job in retailing at Starbucks, Home Depot, or Wal-Mart. Yet despite the unfortunate events that often lead to retail employment and the common perception of retailers taking over the country, the fact still is that there has been nearly no overall growth in that sector.

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From an economic standpoint, we need to understand the effect of these common perceptions of the U.S. economic system. As investors, if the United States were in a long-term decline economically, the price paid for a dollar of earnings in this country would decline so returns would be lower. On the other hand, if the perceptions are too harsh, we must guard against deleterious federal and state economic policies. Closer to home, we can utilize such misperceptions to look for opportunities where stocks have been mis-priced due to unfounded worries. Yes, long-term economic trends continue to point to the loss of low-skilled manufacturing jobs. However, the trend also shows continued steady growth of various service jobs in such fields as education and health care. The truth is despite Wal-Mart's high visibility we are becoming, if anything, a 'Healthcare and Education Nation' and our economy is as strong and promising as ever.

At Manchester Capital, we diversify internationally not out of concern for our economy, but rather to lower portfolio risk. We believe that those staying away from U.S. equities due to the perception of negative long-term economic trends will be proven right only sporadically, but wrong over the long-term. So next time you read a diatribe on how Wal-Mart is "taking over the world", remember the words of Warren Buffett: "No witch doctor ever became famous by saying take two aspirins and call me in the morning."

Inside MCM

We are pleased to welcome Brian Jandrucko to MCM!



Brian works in our Manchester Office where his responsibilities include manager research, investment analysis, and investment management of client portfolios. He formerly served as a portfolio manager in the JP Morgan Private Bank and earlier worked for Lehman Brothers and on the floor of the New York Stock Exchange. With a BA degree in both Philosophy and Communications from Fordham University, Brian also earned a MBA in finance from New York University's Stern School of Business.

Important Year-End Reminders

Tax-Efficient Portfolio Management

It is hard to believe that year-end is fast approaching! To ensure that any and all tax-related concerns are addressed prior to year-end, please contact us if you have any questions or information that could aid in the tax-efficient management of your portfolio.

Year-End Charitable Giving

Please remember that if you wish to make 2005 charitable contributions of stock or cash you must contact us by December 22, 2005 in order to ensure that transactions are executed before year-end. Due to custodial constraints, requests received after December 22, 2005 will not necessarily be completed before year-end.

Best Wishes For A Happy and Healthy Holiday Season!