BCN ADVANTAGE: 2006 ANNUAL REPORT

January 2007	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	11.92% [1 2 3]	19.10% [1 2]	11.69% [1 2]	4.28% [1 2]
Jan ' 97 = $100,000 [4]	$315,156	$268,929	$211,599	$141,128
Beta (2006):	0.58	1.00	0.50	0.00
Risk Adjusted Return:	11.07%	19.10%	11.69%	4.28%

1 Performance results are based on the Federated Kaufmann Fund (14.6% for 2006), the Vanguard Index 500 Fund (15.6% for 2006), the Dodge & Cox International Fund (28.0% for 2006) and an average money market return of 4.28%. The results may not reflect the actual performance of BCN Advantage clients. Past performance does not guarantee future results.
2 Performance results show the year-over-year change to net asset values and do not include the reinvestment of dividends (if any) other than interest earned from the money market fund.
3 Performance results are net of BCN Financial management fees.
4 BCN Financial Inc. is the registered investment advisor. Performance from January 1997 to June 1998 was provided through Quest Securities as the registered investment advisor.

2006 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2006	40%	60%
2	01/09/2006	100%	0%
3	04/01/2006	100%	0%
4	06/07/2006	25%	75%
5	07/01/2006	25%	75%
6	10/01/2006	25%	75%
7	12/31/2006	25%	75%
	Present	25%	75%

Contrary at the Extremes
We are in the late stages of a 4-year bull cycle that began in October 2002. This is the 5th longest bull market in the past 75 years. This is the 2nd longest period in the history of the S&P 500 without a 10% correction. And this is now the longest period in over 107 years without a 2% intraday decline in the DJIA. The late stages of any cycle (whether bull or bear) are always the most difficult to navigate, because we must act CONTRARY to the crowd. When everything looks rosy and complacency runs rampant, beware: a major decline is usually around the corner.

The Battle for Investment Survival
"Willingness and ability to hold funds uninvested while awaiting real opportunities is a key to success in the battle for investment survival," wrote Gerald Loeb, the legendary stock trader who sold just prior to the Crash of 1929. Loeb argued that investors should not buy until the profit possibilities greatly outweigh the risks. We could not agree more.

All major bull markets (such as the long secular bull run from 1982 – 2000) are followed by long periods of consolidation, typically lasting a decade or more. As we emphasized back in January 2003: "likely now is a pattern similar to the one we experienced from 1966 through 1982, when the Dow spent 16 long years butting its head against the ceiling at 1000, in the process going through repeated cyclical bull and bear markets." This channel theory is central to our overall investment strategy. If the markets hold true to their historical norms, then the DJIA should be forming a channel roughly from 12,000 to a low of 7,200. (Since 2000 – seven years). The Nasdaq should form a channel roughly from 2,400 to 1,400. (Since 2001 – six years). And the S&P 500 should form a channel roughly from 1,400 to 850. (Since 2001 – six years).

There are 3 key points to gain from this theory: (1) the channel highs are all approximately 67% above the expected channel lows (exactly in line with what the DJIA experienced in the 16 years prior to 1982); (2) the three major indexes are all currently above (though not by much) their expected channel highs – marking a period of extreme risk; and (3) if the indexes hold to their historical norms, declines of 20% to 40% should come as no surprise.

Housing, Consumer Debt, Interest Rates and Oil

The four horsemen? The U.S. housing market is now in uncharted territory. The 3.6% decline in median sales prices marked the first yearly decline in home prices since the Great Depression. But the real key to housing is the effect declining (or simply flat) real estate values may have on the consumer. All cycles essentially fuel themselves, and this one has been no different: so long as their home prices rose, consumers (whose spending now comprises more than 70% of annual GDP) could borrow against equity and continue to spend; with consumer spending strong, corporate profits could continue to rise (with 13 consecutive quarters of double-digit earnings growth); with stock prices on the rise, companies could use their stock to buy other companies (2006 saw near record activity in IPO's and leveraged buyouts). But this cycle has been fueled almost entirely by debt.

After 17 consecutive rate hikes, lifting the Fed Funds rate from 1% to 5.25%, has the Fed taken away the punch bowl? Over the last 50 years the Fed has made a series of tightening moves 10 prior times: 8 have led to recessions and 9 to bear markets. "Significantly, in all 9 instances where the Fed tightened and the yield spread dropped below 50 basis points, a bear market followed…" [The "Soft Landing" Myth, Comstock Partners, 7/6/2006.] The yield curve is now technically inverted, with the short-term Fed Funds rate more than 50 basis points HIGHER than the 10-Year Treasury Constant Maturity Rate. In each of the four previous instances where short-term rates have exceeded long-term rates, a recession has followed soon afterwards.

The Fed ended its 2-year series of interest rate hikes on June 29, 2006. Two weeks later, on July 14, 2006, oil peaked at $77 per barrel and began a precipitous slide that has seen the price of oil fall by 35%. These two events do much to explain the sudden reversal in the stock market – from severe correction to the mostly uninterrupted bull run that began in mid-August. Much like the inverted yield curve, oil may be forecasting an ominous outcome: a U.S. (and global economy) on the verge of a major slowdown.

Understanding 2006 and the Strategy Going Forward

We made only 2 market moves in 2006, both of which were correct. Unfortunately, it's the mid-August move we did NOT make that caused our underperformance – and cost our clients roughly 7% in total returns for the year. Following our January 9th move to 100% fully invested (with the DJIA at 10,900, the Nasdaq at 2275, and the S&P 500 at 1,275), the markets moved steadily up until mid-May, with the indexes all topping within days of each other at 11,639, 2,342, and 1,326 respectively. Stop! Look at those numbers again and compare them with our expected channel tops. The initial sell-off was especially sharp. Given our belief that the markets were reversing at almost exactly their expected channel highs, we moved 75% defensive on June 7th. The entire correction lasted until mid-August. Then, with the same suddenness that began the decline, the markets reversed course and moved up for the remaining 4 ½ months of the year.

Did we make a mistake? Of course. When our bullish indicators went green again in mid-August, we should have moved at least 70% back into the market. But we firmly believe that the mid-2006 correction gave a strong confirmation of our expected channel tops. And though short-lived, the correction was extremely severe. Although the indexes have fully recovered and since moved to new multi-year highs, the majority of domestic stock mutual funds have still not returned to their May levels. I remind myself often (and my clients whenever they ask): remember what it feels like to be heavily invested in a declining market? Compared to those anxious days and sleepless nights, being partially invested in a rising market is a spring day in the park!

Our strategy going forward is clear. We are now out-of-sync with the overall markets, but we cannot move back into stocks until at least one of these events occur: (1) the markets are now extended and overdue for a correction. That correction will either create a buying opportunity (because the indexes hold above their 2006 lows), or confirm a long-term market decline; (2) the yield curve once again turns positive.

Is this 1995-1999 all over again, the last time the Fed ended a series of interest rate hikes? Or will the markets finally surrender to historical precedent? Our job is to identify the real trend – early – ahead of the crowd.

As always, we look forward with great optimism. We appreciate your faith and confidence. And we are eager to apply the lessons learned for your benefit.