KELLY CAPITAL MANAGEMENT, LLC

MARKET COMMENTARY
FOURTH QUARTER 2005

What's new?

We are pleased to tell you that in December an old colleague joined Dave Przywara and Jim Kelly as a portfolio manager and research analyst: **William "Bill" A. Francis, CFA**. Bill has previously worked with us at Addison Capital Management (ACM) and Walnut Asset Management (WAM). Bill worked with Jim Kelly in designing the first two ETF-based strategies (Large Cap Core and All Cap Multi Style) at ACM and worked with Jim on the same strategies at WAM. We are pleased to have him with us!

In last quarter's commentary we talked about the new **Emerging Markets ETF Strategy**. Please see below our comments on its success. *It has proven to be a real benefit to those clients who have added it to their relationship with us.*

Last quarter we initiated our new **referral program**. We don't expect you to become salesmen for us but what we would like you to do is think of us as a resource for your friends, family and business contacts. We would like you to be ready to mention us to anyone who might indicate an interest in investing. We are happy to tell you that we have obtained some new clients as a result of this program and those clients who referred new customers to us are now enjoying a reduced management fee for this quarter. So put on your thinking caps and remember us if anyone you know might be interested in investing some money. *Clients who refer our firm to a new customer will receive a 10% discount on their next quarter's fee if the referred person/entity becomes a client*.

Lastly, included with this report are realized gain and loss reports for taxable accounts we manage. If you had a taxable account during 2005, a copy of its gain and loss report is enclosed. For those of you who asked to have this information sent to your tax accountant, we have done so.

Market Observations –

We told you last quarter that we believed there would be continued growth in 4th quarter, and we were right. The quarter showed modest inflation concerns, anticipated interest rate increases, leaks in the housing price bubble and a resurgence of oil price worries. Continued concerns about potential oil supply disruptions in South America, Africa and the Middle East fueled oil price increases. Yet we finished the quarter, and year, in fine economic shape with the majority of companies who announced earnings for the quarter being up from the prior quarter and for the year.

Traditional Individual Company Stock Based Strategies:

<u>Large Cap Value</u> –

Overall, large cap stocks were not a great place to be in 4th quarter. October was weak, November was very strong, but December was mixed: the larger the market cap the worse the result. This leads us to conclude that the economic cycle is moving more slowly than we previously thought so the overall good economy we have enjoyed in 2005 should persist in 2006. At some point in 2006, large cap stocks should again dominate returns.

Midcap Core & Midcap Value –

Preliminary results for our core midcap model indicates our total return was better than the Russell Midcap benchmark index's return. Our stock picks in Consumer Discretionary, Finance, Technology, and Materials contributed positively to our results. Preliminary results for our midcap value model indicates our total return was better than the Russell Midcap Value benchmark index's return. Our stock picks in 6 of 10 sectors contributed positively to our results. As a risk reduction strategy, we remained "sector neutral" relative to the Russell Midcap Core and Midcap Value Indexes.

Exchange Traded Fund (ETF) based strategies:

Large Cap Core (LCC) –

Our LCC strategy tracks the return profile of the S&P 500 Index but with better overall diversification and better tax-efficiency. We have a performance goal of better total return over rolling three-year and five-year periods than that of the S&P 500 Index and the typical large cap Core equity portfolio manager. During the quarter our model's preliminary results showed that we did well in October and November but got hurt in December .

All Cap, Multi-Style (ACMS) –

Our ACMS strategy is designed to provide vast diversification combined with style, market cap and sector rotation. It is also referred to as a "Multi-Disciplinary Account" style. ACMS is benchmarked against broad market indices such as the S&P 500, Russell 3000, and Wilshire 5000. For the quarter we did very well in November and December but the oil sector exposure hurt us in October. For the quarter we lagged our benchmark indices. *However, for the year we again beat all three benchmarks.*

Emerging Markets International Equity (EMI) –

Fourth quarter was our first complete quarter since we launched this strategy. From inception (9/2/05) to quarter-end our model account for this strategy was up almost 12% and for the 4th quarter-only it was up over 5%, beating not only its benchmark index but the MSCI EAFE and MSCI World x-USA Indices as well. *We believe that for the coming year exposure to international equities could be a boost to total returns. We invite your inquiries as to how we can add this new strategy to your relationship with us.*

Balanced & Fixed Income Accounts:

Any portfolio strategy we manage in which we include bonds (either taxable or municipal) along with stocks in the client's portfolio is considered a "balanced account". Accounts holding only bonds and bond funds are "fixed income" accounts. In balanced accounts each client's asset mix is tailored to that client and may not look like any other clients' asset mix. As in past quarters, our strategy of investing in short to intermediate term maturities, with high quality and call protection paid off. As interest rates continued to rise during the quarter, the value of the fixed-income component in client portfolios remained relatively flat allowing our positive equity performance to move balanced account values in a positive direction and fixed income only accounts to remain relatively stable.

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