

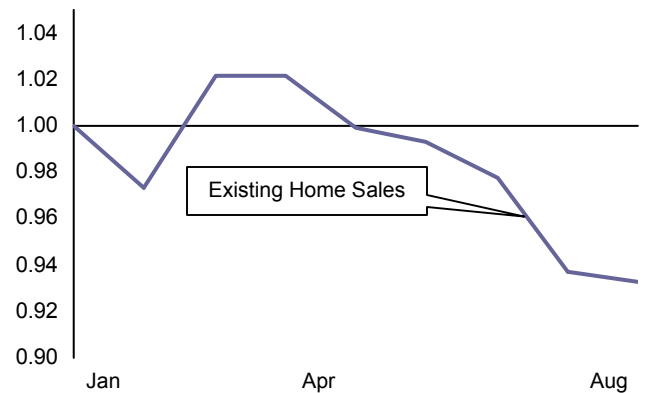
Slower Growth Dampens Inflationary Fears

When the Federal Reserve (Fed) governors met in September, it marked the second time in as many policy meetings that the nation’s central bank left interest rates unchanged. Reflecting much of the same sentiment from its gathering in August, the Fed cited a slowdown in the residential housing market, lower inflationary pressures and the cumulative effects of previous rate hikes as primary reasons to keep the fed funds rate at 5.25%.

On the housing front, the National Association of Realtors reported lower existing home sales for a fifth consecutive month through August (chart 1) and that the median price of existing homes fell on a year-over-year basis for the first time in 11 years. The drop-off was largely expected, however, as homeowners began to reduce asking prices amid weaker sales and higher inventories. These conditions, in turn, are a result of rising mortgage interest rates and slower economic growth. Consequently, the pullback in housing helped push the revised second-quarter Gross Domestic Product (GDP) reading lower than previously estimated, according to the Commerce Department.

The Commerce Department also reported a decrease in its leading index in August. The decline was spurred mostly by weaker consumer confidence and a drop in new orders for non-defense capital goods. The leading index has fallen in five of the last eight months, which tends to support the notion that the economy is cooling and inflation may be contained.

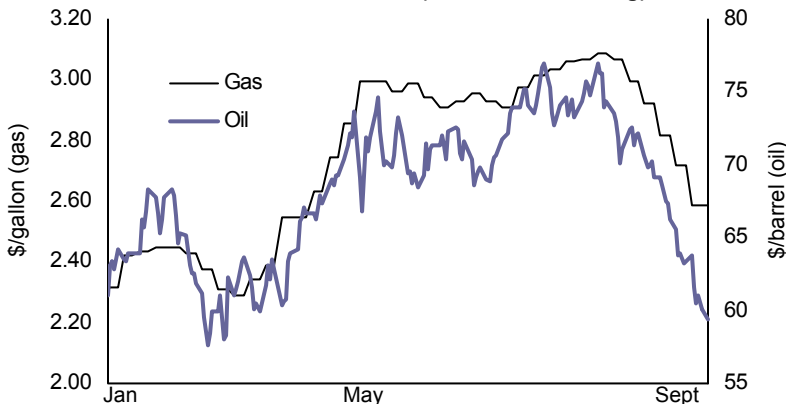
Chart 1
Housing Activity Y-T-D through August
(Source: Bloomberg)



Note: Housing sales provided by the National Association of Realtors.

Evidence that inflation is moderating surfaced when the Labor Department reported a modest up-tick in the Consumer Price Index (CPI) in August that matched July’s reading of a 0.20% advance. The core CPI reading, which excludes the typically volatile food and energy sectors, also advanced 0.20% in August, just as in July, following four consecutive months of 0.30% increases starting in March. Furthermore, consumer spending rose less than expected on a nominal basis in August, but when measured in real (i.e., inflation-adjusted) terms, fell for the first time since September 2005. The CPI and consumer spending numbers come as somewhat welcome news to a market anxious about inflation and further rate hikes by the Fed.

Chart 2
Gas and Oil Prices Y-T-D (Source: Bloomberg)



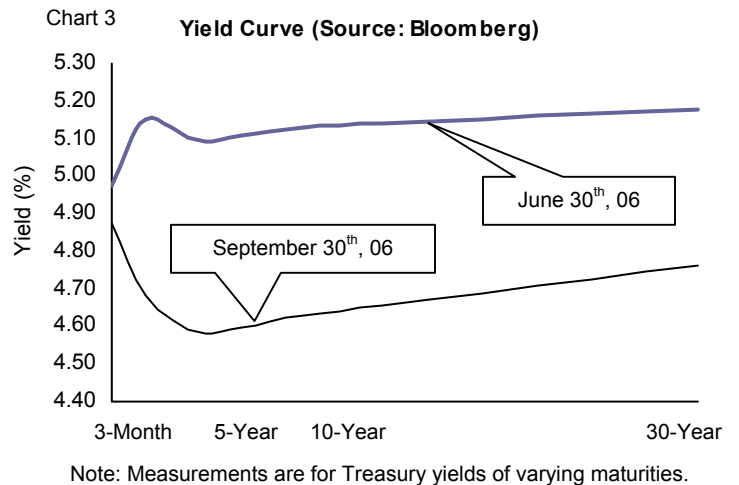
Note: Oil prices are measured by the West Texas Intermediate Index. Gasoline (Gas) prices are measured as the average price of all grades measured by the Department of Energy.

Further assuaging inflationary concerns, the price of the nation’s most widely used commodity fell late in the quarter. After reaching \$77.03 per barrel in July (chart 2), oil prices slid 18% and closed out the quarter at \$62.91 per barrel. Likewise, the average price for unleaded gasoline fell over 20% from a high of \$3.09 per gallon in August to \$2.44 per gallon by the end of the quarter. Oil prices are important, particularly because of the affect they have on inflation and, ultimately, interest rates.

Although a cooling housing market could have an overall negative impact on consumer spending, that effect might be offset somewhat by lower oil and gasoline prices. The question now is, will the economy have a hard or soft landing?

Risk Aversion: Treasury Yield Curve Remains Inverted

As recent reports signal an economic slowdown, investors have increasingly sought the safety of Treasury securities despite better returns in other asset classes. Heightened demand has pushed prices higher and yields lower. The yield on the 10-year Treasury bond fell 0.50% from its close on June 30 to 4.63% at the end of the third quarter. Additionally, investors showed solid interest for the Treasury Department's auction of 2-year notes in September. For the third quarter, yields were lower across the entire maturity spectrum compared to where they stood at the end of last quarter and are now inverted to a larger degree (chart 3). Given the higher short-term rates, businesses are faced with relatively higher costs to finance short-term operations at a time when consumer spending is waning. In the past, inverted yield curves have been a precursor to several economic recessions and lower corporate profits, so the market is watching this barometer closely.



Better Quarter for Stocks, Especially Large Caps

In a sharp reversal from this year's second-quarter performance, most major domestic equity indexes posted positive returns for the third quarter despite less-than-encouraging economic news. The broad-based Russell 3000 Index, a fair barometer of the domestic stock market, advanced 4.64% for the quarter. The more popular stock market indexes, such as the Standard & Poor's 500 Index (S&P 500) delivered its best quarterly performance since **December 2004** by rising 5.67%, while the Dow Jones Industrial Average (Dow) flirted with a new all-time high in September. The Dow closed just shy of its high water mark of 11,723 attained in January 2000 yet returned an impressive 5.71% for the quarter. Even the formerly lagging NASDAQ Composite Index (NASDAQ) joined the party by gaining 4.15% for the same period, an advance that finally lifted this index into the black for the year.

When returns for both the S&P 500 and Russell 3000 are compared by market capitalization (market cap), it's clear why the S&P 500 outperformed the Russell 3000 by its largest margin since **March 1999**. While the Russell 3000 encompasses a wider range of market caps, from large to small, bigger-cap stocks more heavily influence the S&P 500. In a trend that began mid-second quarter of this year and was hastened over the last three months, large-cap stocks outperformed all other market-cap ranges by a significant degree. Table 1 below illustrates a breakdown of select Russell indexes by company size in the second and third quarters of 2006.

Index (Table 1)	3 rd Q 06' Return	2 nd Q 06' Return
Russell Top 50 (LC)	8.37%	-1.15%
Russell Top 200 (LC)	6.29%	-1.27%
Russell 1000 (LC)	5.06%	-1.66%
Russell 2500 (SMID)	0.52%	-4.34%
Russell 2000 (SC)	0.44%	-5.02%
Russell Micro Cap (MICRO)	-0.67%	-6.77%

Source: Frank Russell. LC=Large Cap, SMID = Small to Mid Cap, SC = Small Cap

As Table 1 shows, the migration toward large-cap stocks largely reflects investors' concerns over a slowing economy. Traditionally, large blue chip stocks provide higher, more stable dividend yields, economies of scale, more global revenue streams and lower volatility than their small-cap counterparts. Such attributes make large caps more attractive to the average investor compared to small caps when U.S. economic activity decelerates.

Index (Table 2) (as of 9.30.06)	Quarter	Year-to-Date	One Year
S&P 500	5.67%	8.53%	10.79%
Russell 3000	4.64%	8.02%	10.22%
Dow Jones Industrials	5.71%	10.85%	13.14%
NASDAQ	4.15%	3.02%	5.84%
Russell 1000	5.06%	7.95%	10.25%
Russell 2000	0.44%	8.69%	9.92%

Source: Bloomberg

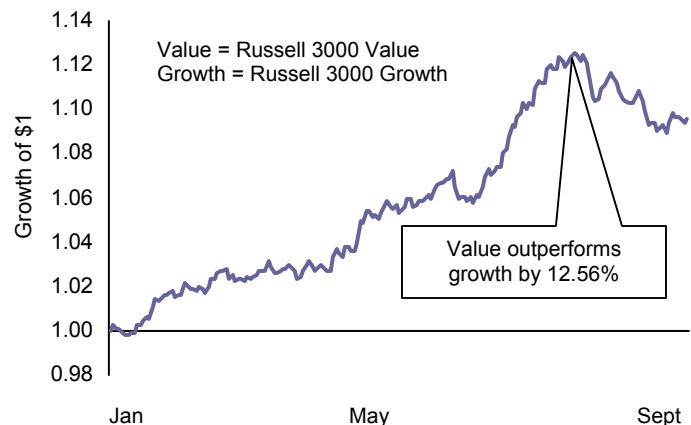
Table 2 above illustrates the returns of the major U.S. equity indexes. Noteworthy is the fact that four of the six indexes have double-digit returns over the past year, with only the tech-heavy NASDAQ trailing considerably.

Value Dominates Growth

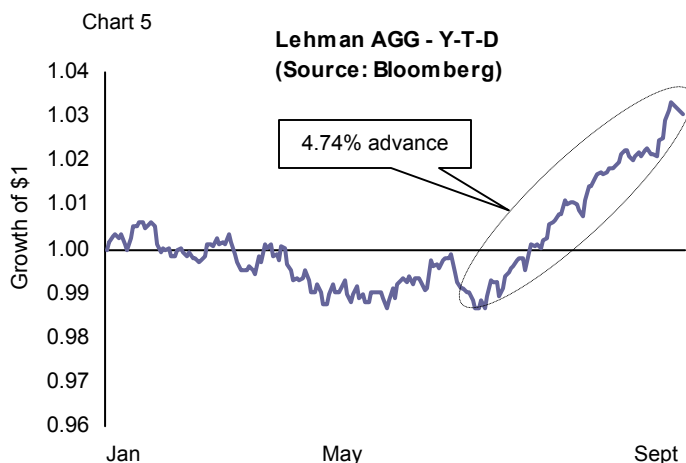
Just as large caps recently have outpaced small caps, value stocks have continued to dominate growth stocks by style category. For the past quarter, the Russell 3000 Value Index gained 5.88% while the Russell 3000 Growth Index advanced 3.44%. More significant is that this group of value stocks topped their growth peers 13.18% compared to 3.11% year-to-date (chart 4), or by 10.07%. By mid-August, this Value/Growth gap peaked at 12.56% in favor of value stocks. Since that time until the end of the quarter, however, growth has rebounded somewhat versus value. Nevertheless, the third quarter marked a continuation of a trend that has seen value outperform growth 12 out of the last 20 quarters by an average of 4.09% per quarter.

Chart 4

Value vs. Growth - Y-T-D (Source: Bloomberg)



Bonds Are Making Strides



Year-to-date though late July, the broad-based Lehman Brothers Aggregate Bond Index showed few signs of life. In fact, the index had lost ground. But as recent economic news pointed to a slowdown, investors gradually have shifted assets into bonds on the assumption that the Fed is done raising interest rates for the time being. With inflationary concerns abating from earlier levels, investors appear more comfortable with fixed-income securities. From its trough to peak, the Aggregate Bond Index advanced 4.74% (chart 5) year-to-date. For the quarter, the index gained 3.81% and is up 3.05% so far this year. Longer maturity bonds performed the best with the 10+-year maturity range climbing 6.82% in the period while the 1-3-year range added a solid 2.07%. Table 3 below details the maturity returns of the Aggregate Bond Index.

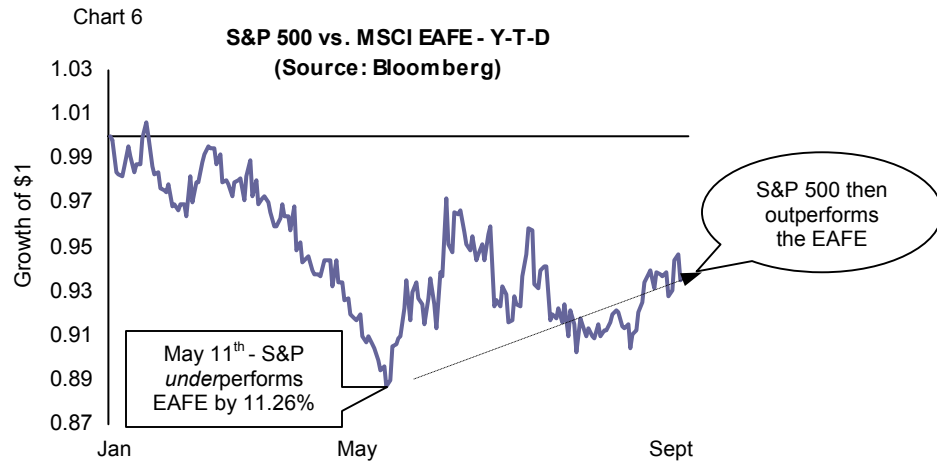
Index (Table 3) (as of 9.30.06)	Quarter	Year-to-Date	Year
Aggregate	3.81%	3.06%	3.67%
1-3 Year	2.07%	3.22%	3.92%
3-5 Year	3.16%	3.25%	3.81%
5-7 Year	3.68%	3.36%	3.84%
7-10 Year	4.32%	3.16%	3.61%
10+ Year	6.82%	1.65%	2.60%

Source: Lehman Live

Parsing returns by credit quality, the lower-rated Baa issues in the Aggregate Bond Index advanced 4.79% for the past quarter compared to a gain of 3.60% for Aaa bonds. Year-to-date, credit returns in the Aggregate Bond Index are fairly even. Meanwhile, high-yield bonds were up 4.07% for the past quarter and have tacked on 7.34% so far this year as measured by the Lehman Brothers U.S. High Yield Bond Index.

International Stocks Lag S&P 500

For the first time since the second quarter of 2005, the MSCI EAFE Index lagged the S&P 500 on a quarterly basis. The EAFE advanced 3.99% for the quarter — 1.68% behind the S&P 500 for the same period. After a considerable run-up earlier this year compared to the S&P 500, the EAFE reversed course and has trailed domestic equities since mid-May. Although the EAFE has outgained the S&P 500 14.97% to 8.53% year-to-date, since May 11 the S&P 500 has moved ahead versus the EAFE, 1.73% to -3.37% (chart 6), driven by the out performance of large caps. Elsewhere, the MSCI Emerging Markets-Free Index managed a gain of 4.96% for the quarter and 12.41% year-to-date despite investors' heightened concerns over market volatility. Emerging markets tend to be among the most volatile investment sectors, but unlike small-cap domestic equities, they posted noteworthy returns in the quarter. Over the past 12 months, the EAFE is up 19.73% while the Emerging Markets Index is higher by 20.60%.



REITs Stay on Track

The National Association of Real Estate Investment Trusts Index (NAREIT) has produced just four negative quarterly returns over the past 20 quarters. As for the other 16 quarters, the NAREIT has advanced on average 8.16% every three months. By this measure, the NAREIT's performance for the third quarter was typical as the index advanced 8.61%. Year-to-date, the NAREIT is up an impressive 22.50% and ahead 24.04% over the past 12 months.

Despite the substantial increase in REIT capitalization, the dividend income for these vehicles remains attractive versus blue chip stocks. According to the National Association of Real Estate Investment Trusts, the dividend yield of its primary REIT index is roughly 4.36% compared to 1.82% for the S&P 500. Demand for investments that can pay an attractive yield and potentially offer capital appreciation above corporate bonds likely will keep REITs in the spotlight as an appealing asset class.

Dr. Jekyll and Mr. Hyde

As investors have witnessed, much can change over the course of a year. What once was a sizzling housing market has cooled significantly. Higher energy prices reversed direction in a matter of just a few months. What was at best lackluster performance for fixed-income instruments turned around on news of slower economic growth. Small-cap stocks lost their luster and under performed large caps for the third quarter. International equity performance began to lag that of domestic equities.

The process of investing is dynamic, as these changes make clear. This changeability is further exacerbated amid heightened economic uncertainty and investor emotion. Directions change, trends reverse, and while some movements are expected, others are not. As always, we continue to believe that the best course of action is to maintain your strategic focus in accordance with your risk and return objectives, and to adhere to your time horizon within a diversified portfolio.

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