

MARKET ANALYSIS

INVESTMENT STRATEGIES GROUP

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H₂O: THE WORLD'S MOST PRECIOUS COMMODITY¹

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Commodities have become a treasured asset class for many investors — and for good reason. The world is in the midst of a secular bull market in commodities, with soaring demand and tight supplies driving the prices of petroleum, gold, nickel, copper and a host of other commodities to multi-year highs. Interestingly, for all the talk about this worldwide boom, very little attention has been paid to the world's most precious commodity and its underlying importance to the global economy.

Making the case for global water companies

According to a United Nations (UN) population study, the world's population grew by 380 million persons, to approximately 6.3 billion, between 2000 and 2005. The majority of that growth, or 310 million new persons (a number greater than the entire population of the United States), occurred in urban environments. Less than a fifth, 70 million new persons, of global population growth took place in rural areas. The UN estimates that world population growth will occur entirely in the world's largest cities after the year 2020, as the migration from the farm to the factory continues.

This mass demographic change will have a profound effect on global demand for basic commodities, including energy supplies, metals and materials, food and, most importantly, clean water. It is in this light that the UN has deemed the ten years between 2005 and 2015 as the “Water for Life” decade. This phrase underscores what could be a critical global issue, as many of the world's nations will likely face water shortages, a disconcerting trend from which even the United States is not totally immune.

Why water? Why now?

The demand for water increases with the global population, but the world's supply of water has been fixed for, literally, billions of years. Due to the impact of urbanization on key water resources and delivery systems, the supply of potable freshwater is fast declining. To effectively support population spillover in key regions, the world's nations will have to at least maintain, if not materially increase, the world's access to freshwater.

¹All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors.

There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

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In our view, efforts to meet the demand for water will come on two fronts. In the developing world, the local water supply, quality of water infrastructure and efficiency of water usage fall far behind the industrialized nations. Broadly speaking, the inefficient delivery of clean water runs counter to epochal growth taking place in these regions. Massive investment in water infrastructure is in immediate and dire need in order to support record economic expansion and avert what could become regional crises. In the industrialized world, the past decade witnessed a series of innovative developments in the products and services available to establish efficient and high-quality water systems. We believe that private companies are consciously becoming further engaged in the web of industries that present viable and innovative solutions to the global water conundrum.

A tale of two cities

Exhibit 1 compares water usage in the industrialized versus the developing world. Water consumption in developed economies is dominated by industrial uses, ranging from manufacturing to thermoelectricity. In the developing world, however, agricultural uses make up more than 80% of total water consumption. Implications from these statistics include the following:

- The industrial water cycle in developed nations will require greater water efficiency and water reuse, given increasing concerns for water quality and environmental regulations on wastewater output.
- Residential and industrial water usages in the emerging markets are becoming more critical components of total water consumption due to rapid urbanization trends. Meeting the growing demand will require establishing and improving upon municipal and industrial water infrastructure.
- Global manufacturing capacity is increasingly outsourced to the developing world. As a result, the industrial water cycle in the emerging markets will soon encounter the same issues facing the developed world. Maturing emerging market industries will preempt water-related

constraints by planning ahead for water self-sufficiency.

Distinct solutions will be needed to address issues confronting each area. Investors that understand water-related industries across the various sectors and niche industries should be well-positioned to consider the potential benefits of exposure to this emerging trend.

Industrial water sector

Related industries:

Industrial water treatment, filtration

The industrial water cycle today presents an interesting paradox. U.S. industries increasingly require ultra-pure water (e.g. pulp & paper, food & beverages, semiconductors, biotechnology and auto manufacturing) yet produce higher volumes of industrial wastewater each year, thereby exacerbating the decline in public water quality. The U.S. Environmental Protection Agency (EPA), which sets domestic standards for water quality and restrictions on wastewater output, has become more demanding of U.S. industry. This dilemma has created an opportunity for innovative and cost-saving water solutions in industrial water treatment, filtration and wastewater reuse that, in part, remedy the discrepancy between industrial water inputs and outputs.

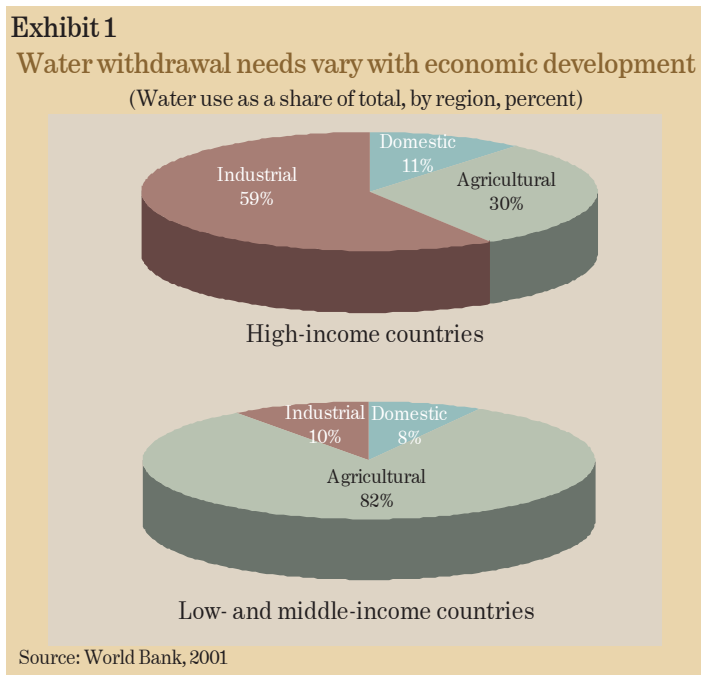
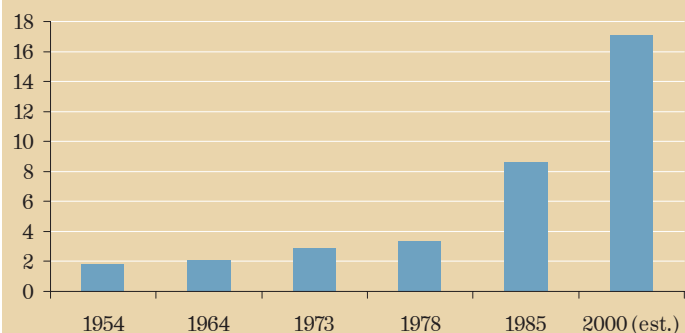


Exhibit 2

U.S. manufacturers more reliant on treated, recycled water

(Recycled water use as a share of total, percent)



Source: ITT Industries, *Guidebook to Global Water Issues*

Industries are readily adopting these technologies (see Exhibit 2). Reprocessing water for industrial uses achieves both self-sustainability (through operative cost reduction) and environmental efficiency (via mitigated exposure to environmental regulations and standards), both of which are attractive prospects for any water-intensive industry. In our view, the developed nations are a ready marketplace for water reuse technologies.

Within water reuse industries, few “pure play” suppliers remain after a recent wave of merger and acquisition activity. Several large, diversified industrial conglomerates recently acquired key firms that derive primary revenues from water reuse.

We believe growth in industrial water treatment and filtration will be fostered by a number of factors, including increased capital expenditure driven by global manufacturers with record cash stores on balance sheets, manufacturers seeking to cut operating costs and boost bottom-line growth in a decelerating earnings environment and the potential for even tighter water regulation as local water issues gain greater public acknowledgement.

Municipal water sector

Related industries: Residential water and wastewater treatment, filtration, testing and diagnostics

U.S. utilities — Water in America is a highly fragmented and regulated industry. Municipal government dominates residential drinking water supply and wastewater treatment. Private water companies provide only 15% of U.S. drinking water and treat just 2% of residential wastewater. At present, only eleven U.S. water utilities are publicly traded stocks; all fall into mid-cap, small-cap or micro-cap classifications².

Even under a seemingly disjointed operating environment, U.S. water utility stocks performed exceptionally well last year. The S&P 1500 Water Utilities Index returned 46.3% in 2005, including dividends, as a wave of consolidation sparked industry gains. Since U.S. water utilities cannot easily raise prices (due to local regulations on water rates), they augmented growth by acquiring competing private water assets and expanding into regions where populations were booming (the Sun Belt, for example). Going forward, our view is that the most attractive deals have already been made. Given high industry valuations and past merger and acquisition volumes, few private assets appear ripe for acquisition. The most viable option U.S. private water utilities have now is to take a shot at municipal water assets. We view this as an uncertain prospect, given the social consensus in the United States that water should remain a “public good.” However, we note that this element of privatization may soon become more probable and acceptable, in light of the massive investment outlays in U.S. water infrastructure estimated to be on the horizon for government-owned water utilities (see later section on Infrastructure for more detail).

There are, however, indirect ways to participate in the U.S. water utility industry. In 1998, the EPA began looking beyond conventional chlorination for better methods of water purification. This opened up a new market for ultraviolet (UV) sterilization, which is similar in cost, but more effective than chlorine. In January 2006, an EPA amendment mandated UV sterilization on public water supplies to combat potentially carcinogenic byproducts of chlorine purification. Consequentially, the EPA estimates

²Share prices of small- and mid-capitalization companies tend to be more volatile than those of larger companies. Because small companies often have narrower markets, limited financial resources and stocks that are not as actively traded as large company stocks, their share prices may be even more volatile.

this will require the installation of up to 1,000 new UV purification units over the next decade. Also in January of this year, the maximum EPA-allowed level of arsenic in U.S. drinking water fell from 50 to 10 parts per million. More stringent water standards require better diagnostic tools, and, as previously mentioned, updated purification and filtration technologies.

International utilities³ — European firms lead the way in the privatization of water utilities — not surprising, as they've had a two thousand-year head start. It's no coincidence that France, home to the largest and most transnational water utilities, can also lay claim to the popular tourist attraction Pont du Garde, an ingenious (and still standing) Roman-era aqueduct. That such innovation birthed prominent water giants is testament to Europe's longstanding expertise in water management.

The French municipal water market, like the U.S. market, is a highly fragmented industry with over 15,500 municipal water systems. Yet, in France, large private water firms are contracted to operate and manage most of the state-owned water assets. In the U.K., just a handful of large, private utilities both own and operate the majority of water assets for England and Wales (roughly 70% of the market is private). The U.K. privatized its national water assets in 1989 in advance of an approaching infrastructure deficiency that required massive investment and improvements. The tactic of shifting water-asset investment and financing burdens to the private sector was a general success, as private water companies adequately funded infrastructure requirements, and the market is regarded today as one of the most efficient in the world.

That said, two large British water utilities were recently put up for sale, to the industry's surprise. There is something to be gleaned from the fact that European utilities are taking capital out of their saturated, yet stable, domestic water markets. That they are reinvesting this capital in developing countries says even more, as most emerging market

water municipalities are now in dire need of water infrastructure and operating expertise. The common industry conception is that industrialized markets offer growth in the range of 4%–6%, while developing markets yield more lucrative 10%–15% returns. If European utilities have reoriented their sights on high-growth markets, investors appear to have recognized and rewarded this growth strategy, as the MSCI Europe Water Utilities Index⁴ returned a respectable 22.3% in local terms last year and is already up 4.6% in the first month of 2006.

Asia is also keen on expanding into global water treatment. Water utilities from Malaysia, Philippines, Singapore and Thailand are growing quickly and leveraging regional needs for municipal water management. Regarded as the largest and generally most promising market in Asia, China also has its share of ambitious water utilities, which present formidable competition to the European water utilities seeking inroads to the mainland. However, foreign utilities still offer a way to invest in China, as they have the seasoned expertise and competitive advantage against young, local firms vying to bring China's water infrastructure up to par with its rapidly expanding urban base.

Latin America, on the other hand, is a developing region where prospects for foreign water utilities are slim. During the 1990's, experiments in privatizing water resources in Argentina, Bolivia and Brazil failed, due to pricing disagreements and public backlash in markets where, historically, water scarcity was seldom an issue. As a result, most foreign industry participants rapidly departed the Latin American market, which opened doors for new local investment in water assets. It is important to note that foreign water utilities' departure from Latin America does not mean outsourced water treatment and management cannot be profitable in the developing world. If anything, these companies learned from previous mistakes, and have since repositioned their focus on high-growth, water-scarce, infrastructure-deficient developing regions.

³Investing in international investments may involve special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other monetary and political risks associated with future political and economic developments.

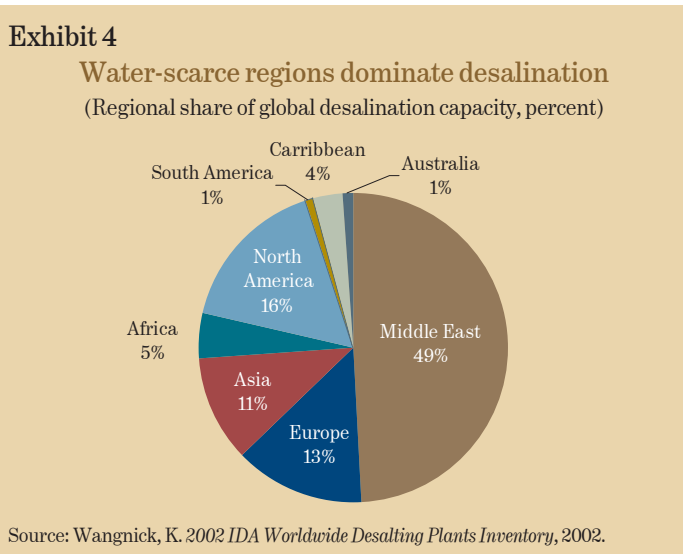
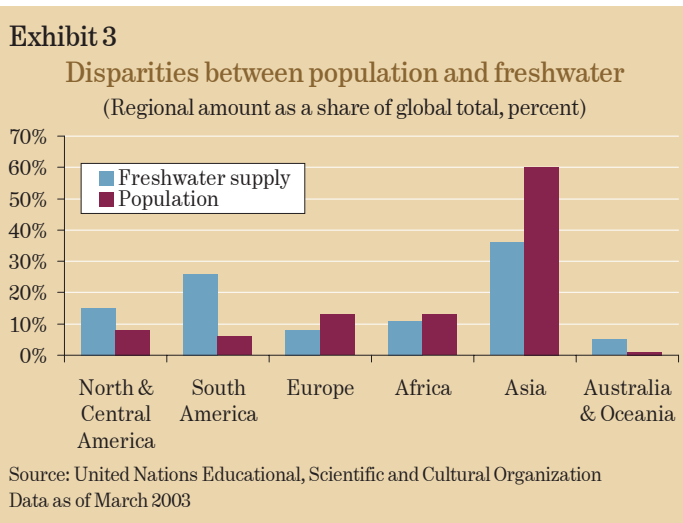
⁴The MSCI Europe Water Utilities Index is a free float-adjusted market capitalization index that is designed to measure the local-currency equity performance of utility companies based in developed Europe. The dividend is reinvested after deduction of withholding tax, applying the rate to non-resident individuals who do not benefit from double taxation treaties. MSCI uses withholding tax rates applicable to Luxembourg holding companies, as Luxembourg applies the highest rates. It is unmanaged and unavailable for investment.

Desalination — Desalination is a process that draws freshwater from a saltwater source on a molecular level. The benefits are obvious. Given that 97% of the world’s water is stored in the earth’s saltwater oceans, desalination can effectively augment the world’s freshwater supply, especially in arid, coastal regions. Arguments against desalination typically focus on high fixed and operating costs, which are passed on to the consumer, and its high energy intensity per unit of freshwater produced.

On the bright side, a number of breakthroughs have improved the efficiency of desalination technology. The move from thermal processes (essentially, using heat to vaporize saltwater, then condense it into freshwater) to less energy intensive — thus, less costly — membrane technology (via reverse osmosis or electrodialysis) has greatly reduced desalination costs. In the past, thermal processing plants had to be rather large in order to cover costs and capture economies of scale. With membrane technologies, smaller desalination units provide greater flexibility of application and location.

For water-scarce regions, desalination is a viable answer to a limited water endowment. Exhibit 3 and Exhibit 4 highlight the link between regional water scarcity and areas with the greatest desalination capacity. In fact, three out of every four major desalination projects currently under construction worldwide are located in North Africa or the Middle East. We believe the petrodollar wealth effect in water-scarce, oil-producing regions of the world has jumpstarted municipal investment in new desalination capacity. We believe this trend will continue so long as oil prices support massive budgetary surpluses in these regions, which should boost contracts outsourced to companies in desalination technology and plant construction.

Bottled water — Global gains in bottled water consumption appear to be an ancillary effect of industrialization, urbanization and rising standards of living. Simply put, bottled water serves as a higher-quality, imported water supply, although held to quality standards little stricter than the water that comes out the average American spigot. Since 1975,

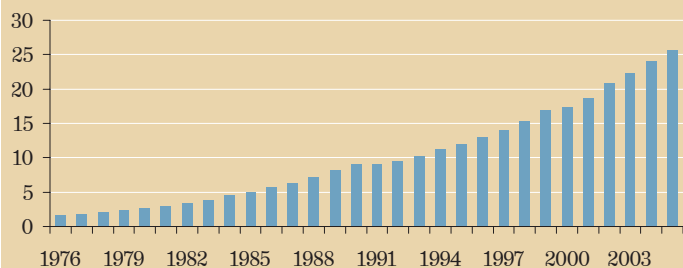


bottled water consumption has grown massively in the U.S. In 2003, it became the second most consumed beverage behind carbonated soft drinks and approached \$10 billion in domestic sales last year (see Exhibit 5). Much of this growth is the result of shifting cultural stigmas, health-related concerns and convenience, yet we also view bottled water as a supplementary product to a weakening and less reliable municipal water supply. Demand has grown so strong that, on average, bottled water costs more for U.S. consumers than gasoline. The premium paid for store-bought water is staggering — in some cases, up to a several-thousand percent markup exists over the cost of (government subsidized) tap water.

Like the surge in U.S. bottled water demand in the latter half of the twentieth century, we believe bottled water consumption will increasingly catch on in the developing world, particularly in Asia. As

Exhibit 5

U.S. bottled water: Potential growth precedent (U.S. consumption of bottled water, annually, gallons per capita)



Sources: Beverage Marketing Corporation; International Bottled Water Association; Investment Strategies Group
Data through December 31, 2005

urbanization trends continue and new middle classes are created in the cities, store-bought water will increasingly become a viable form of water supply for class-conscious consumers ready to move beyond relying on stressed municipal water resources. Exhibit 6 shows the top ten markets for bottled water consumption in 2004. The three markets with the highest rates of consumption growth since 1999 (China, India and Indonesia, respectively) also have some of the lowest penetration rates for bottled water consumption per capita. In that developing Asia is home to approximately half the world's population, we believe these markets present a huge growth opportunity for commercial water exporters.

Infrastructure

Related industries: Pumps, valves, pipes, meters, automation and engineering/consulting services

Water infrastructure needs exist today both in the United States and the developing world, but for differing reasons. Infrastructure replacement is a pressing concern for the United States. The Congressional Budget Office report titled "Future Investment in Drinking Water and Wastewater Infrastructure" estimated that required improvements to U.S. drinking water and wastewater infrastructure will average \$14.6 billion to \$41.0 billion per year through 2019. In order to put this massive infrastructure requirement into perspective, consider that America's drinking water network has 800,000 miles of pipe — five times as much as the national highway system has roads. In many places, this infrastructure is approaching the

end of its life cycle and is in need of repair; the International Water Supply Association estimates the U.S. loses up to 30% of its treated drinking water through leaky and corroded pipes. The aggravating factor is that public funding has not kept up with demand. Federal appropriations for drinking water supplies in fiscal year 2006 were only \$850 million, the same as the year prior, while outlays for wastewater services totaled \$730 million, a third less than fiscal year 2005 — hardly enough for a system the American Society of Civil Engineers in 2005 called "poor, due to a lack of investment in plant, equipment and other capital improvements over the years." In the long term, we believe that infrastructure needs will become so severe that, barring even more tax-friendly municipal financing methods than what is now afforded to U.S. states, the government could simply shift the burden of responsibility onto the private sector, similar to the water utility bonanza described earlier that swept through the United Kingdom in the 1990s.

Developing Asia takes precedence as the most viable new market for water infrastructure outside of the U.S. In recent decades, many of the world's largest cities have sprouted rapidly, particularly in China, India and surrounding regions. These sprawling metropolises have grown far ahead of their capacity to effectively supply drinking water

Exhibit 6

Top ten markets for bottled water (Annual consumption in billions of gallons and annualized growth rate in percent)

Rank	Nation	1999	2004	5-year annualized growth rate (%)	2004 gallons per capita
1	United States	4.6	6.8	8.2	22.8
2	Mexico	3.1	4.7	8.8	43.6
3	China	1.2	3.1	20.9	2.4
4	Brazil	1.5	3.1	15.4	16.4
5	Italy	2.4	2.8	3.6	48.4
6	Germany	2.2	2.7	4.4	32.9
7	France	1.8	2.3	4.2	37.3
8	Indonesia	0.9	1.9	16.5	8.7
9	Spain	1.1	1.5	6.2	33.7
10	India	0.4	1.4	25.0	1.2
Top ten subtotal:		19.2	30.2	9.5	8.7
Rest of world:		6.8	10.5	9.0	3.5
World total:		26.0	40.8	9.4	6.3

Sources: Beverage Marketing Corporation; International Bottled Water Association; United Nations Population Division; Investment Strategies Group at Bank of America
Data through December 31, 2004

and treat wastewater for their citizens. Local governments and global water companies are keenly aware of this lack in basic infrastructure. Statistics published by the U.S. Department of Commerce show urban water coverage in China is lacking; in 2002, water supplies in the 660 largest cities covered only 77% of the local population, while less than 40% of wastewater went treated by local municipalities (rates were even lower in rural areas). As urban populations inflate due to emigration from rural highlands, water supplies in China will fall under increasing stress, while untreated wastewater will become an even greater threat to existing water resources. This goes the same for industrial water users, which are exponentially producing unregulated wastewater as economic growth surges. In that China wants to avoid another large scale environmental catastrophe like the benzene spill that fouled water for millions of people in Harbin last year, we believe a concerted effort to manage and effectively treat China's wastewater has finally arrived.

The good news is that, in China specifically, water market reforms have followed its acceptance into the World Trade Organization (WTO). China is now making way for a more open and liberalized water market, one readily accessible to foreign water companies from France, Germany, the U.K. and the United States. In this regard, we believe all facets of private water will become further involved in China, though, at this point in time, we place particular emphasis on pipe, valve and pump production, automation and engineering and consulting services as primary beneficiaries of pressing infrastructure and treatment demands.

Developing Asia is the most viable new market.

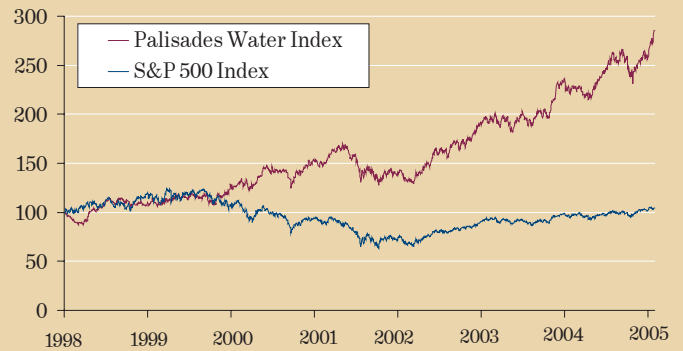
Water, water everywhere

When it comes to tracking companies engaged in the global water industry, the American Stock Exchange Palisades Water Index⁵ (ticker ZWI) is

Exhibit 7

Water stocks outperformed S&P 500 after 2000

(Index values = 100 as of December 31, 1998, daily close, price return)

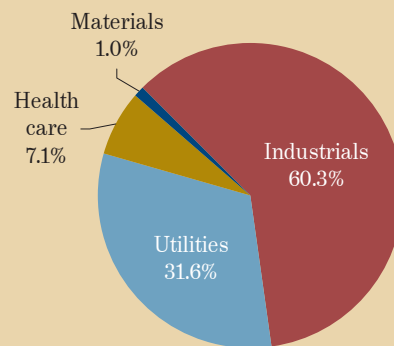


Sources: American Stock Exchange; Bloomberg
Data through January 31, 2006

Exhibit 8

Palisades Water Index sector weights

(Proportion of index member weights by sector as of December 31, 2005, percent)



Sources: American Stock Exchange; Bloomberg

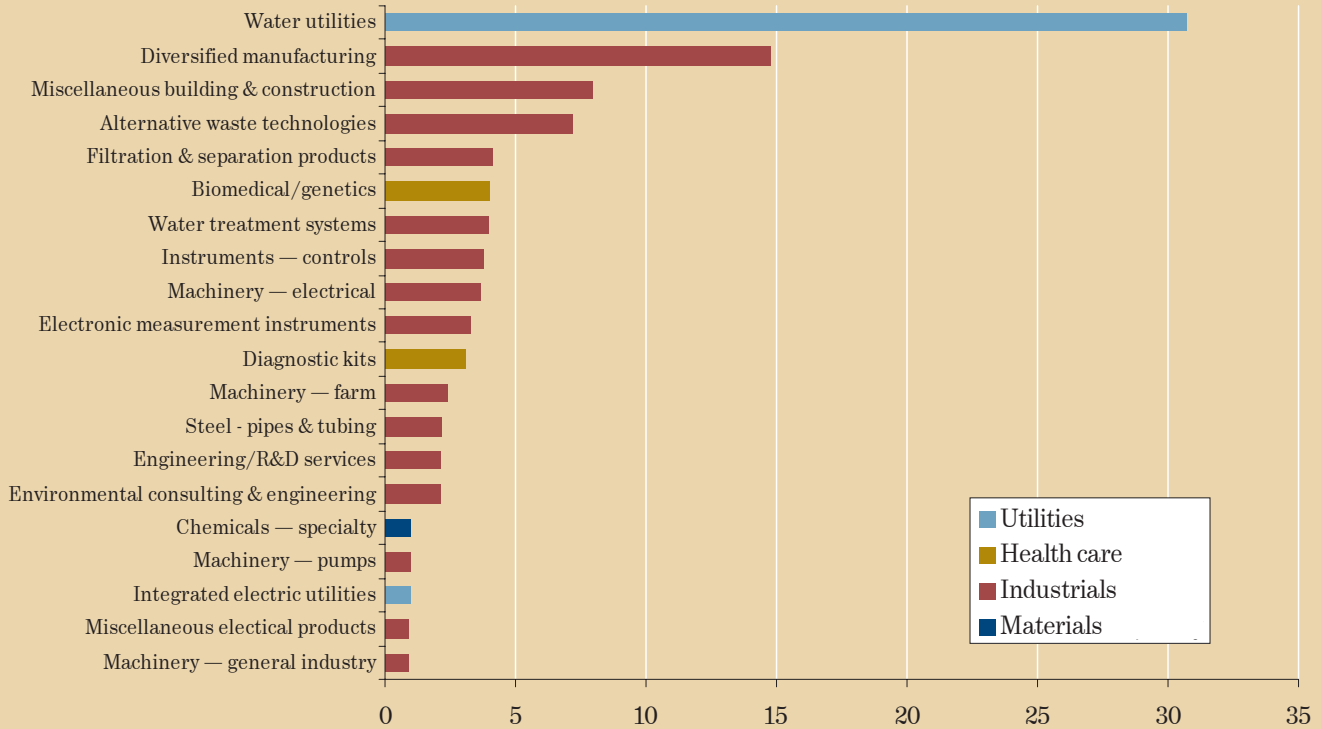
widely recognized as representing a broad array of businesses involved in meeting the global need for safe drinking water, environmentally-sustainable usage and industrial water process improvement. Each industry previously mentioned in this article, with the exception of bottled water, had representation in the Palisades Water Index as of the beginning of January 2006. The index contains shares of U.S. companies and American Depository Receipts (ADRs) representing foreign-domiciled firms, highlighting its broad exposure to the global water theme. Other indices offering lesser exposure to water-related companies include, but are not limited to, the Dow Jones U.S. Industrials, MSCI Europe Water Utilities Index, Bloomberg World Water Index and S&P 1500 Water Utilities Index.

⁵The Palisades Water Index (ZWI) is a modified equal-dollar weighted stock market index. It is designed to track the performance of companies engaged in the global water industry such as pump and filter manufacturers, water utilities, and irrigation equipment manufacturers. The index was set at 1000 as of December 31, 2003. It is unmanaged and unavailable for investment. **Past performance is no guarantee for future results.**

Exhibit 9

Industry composition by index weight

(Palisades Water Index weight by subsector as a share of total, percent)

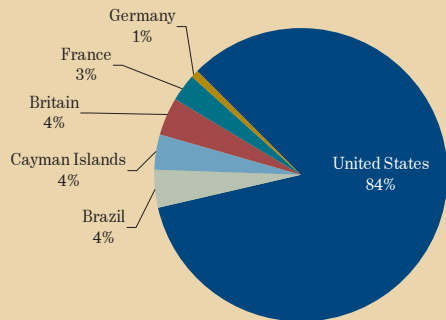


Sources: American Stock Exchange; Bloomberg

Exhibit 10

Palisades Water Index country weights

(Proportion of index member weights by country as of December 31, 2005, percent)

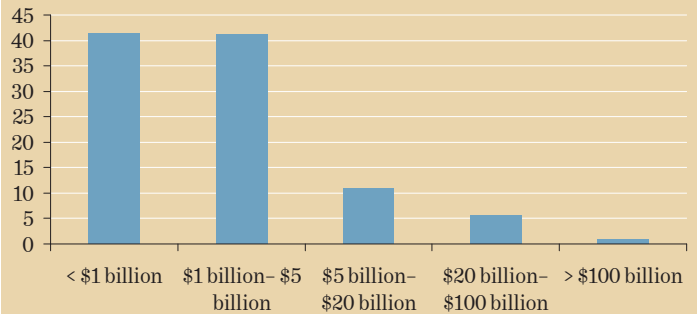


Sources: American Stock Exchange; Bloomberg

Exhibit 11

Palisades Water Index member market cap size

(Proportion of Palisades Water Index total weight by market cap, percent)



Sources: American Stock Exchange; Factset
Based on member market values as of January 31, 2006

While it is not possible to invest directly in an index, there are a variety of exchange-traded funds (ETF) and mutual funds that will enable you to whet your appetite for water — including ETFs that seek to mirror the performance of water-related indices

such as the Palisades Water Index, the S&P 1500 Water Index and others. Please speak to your investment professional to learn more about investing in water and to determine if an allocation to this vital commodity has a place in your portfolio.

Exchange Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. You should carefully consider the investment objectives, risks, charges, and expenses before investing in ETF's and mutual funds. This and other important information is included in the prospectus, which should be read carefully before investing. Prospectuses can be obtained from your investment professional or by calling Banc of America Investment Services, Inc., at 800-926-1111.

¹The Bloomberg World Water Index is a capitalization-weighted index of the leading water stocks in the world. There are 10 holdings in the index. It is unmanaged and unavailable for investment.

²Standard and Poor's 1500 Water Utilities Index is a market-capitalization weighted sub-industry index derived from the S&P 1500 Utilities index, which is in turn derived from the S&P Composite 1500 (S&P's total U.S. stock universe). It is designed to track the performance of a select group of companies that purchase and redistribute water to the end-consumer including those that deal in large-scale water treatment systems. It is unmanaged and unavailable for investment.

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