NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

CHANGING SHADES OF GRAY

Big Winners, Big Losers

The year 2007 will be remembered for a string of 300-point swings for the Dow Jones Industrials that became commonplace. 2007 was also a year of big winners and big losers. Anything global or commodity-related advanced steadily as investors jumped on the Chinese growth story. Emerging markets advanced 36.4%, Pacific Basin ex-Japan gained 37.7% and natural resources returned 39.6%.[1] Companies like Google, Apple and Research in Motion, recalled the tech boom of the 1990's. Meanwhile, "subprime" entered every day parlance as the housing bubble burst. There were staggering losses for venerable banks, brokers and mortgage lenders reminiscent of the terminal declines in Enron, WorldCom and Global Crossing. The NAREIT (National Association of Real Estate Investment Trusts) Index *declined* 15.7%, financial services *declined* 13.2% and small cap value funds *lost* 5.6%.[2] It was a critical year to emphasize the winners and avoid the losers.

2008 is starting out much the way 2007 ended. It is challenging! The Dow Jones Industrial Average lost 3.5% in the first three trading days; the worst first three days of a new year since 1932.[3] By January 22, 2008, the Dow was down 15.1% from its October high.[4] In this environment we will continue to do what we did in 2007. For each portfolio our strategic focus begins with an appropriate long term diversified target allocation that is then adjusted for the risk/return potential of the market. This allows us to capture the upside when times are good and lets us cushion the fall in the not-so-good-times. From a tactical viewpoint we

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overweight those asset classes and sub-sectors that we believe will outperform the strategic benchmark portfolio and underweight those areas that we believe will underperform the benchmark portfolio. Additional measures that we may take to reduce portfolio risk and increase return are:

1. Raising cash for intermediate (four to six months) periods of time - we could go 25% to 70% in cash and bonds.
2. Buying inverse mutual funds and ETFs (Exchange Traded Funds). These funds go up in value when the market declines.
3. Buying S&P 500 put options as a hedge against long positions.
4. Avoiding the troubled areas - in 2007 and early 2008, these were the financials, real estate, consumer durables and retail areas.
5. Overweighting the secular leadership areas - in 2007 and early 2008, these were the natural resources, industrials and international areas.
6. Overweighting recession resistant stocks like consumer staples, drugs and biotech.
7. Staying nimble and flexible in a very dynamic and volatile investment environment that is never black and white but changing shades of gray.

Current Economy

United States Economy

The economy is teetering on the edge of recession or in a recession. Policymakers have been responding quickly and aggressively to stimulate economic growth. The Federal Reserve is clearly biased toward lowering interest rates. They cut the Fed Funds rate by 1.25 % in two weeks time, the most abrupt rate-cutting spree in the modern history of the U.S. central bank. A couple of weeks later, President Bush signed a $168 billion stimulus package to help boost the slowing economy. Policymakers were reacting to dismal economic numbers: a crashing housing market, falling stock prices, rising costs for energy, goods and services and climbing unemployment. The American consumer is being hit from all sides.

Unusually difficult housing and credit markets mean no one knows whether this is going to be a mild recession, one that is over by the second half of 2008, or a worse than normal recession that could persist into 2009. The stock market has already priced in a mild recession but is reserving judgment on a more severe one. We'll be watching to see if the "worst-case" scenario is unfolding and therefore warrants a more defensive investment posture.

World Economy

World GDP (Gross Domestic Product) is expected to retreat from 4.7% growth in 2007 to 4.1% in 2008.[5] The Far East is starting to decelerate, although still growing at a nice pace. JPMorgan sees fourth quarter growth in emerging Asia slowing to 5.2% compared with an average of 9.3% in the first three quarters of 2007. Stripping out China and India, the fourth quarter number falls to 3.3%.[6] Western Europe may grow 2.0% in 2008 and Japan 1.3%[7] (as we go to press, Japan has surprised with stronger-than-expected Q4 GDP of 3.9%).[8]

Asset Allocation

U.S. Stocks and Bonds

We are assuming that the U.S. Stock Market is in a bear market. From the October 2007 highs to January closing lows, the S&P 500 Index was down 16.5%, the NASDAQ 100 Index 22.3% and the Russell 2000 (small cap index) 23.1%. The markets have retreated enough that one might argue that the lows in January could be the bottom for this particular bear. If, on the other hand, this is not a mild recession, we may see those lows broken. With this uncertainty, we believe it is not a time to be fully invested. Even though there is an overwhelming current of negative sentiment in the markets (often a precondition for *the* bottom), it is too soon to assume that the bear is finished. Still, we cannot ignore that the recent market decline has served up some tremendous buying opportunities, from a long term perspective, which we should try to exploit. Since one never knows a bottom has been seen until after the fact, we are inclined to add to positions at intermediate bottoms (one is currently forming) and take off positions at intermediate tops. Also, we would be inclined to remove some hedges at intermediate bottoms and put them back on at intermediate tops. We continue to like big-cap growth, selected health, technology and industrials, biotech and selective consumer and telecommunications stocks.

In fixed income, we are buying high quality cash instruments, short-term bonds, and foreign cash funds such as Australia's, where current yields are higher than in the United States. We see approaching opportunities in mutual funds that focus on high-quality Mortgage Backed Securities, intermediate-term corporate bonds and long-term municipal bonds, where nominal yields now exceed those of treasury bonds. Treasuries are overpriced and offer little value relative to inflation rates. Cash fled to this “safe haven” investment, happy to give up yield for safety of principal. Currently, six month Treasury Bills are yielding 2.1% in a 4% inflationary environment (not a great after-tax, after inflation, rate-of-return). While a worst-case economic scenario could push short-term treasury yields to lower levels, much if this appears to be fairly discounted.

International

We are also assuming that foreign stock markets are in a bear market. Most international markets are down between 15% and 35% from their highs. Far East economies are still growing, though more slowly than before. We think that the Far East and emerging markets still offer the best opportunities. We advocate the same strategy as in U.S. markets; buy the intermediate bottoms and sell the intermediate tops until there are indications of a new bull market. Overall, we remain neutral to overweight in this area.

Natural Resources and Energy

Investors should continue to ride the energy bull. Oil prices are quietly moving higher after a choppy correction late last year. There are two long-term supports for energy prices: demand and supply. First, demand from emerging markets is bullish for energy. The primary force behind increasing demand is rising per capita income, driven by industrialization and urbanization. For example, if China consumed energy on par with more developed Asian countries such as Korea or Japan, energy demand would increase to a level that is *twice* as large as U.S. consumption,[9] currently the world's largest energy user. The second long-lasting source of support for energy prices is the slow supply response. Oil discoveries peaked in mid-1960. Since consumption continues to steadily increase, there has been a growing deficit between oil discoveries and demand since the early 1980s. Both energy commodities and stocks should continue to benefit from the growing imbalance between demand and supply

Real Estate

REITs (Real Estate Investment Trusts) in 2008 are showing signs of recovery after a full year of falling prices. From their highs in February 2007 to their lows in January 2008, REIT stock prices were down 35% to 40%. We see some select issue interest in this area but remain significantly underweight.

Summary

The U.S. economy is in or close to a recession. All markets around the world are currently in bear markets until proven otherwise. Portfolio management should be oriented toward preserving capital until the bear is proven dead. It is too early to be fully invested. In the U.S market selective positions can be added at intermediate bottoms but should be reduced at intermediate tops. We recommend being overweight energy and natural resources, neutral to overweight international markets and underweight real estate.

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