Commentary - 1st Quater 2007

During the second half of 2006, the economy was growing at a pace that was not too fast and not too slow. Sometime during the middle of the first quarter of 2007, our Goldilocks economy was waylaid by a surge in defaults in the subprime mortgage sector. With mortgage defaults rising, the housing sector weakness may spread to other areas of the economy, causing that long-predicted recession. More about that in a minute.

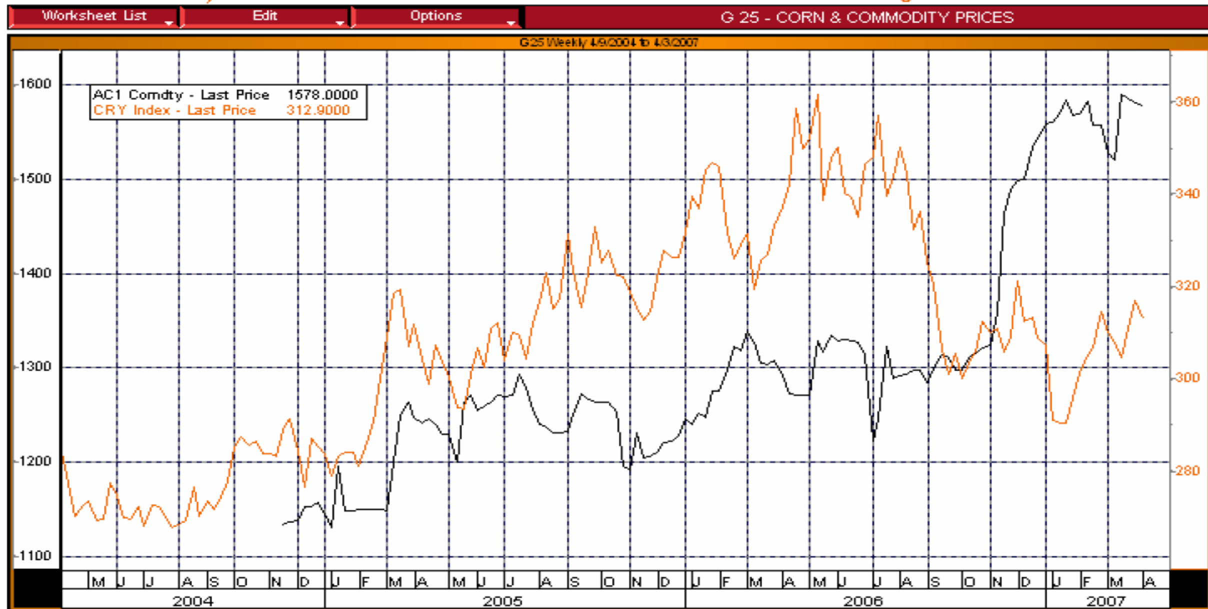
The broad stock market eked out a small gain for the first quarter, with the S&P 500 Index rising 0.70%. In mid-February, the markets were up over 3.0%. But then the Chinese stock market suffered a 9% decline in one trading day, causing investors around the world to recognize that risk still existed and they had not protected themselves adequately. All of a sudden a market that had only traded in one direction – up, over the last six months, suffered a serious crisis of confidence. Volatility is back!

After the last meeting of the Federal Reserve to set policy on interest rates, the Fed announced they saw risks to the economy balanced between inflation and a potential slowdown from the housing sector. This small change in their outlook from their previous stance that higher inflation was the primary risk, indicated to Fed watchers that the Fed was changing their bias from one of potentially raising interest rates to one of potentially lowering interest rates. Big deal, the bond market has lowered market interest rates over the last three months without any help from the Fed. The two year maturity Treasury note is trading at a yield of 4.60% down from 4.80%, much lower than the Fed's 5.25% Fed Funds target. The Fed may still be worried about inflation, but the bond market is more worried about the housing sector and the subprime mortgage meltdown leading to a credit crunch as banks tighten their lending standards. Subprime mortgages are home loans that are made to borrowers with poor credit history (or no credit history) who cannot qualify for conventional mortgages. Unfortunately, mortgage originators made it too easy for these buyers to purchase homes with little or no money down, no proof of income, and no credit checks. This was a recipe for disaster, and now many of the mortgage originators are struggling to cover mortgage defaults on mortgages they sold to investors. Over twenty mortgage originators have gone out of business in the last ninety days with New Century Financial, the second largest originator of subprime loans, declaring bankruptcy this week. The concern economists have is whether or not the surge in mortgage defaults results in a huge increase in repossessed real estate that is dumped on an already weakening housing market. The Fed stated that they do not see any spillover effect from the subprime sector into other areas of the economy…yet.

The Fed's other cause for anxiety is the resilience of inflation. Price increases moderated in the second half of 2006 as energy prices subsided. However, oil prices rebounded over the

last few weeks and higher corn prices are going to spread through the food chain. Corn is in very strong demand because new ethanol plants are big purchasers of corn. Unfortunately, corn is used in many other products as well as feed for livestock and poultry. Other commodity prices are still rising, as shown on the graph below. Corn prices are represented by the black line, and the CRB Index of other commodity prices is shown by the orange line.

GRAPH 1. CORN PRICES AND CRB INDEX



Our confidence in a positive market return for 2007 has been shaken by recent events, but the bond market's response with lower interest rates should support the financial sector. As long as job growth remains resilient and consumers' incomes rise, consumer spending should keep the economy moving ahead. We may see an improvement in economic growth in the second half of the year if the housing sector stabilizes and low interest rates spur activity.

As usual, we have to throw in a caveat or two. During the first quarter, China announced that it was going to change how it invests its foreign reserves. Previously, the Chinese monetary authorities purchased U.S. Treasury and Federal Agency bonds with the proceeds of the country's trade surplus. Since the reserves are approximately $1 trillion, the Chinese authorities are going to look into investing the surplus dollars into other assets. If they reduce their purchases of U.S. Government securities, that could have a harmful effect on our bond market, causing our interest rates to rise. Rising interest rates are about the last thing our economy needs right now. And to add momentum to the Chinese move, the U.S. administration recently announced that we would impose tariffs on coated paper imports from China. Isn't that a great way to treat one of your major suppliers of credit, start a trade

war with them? Who came up with that brilliant idea?

Here is a look at how our asset class strategies performed during the first quarter's rollercoaster ride:

Large Cap Stocks: The Blue Chip Strategy fell 0.29% in the first quarter versus a 0.70% rise in the S&P 500 Index. Alcoa was the best performing position, gaining 13.5% as they reported strong earnings and rumors of potential mergers boosted their shares. The weakest position was Johnson & Johnson, down 8.2%, followed closely by Home Depot, down 8.0%. With an estimated price to earnings ratio of 14.47 and a dividend yield of 2.23%, the Blue Chips are very reasonably priced. Unless there is some kind of extraneous shock to the economy, the downside for big company stocks appears limited. Once investors regain confidence in the economic outlook, we could see a nice gain in the broad market. You should notice that Kraft was added to your Blue Chip holdings recently. It was spun-off from Altria (the new age name for Phillip Morris). Most analysts are downbeat on Kraft, so it may trade at a low valuation. Since expectations are so poor, we may keep it a while to see if they can prove their doubters wrong.

Small Cap Stocks: Amazingly, the Small Cap Value Strategy rose 11.69% in the first quarter versus 1.66% for the Russell 2000 Index. The position with the largest gain was our long-time holding American Pacific Corporation. American Pacific rose 45% after announcing earnings and forecasting significant growth this year. Brett and I met with their management team during a trip to Las Vegas and were impressed with their strategy. In the past, they had used cash flows from their rocket fuel business to make some poorly performing acquisitions. But in late 2005 they announced the purchase of a pharmaceutical chemicals business from Gencorp. This is a good fit for American Pacific because they are familiar with the manufacturing process of fine chemicals in their other businesses. The pharmaceutical chemicals they produce are the building blocks that drug manufacturers use. This business is growing at 30% per year with 25% margins. They can reinvest their rocket fuel cash flows into expanding this business. So we think their stock price may finally "take off". Synagro Technologies, a waste treatment company, announced it was being acquired by a private equity firm and the deal closed yesterday. The position gained 31% during the quarter. Our weakest position was Hawaiian Holdings, the parent of Hawaiian Airlines, falling 35.7% in the last month. They announced that yields per passenger flown would fall by 11-12% in the first quarter as competition is hurting pricing. Hawaiian was recently named the top airline in customer satisfaction. It is too bad that they are facing so much price competition and their bottom line is not able to benefit from the high levels of service. If price competition subsides their financial performance could improve dramatically.

Convertible Securities/High Yield: Our Convertible Securities/High Yield Strategy kept forging ahead, gaining 4.53% versus 2.39% for the Merrill Convertible Index and 4.67% for the Merrill High Yield Index. It is surprising that the high yield sector has performed as well as it

has with volatility increasing in the financial markets. Taxable accounts in the strategy benefited from strong performance of our MLP positions. The best performing convertible bond during the quarter was Fairfax Financial which gained 9%. The Fairfax bonds are now trading above conversion price of the underlying stock. The weakest performers included Continental Airlines bonds that fell 9% and Penn Treaty American stock held in our older portfolios that was down 21%. Our Echostar Communications bonds were called away during the quarter for a nice gain and we purchased a position in AES convertible preferred that yields 7.0%. There may be some opportunities in housing related issues but we are viewing the sector with caution at this time.

Intermediate Bonds: The Intermediate Bond Portfolio strategy rose 0.80% in the first quarter versus a 1.57% gain in the Citigroup 1-10 Year Government/ Corporate Index. The Intermediate Tax Exempt Bond Portfolio rose 0.61% in the first quarter versus 0.92% for the Merrill Insured Bond Index. We have not seen many opportunities to purchase longer maturities at attractive yields. We are staying with short term Treasuries and Agencies in the taxable portfolios since the yield advantage from corporate bonds is not high enough to offset the credit risk and short term maturities offer the highest yields. Now that the Fed has moved to a neutral bias on short term rates, the Treasury yield curve is developing a more normal positive slope. This could indicate the bond market expects economic growth will improve or inflation could become more of a problem. If stock market volatility subsides, the bond market will lose some of its safety premium that was built into prices over the first quarter. We are buying intermediate maturity tax exempt bonds in the muni portfolios as their yields are attractive versus short maturities since the tax exempt yield curve is positively sloped.