

## Commentary - 2nd Quarter 2008

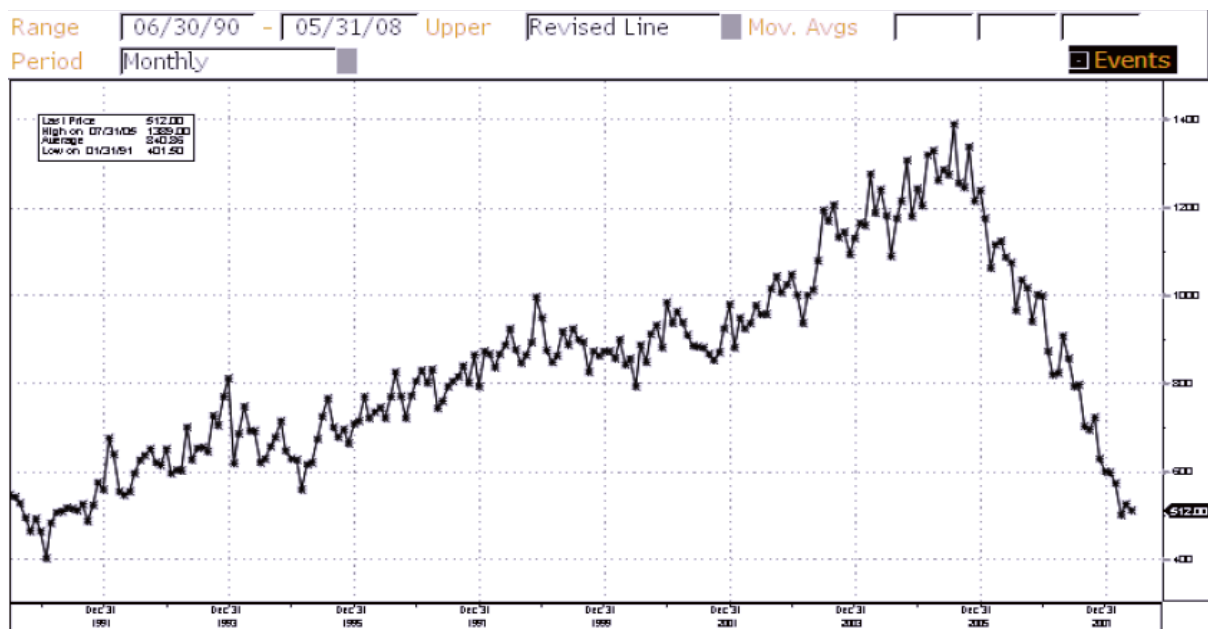
The stock market ended the quarter on a sour note. The Dow Jones Industrials fell almost 10% in June, with four percent of that decline coming in the last week. The subprime mortgage crisis is still causing pain for the financial sector but it is not deteriorating like it was in the first quarter. The markets are more concerned now with skyrocketing energy prices and food prices. The economy survived the subprime meltdown, but now that food and energy prices are putting the squeeze on consumers, the economy may have hit a wall in the second quarter. Car sales are plummeting, the airlines are scrambling to cut capacity and raise revenues, and the politicians are blaming anybody but themselves for causing the mess. The S&P 500 is now down 12% for the year and the Dow is down almost 20% from last fall's high. Pretty ugly.

The panic and fear that pervaded the market in March gave way to relief in April and the first part of May. Risk premiums declined and the flight to quality in the Treasury bond market unwound. First quarter gross domestic product came in better than expected and investors began to think that we had dodged a recession and the worst of the credit crisis was over. The Fed had concentrated on stabilizing the U.S. financial system since the subprime mortgage blow up hit last summer. They lowered the Fed Funds rate from 5.25% to 2.00%. This added liquidity to the banking system and for the first time they allowed investment banks to borrow from the Fed. When Bear Stearns almost failed, the Fed arranged a rescue package with J.P. Morgan and the Fed purchased almost \$30 billion of Bear's assets. This series of events averted a complete financial system failure. So in that sense, the Fed was successful. However, by lowering short term interest rates aggressively and flooding the banking system with money, the Fed allowed the dollar to weaken and commodity prices quickly responded by vaulting higher, led by oil prices. Gold prices also moved substantially higher over the last few weeks. These commodity prices indicate that monetary conditions, managed by the Fed, are way too easy. The dollar has lost over 13% versus a basket of foreign currencies since the subprime/credit crisis began. The Fed made the conscious decision to salvage the banking system and worry about the dollar and inflation later. Unfortunately, the markets are going to demand that the Fed pay attention to the inflationary effects of its policy sooner rather than later. Federal Reserve Chairman Bernanke indicated he was in favor of a stronger currency in mid-June, subsequently Treasury bonds sold off and interest rates moved higher. Higher interest rates put selling pressure on the stock markets and when Bernanke modified his remarks to indicate the Fed was not in any hurry to raise rates, the commodities markets took that as a green light to take off again. Oil moved from \$120 per barrel to \$140 in a flash. After the Fed meeting last week resulted in no change in interest rates, oil rallied again, the dollar weakened, and the Dow fell 400 points. Oh, how we long for a return of the Reagan/Volcker policies of supply side stimulus and higher interest

rates. The economy is beginning a tailspin that could be arrested by tax cuts to spur productivity. The dollar needs support from higher interest rates. Tax cuts would provide the economic stimulus to offset higher interest rates, and a stronger dollar would invite more foreign investment. Have all the policymakers forgotten what worked in the past? Are we doomed to repeat the mistakes of the 1970s?

All is not doom and despair, no matter what the television reporter says. We are starting to see signs of life in the housing market. Existing home sales have increased two out of the last four months and appear to be stabilizing after eleven straight monthly declines. New home sales are close to levels seen during the last severe housing market downturn in 1990 as shown in the graph below. Considering that the economy is now 64% larger in real terms than 1990, for new home sales to be at 1990 levels is a severe correction. Since the housing sector got us into this mess, some stabilization in the housing markets would indicate that the economy is bottoming.

Graph 1. New Home Sales, 1990-Present, Source: Bloomberg



We have observed some other positive signs. The Dow Jones Transportation Index is up approximately 9% for the first six months of the year. This economically sensitive sector has struggled recently, but for it to still be in positive territory suggests that economic activity could rebound. In addition, small company stocks are performing better than large company stocks. Typically small caps lead the stock market out of downturns because they are more responsive to domestic economic activity. (On the other hand, the large cap stock indices may be hurt more by the financial sector problems than the small cap indices.)

Our outlook was generally positive a few weeks ago. The recent run up in energy prices has dimmed our view. The major banks were able to raise capital and deleverage their balance sheets in the second quarter, giving us some confidence that the financial sector was stabilizing. Now that the consumer is being squeezed by higher prices, the economic outlook is more fragile. If more investors take advantage of some of the bargains we are seeing, then capital will be more readily available for new investment and growth initiatives.

There has been a spirited debate on whether or not the run up in oil prices has been due to speculative activity or real demand. In our opinion demand has been strengthened by easy monetary policy, "hot" money, and foreign countries' energy subsidies. Hedge funds, pension funds, and other institutional investors have migrated to commodities because that is the strong momentum investment sector right now. The easy money policies of the Fed supported the tech bubble of the late 1990s. Once the tech bubble burst, the hot money flowed to the housing sector. Sure demand was stronger in the housing sector, but that was mainly because it was easy to finance the purchase of a house and lenders could securitize the mortgage and play hot potato with it. Now the hot money has moved into commodities, especially oil. It is easy for hot money to purchase oil futures contracts that only require a small percentage down payment. Speculators can also invest in energy assets through the use of other types of non-regulated derivative contracts. In order to control speculative activity the regulators need to increase margin requirements and bring the derivative business onto transparent exchanges like the Chicago Board of Trade or the NYMEX. For the dollar to fall less than half of one percent and oil prices to rise by four or five dollars, it is pretty obvious that speculators are involved.

Here is how our various strategies performed during the second quarter.

**Blue Chip Strategy:** Our large cap stock strategy fell 7.32% in the quarter versus a decline of 2.73% in the S&P 500. For the first half of the year our Blue Chips are down 13.55% versus 11.95% for the S&P 500. Mortgage losses are still hurting the banks and now credit card and auto loans are beginning to weaken. Auto sales are falling; especially the large SUVs that were the main profit generators for General Motors. GM's share price traded down to levels not seen in over forty years. Last year's deal with the unions to lower benefits costs doesn't begin to pay off for another year and investors are worried that GM may run out of cash before they can bring new high mileage vehicles to the market. We wrote about the changes to the Dow Jones Industrials last quarter. Unfortunately, one of the recent additions, Bank of America, was one of the poor performers for the second quarter, dropping 35% as investors worried about their purchase of Countrywide. AIG was another financial stock that was hurt by the prolonged decline in subprime mortgage securities. It dropped 38% in the quarter. The other new addition to the portfolio, Chevron Corp., was the leading gainer for the quarter, up 16%. We are not anticipating a rebound in the large cap stocks until the financial sector stabilizes and energy prices moderate.

**Small Cap Value Strategy:** Again our small cap stock portfolio was our best relative performer during the quarter, rising 6.56% versus a gain of 0.58% for the benchmark Russell 2000 Index. For the first half of 2008 the small caps were up 6.50% versus a decline of 9.37% for the Russell 2000. We were fortunate to book some gains on Genco Shipping in May when we sold half of the position. We liquidated our position in Value Vision Media as they were not able to compete effectively in the home shopping arena. We added three new positions in the last quarter using the proceeds from Value Vision, the Genco gains, and our gains on Universal Virginia we booked in the first quarter. We purchased Xerium Technologies in March and April. Xerium is a manufacturer of rolling machines and supplies used in the production of paper. The second purchase was Jackson Hewitt Tax Service, a company that provides services similar to H&R Block. The company had an earnings shortfall this year but it offers a 5% dividend yield and should improve its product offering this year. Finally, we purchased Cooper Tire and Rubber. Cooper is the fourth largest domestic tire manufacturer that focuses on the replacement tire market. We expect more consumers to hang on to their used cars longer during this period of economic malaise so that should benefit the replacement tire market. Cooper's margins are being pressured by the increase in raw materials costs, but when materials costs moderate, they should rebound nicely. (Research summaries are enclosed for clients in the small cap strategy.) The poorest performing position in the strategy during the quarter was Air Transport Group, formerly ABX Air. Air Transport has been the primary domestic airline that services DHL's package delivery service. DHL announced that they were going to discontinue their contract with Air Transport and move that business to UPS. Air Transport is somewhat protected from this move since they can sell their surplus aircraft to DHL without a loss and they have been aggressively growing their non-DHL business. We sure wish management of Air Transport had accepted the buyout offer of \$7.75 per share that they received in the summer of 2006. The best performing position in the portfolio in the second quarter was Meridian Resources, an oil and gas exploration company that almost doubled. Meridian's exploration program includes Louisiana marshlands and an Austin Chalk project in East Texas. With energy prices skyrocketing, Meridian's value rose with the sector. Our outlook for the small cap sector is cautious with the economy struggling and banks restricting their lending. Fortunately our economy is resilient and once energy prices moderate, we should see a strong rebound in share prices.

**Convertible Securities/High Yield Strategy:** Our high yield convertible strategy rebounded slightly in the second quarter providing some welcome relief from the first quarter. The strategy rose 1.75% versus a gain of 1.97% in the Merrill Convertible Index and 1.80% in the Merrill High Yield Index. For the first half of the year, the convertible strategy declined 8.15% versus a decline of 3.17% in the Merrill Convertible Index and a decline of 1.24% in the Merrill High Yield Index. Our exposure to airline bonds hurt performance as airlines are struggling to deal with higher fuel costs and lower demand. Our positions in energy companies did not perform well enough to offset the airline bonds. Also, we were too early to move into the financial sector. Our Franklin Bank bonds declined substantially after they

delayed their financial filings due to accounting problems. They subsequently announced higher non performing loans, writeoffs, and removal of top management. We expect Franklin to raise additional capital or be acquired. We added some new positions to the portfolio during the quarter including Navios Maritime Partners, a bulk shipping company with a dividend yield over 9%, Crosstex Energy Inc, a pipeline company with a 4% dividend yield that should grow at 30% annually over the next couple of years, Affymetrix convertible bonds, and Lifetime Brands convertible bonds. Affymetrix manufactures chips used in the processing of DNA for disease relief and solutions. The bond yields over 8% to a put date in 2013. Lifetime Brands owns numerous dinnerware and cutlery brands. Their earnings are down with consumer spending but they are still expected to turn a profit this year and our bond yields 14.75% while we wait for their sales to rebound. We have not seen high yield bond opportunities like this since 2001. When you can purchase bonds with yields over 13% from profitable companies, the relative value is very high. The high yield bond market is being buffeted by investor fears of a financial system meltdown, but we think the Fed's move to backstop the investment banks makes that scenario unlikely.

**Intermediate Bond Portfolios:** Our taxable bond strategy fell 0.76% during the quarter versus a decline of 1.54% in the Citigroup 1-10 Year Govt./Corp. Index. For the first half of 2008, the Intermediate Bond Portfolio rose 0.79% versus a 1.57% gain for the index. Interest rates rose during the quarter as the credit crisis abated and jumped significantly in early June with Fed Chairman Bernanke said he was worried about dollar weakness and inflation. The bond market quickly priced in a Fed tightening move but the sell-off in the stock markets mitigated some of the bond market weakness. Our tax exempt bond portfolios fell 0.43% during the quarter while the Merrill 3-7 Year Insured Bond Index fell 0.78%. For the first six months the tax exempt portfolio was up a whopping 0.03% versus 1.05% for the index. Municipal bonds were once again hurt by the deteriorating financial strength of the municipal bond insurers. MBIA and AMBAC were downgraded by S&P and Moody's in June, adding fuel to the credit market problems. The yields on municipal bonds are very attractive versus taxable bonds as the downgrades on the bond insurers are causing heavy selling pressure. We continue to add tax exempt bonds to our client portfolios as cash flows and maturities permit. We expect the bond markets to continue to be volatile as inflation worries, credit problems, and dollar weakness exert selling pressure on fixed income securities.

These are trying times in the financial markets. The excessive use of credit over the last thirty years is being unwound at a rapid pace and the financial system is struggling to maintain its capital base. Policy makers could help the situation by stimulating the economy with tax cuts while the Fed raises interest rates to strengthen the dollar and reduce inflationary pressures. We think the worst of the credit market problems are behind us so our balanced portfolios should be able to weather future market declines in a satisfactory manner. If the housing sector begins to stabilize as recent indicators suggest, then mortgage backed securities will perform better and strains on the financial sector will subside.