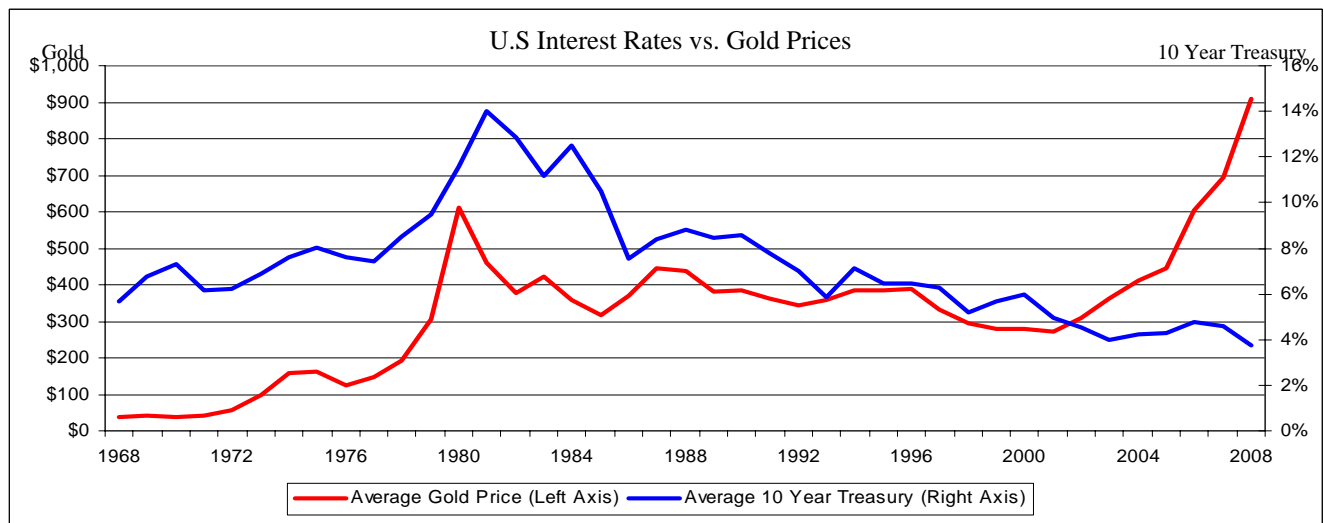


# Quarterly Commentary

## 2nd Quarter 2008

As we discussed in our last piece, we see current intermediate and long-term interest rates as very unattractive. To refresh from last quarter, we believe that inflation is even higher than the rising numbers the government is publishing. When comparing current interest rates to inflation, a domestic fixed income investor is put into a losing position from day one.

There is no doubt that interest rates have de-coupled from inflation expectations over the last five years. The chart below reflects this. **The** key measure of inflation expectations, the price of gold, once highly correlated to changes in interest rates, has skyrocketed. At the same time, interest rates have actually fallen.



Source: Yahoo! Finance, Kitco

We believe that current low interest rates are artificial to some degree, not fundamental. This artificiality derives from two main sources: an overly accommodative Federal Reserve policy and huge amounts of foreign buying of U.S. debt, even in the face of a rapidly declining dollar over the last 30 months.

We have discussed our disagreements with Fed policy ad nauseum, so let us focus on the vast foreign holdings of U.S. Government, U.S. Government Agency and U.S. corporate debt. As can be seen from the chart below, foreign holdings of U.S. debt have skyrocketed over the last five years. While the numbers for fiscal year ended June 30, 2008 are not yet available, we are highly confident that this trend is still in place. The fact that foreign demand for U.S. debt has not been impaired by large currency losses experienced by foreign holders says that foreign holders are motivated by other factors in choosing U.S. debt.

One of these motivating factors is the importance for these countries to support export trade to the U.S. Through the re-investment of dollars received in trade back into dollar denominated securities (Japan, China and the Middle Eastern countries are good examples) the value of the dollar is supported vis-à-vis other currencies, thus making foreign exports to the U.S. more attractive than they would otherwise be. Several countries have recently expressed interest in diversifying their dollar holdings into investments other than those denominated in dollars. While a major shift of this nature has not yet been reflected in the foreign holdings, we believe that it would impact our interest rates significantly to the upside.

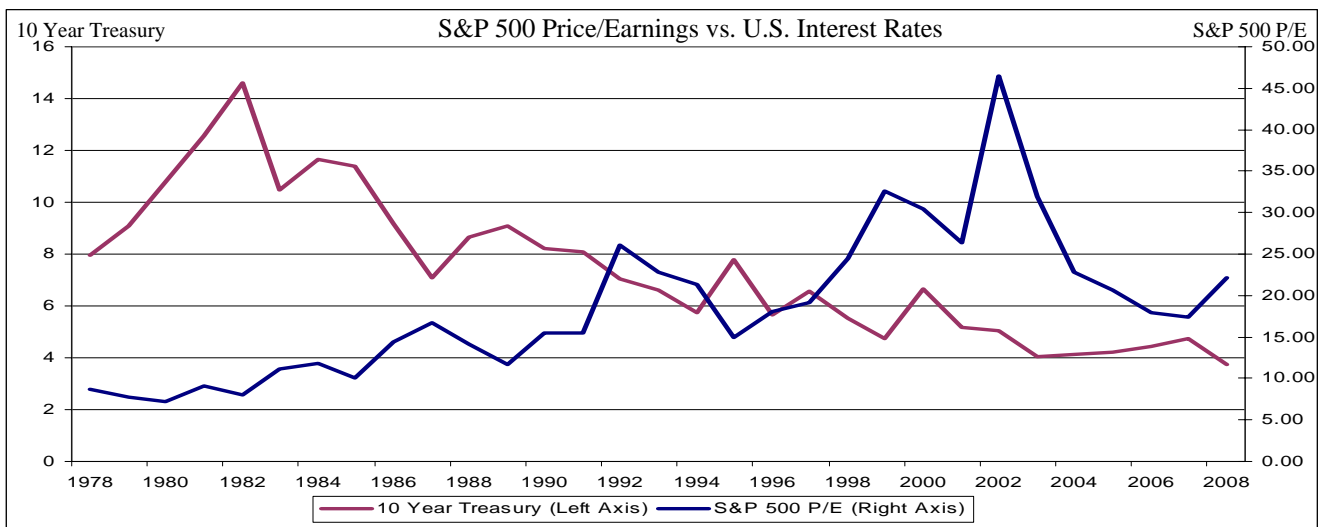


There are at least two other factors that foreigners may consider in holding our debt in the face of a declining dollar. First, our country is seen around the world as a relatively free economy that offers a safe haven for capital. Secondly, U.S. interest rates may be more appealing than those in their own country (the best example of this has been Japan over the last twenty years).

While we are not necessarily predicting it, we see the potential for any of the above factors to change. Fixed income investors in securities denominated in U.S. dollars might suddenly realize that inflation and dollar degradation are eating away at their capital. Suffice it to say that our dependency on foreign capital, we believe, is a

potentially unstable way to finance an economy. Similar to this country's increasing dependence on foreign oil, our reliance on foreign capital could become increasingly expensive.

Our equity clients may be wondering what any of this has to do with stocks. The answer is that historically, prevailing interest rates have had a huge impact on stock valuations. This makes sense intuitively, as bonds and stocks compete with each other for funds based on the promise of investment returns. As interest yields on bonds increase, investors will move money out of stocks, a riskier asset class, in favor of bonds. The graph below supports this thesis. As you can see, starting in the late '70's, interest rates were on the rise and stock valuations, as measured by price to earnings ratios, were in decline. As interest rates fell throughout the '80's and '90's, stock valuations rose. Price to earnings ratios actually peaked prior to the tech/growth stock bubble bursting between 2000-2002. While nowhere near where they were at their peak, valuations today still remain considerably above the long-term average of 14 times earnings.



Source: St. Louis Federal Reserve, Standard and Poor's

If we knew for certain that interest rates would stay in the very low territory they now occupy, we would be warranted in paying current valuations for many stocks. Because we do not know that, it is incumbent on us to select stocks that contain a margin for error. In other words, we are not selecting stocks where we can make a case for a 5%, 6% or even 7% return. We want stocks that represent the potential for a 12%-15% return. While we know that not all of these will work out as well as we envisioned, there have historically been some that worked out even better. By demanding a higher potential return (we would call it being more price sensitive) we will hopefully be somewhat protected should interest rates rise in the future. As always, this approach requires patience, particularly for our newer clients that want to be fully invested.

## **Mid-Year Assessment**

It is hard to believe, but we've already hit the halfway point in 2008 (for anyone under age 30 reading this, be forewarned...the years go faster as you gain seasoning).

It has been a difficult year for most stock investors thus far. Large asset write-offs have continued to cause weakness in the financial sector, and rapidly rising commodity prices have also helped to unnerve the market. The S&P 500 Index total return is down 11.9% for the first six months of this year. A fascinating statistic, and one we alluded to last quarter, is that the total annualized return for this broad market index for the ten years ended June 30, 2008 stands at just 2.88% (thankfully, not our clients' experience). It is no wonder that we are beginning to see many signs that the general public is becoming increasingly frustrated with stock investing.

By no coincidence, that brings us to the good news! We are beginning to have new companies come closer to our target prices for possible acquisition. What is even more encouraging is that many of these companies are very strong, large organizations that pay highly attractive dividend yields. We review these target prices prior to adding a position to your portfolio, trying to assure our clients the best chance for a high potential return on their capital.

We have received many questions regarding rapidly declining bank stocks and whether we consider them to be bargains at this point. We always state that there are many uncertainties when buying financial stocks. These uncertainties are very important to recognize due to the leverage at play (a large amount of assets sitting atop a small amount of capital) in any financial institution. Thus, investors in financial stocks are highly dependent on management. It seems to us at this writing that there are still more potential asset problems (loans and investments) relating to a highly indebted consumer waiting to be revealed. As can be seen from the table below, the fundamentals of bank stocks are nowhere near as attractive as in the early 1990's, when these stocks were proved to be bargains.

	<b>Price/Book Value</b>		<b>Price/Earnings</b>		<b>Dividend Yield</b>	
	<b><u>12/31/1990</u></b>	<b><u>3/31/2008</u></b>	<b><u>12/31/1990</u></b>	<b><u>3/31/2008</u></b>	<b><u>12/31/1990</u></b>	<b><u>3/31/2008</u></b>
J.P. Morgan	0.33	1.16	5.84	11.58	21.30	3.54
Wells Fargo	0.75	1.99	3.64	12.49	8.00	4.26
Comerica	0.76	1.00	4.89	8.88	7.91	7.53
Bank of America	0.84	1.21	8.70	16.00	6.21	6.75

Based on the uncertainties surrounding asset quality, and the lack of attractive fundamentals relative to the stock prices, we have chosen to pass on the bank stocks for now.