Review, Outlook and Opinion ________________ January, 2008

By: Scott Walker, CFP

Light at the End of the Tunnel – Greetings and happy New Year! We've had a rough go of it lately, but remain confident that our balanced asset allocation approach is the best way to build and preserve long-term wealth. Last year we misjudged the extent of the downside risk in our quest for high yield as some of our fixed income securities were adversely affected by the sub-prime mortgage induced credit crunch. Portfolios heavy in preferred stocks, closed-end income funds, and reverse convertible notes fared the worst. Although we had more winners than losers, we have made a policy decision to stop purchasing any new reverse convertibles. We pledge to work harder in our due diligence and research process moving forward, and are happy to meet with you and discuss your personal situation further.

Last year there was a flight to safety, so high quality bonds (Treasuries, government agency securities, and many municipal bonds) benefited and moved higher in price. Higher prices mean lower yields for bonds, and the stampede into Treasuries has pushed the yield on the 10-year bond down to 4.03%. The earnings yield on stocks is currently 5.60% for the S&P 500, so stocks currently represent better value than high quality bonds.

The bullish case for stocks rests on global growth continuing from the developing market economies. Monetary authorities (the Federal Reserve and other world central banks) hold the keys. High oil prices will require more aggressive stimulus from policymakers in order to support economic growth, and we expect at least another ¼% drop at the January 30th meeting, with more to follow. Sovereign wealth funds, large investment pools organized by foreign governments that have accumulated massive cash reserves, represent another catalyst to push stocks higher. While acknowledging short-term risks, we believe the sell-off in stocks is in the very late stages, and view the current environment as a mid-cycle temporary correction, and look forward to a good 2008.

Globally exposed large cap growth stocks will continue to lead the way domestically, with energy, technology, and health care poised for continued leadership. Gold and mining shares may continue to do well, but are notoriously volatile and only appropriate for risk tolerant accounts. Domestic small company and value stocks, like financials, that outperformed from 2001 – 2006 will likely continue to struggle in the near term as the U.S. economy adjusts to slower growth. However, many of the financials have been bloodied and sport dividend yields higher than bonds, so we are not abandoning them altogether.

Stock Funds – Global and international funds outpaced their U.S. rivals again in 2007, and we see no reason to believe they won't continue to deliver in the quarters ahead. We continue to like the **American Funds**, **Dodge & Cox**, **First Eagle**, and **Matthews**, but our largest holding is the **Wintergreen Fund**, which carries a global value mandate. The fund eked out a small gain for the quarter and was up 21.1% for 2007. Lead manager, David Winters was a protégé of Michael Price, from the old Mutual Series funds that were sold to Franklin Templeton. Winters left Franklin a couple of years ago and set up Wintergreen, so we had the enviable combination of a new fund with an experienced successful manager. In a recent shareholder report, Mr. Winters states that the fund "seeks to invest in companies that are not overly sensitive to specific investment fads, but rather in companies that he believes will do well in all market conditions. Many of the fund's holdings are companies that are buying back their own stock and are positioned to respond to consumer demand in an up or down market. Top holdings, include Weyerhaeuser, the high quality forest products conglomerate, and Shun Tak, a Hong Kong listed company with substantial assets in Macau, which consists of two small islands located in a special administrative region of China that has the gaming monopoly for the country. This is a core stock fund that will make us lots of money in the years ahead.

Sector Funds / ETF's – These holdings give us access to a specific industry sector, so they provide more pop than broadly diversified funds, but carry less risk than individual common stocks. Several years back we purchased the **Vanguard Health Care Fund** for many clients, but it subsequently closed to new investors, so we have been unable to purchase shares for newer clients. We have been leery of adding to our health care exposure with the uncertain political landscape and drug pricing concerns. However, the demographic argument for higher demand is compelling and the sector has demonstrated resilience to weakness in the general economy. We are looking to add the **T. Rowe Price Health Sciences Fund** for certain clients not holding the closed Vanguard fund. T. Rowe Price has a good natural resource fund, the New Era fund that we own in several accounts. The health care fund is able to traverse the entire health care spectrum and owns companies involved in the four main areas of the health care industry: pharmaceuticals, services, devices, and biotechnology. The fund has been managed by Kris Jenner since 2000. He is a physician by training and keeps his entire retirement account invested in the offering.

Exchange-traded funds (ETF's) have exploded with a myriad of new offerings covering every possible market niche. These lower-cost tax efficient vehicles used in small doses add spice to our more diversified actively managed core funds. Although the energy move is getting long in the tooth, there's more gas in the tank, so we continue to own two energy ETF's, the **Energy Select Sector SPDR** (XLE), and the **SPDR S&P Oil & Gas Equipment and Services** (XES). We also continue to like the **PowerShares Water Resources** (PHO) as a specialty play on this valuable finite commodity.

Common Stock Spotlight – Technology and solar stocks were the rage last year and seem poised to continue moving higher in 2008 following a brief dip recently. **MEMC Electronic Materials** (WFR) has the raw material that powers the chip and solar industries. The St. Peters, MO based company supplies polysilicon wafers to chip makers, and on October 25, announced a 10-year supply agreement with a large German solar firm, that will generate $7-8 billion in revenue for MEMC. The company has also expanded its multi-year agreement to supply solar wafers to Taiwan-based Gintech by $3-4 billion. This stock is volatile, moving $2-3/day up or down, and trades at a higher multiple, but good growth stocks have a way of growing into their multiples over time.

Stocks discussed may not be appropriate for all client accounts. Client holdings will vary based on individual objectives, different inception dates and manager discretion.

Preferred Stocks – Our preferred stocks were marked down in price last year, but have mostly turned higher since the calendar ticked over to 2008 and tax-loss selling has abated. A new purchase for us last quarter was the **Virginia Power Capital Trust II Preferred – Series A**, (VEL+A) with a 7.375% dividend rate. The utility company is a wholly owned subsidiary of Dominion Resources, Inc. We also took advantage of price weakness to add to positions in some of our favorite names in the financial realm like highly rated issues from **Bank of America**, **ING**, and the **Royal Bank of Scotland**. All have current yields in the 7-8% range. We're sticking with **Thornburg Mortgage Preferred** (TMA+C) based on the high credit quality of their jumbo adjustable-rate portfolio and the sterling reputation of the organization.

Although we're not big fans of Merrill Lynch, they have packaged some interesting products that occasionally trade at nice discounts to par value on the secondary market. We expanded our holdings in the **ML Depositor PreferredPlus - Unum Provident** (PJR) 7.4%, and **El Paso** (PJJ) 7.6%. These trust preferreds are very similar to bonds and pay interest semi-annually.

<u>Closed-end Income Funds</u> – It was a mine field in this area last quarter, but the new year has breathed new life into these exchanged-traded dividend payers. **Global High Income** (GHI) is an emerging markets bond fund with a managed dividend policy to pay out a monthly dividend at 9% of the net asset value. The fund gives us a lower-risk avenue to play emerging markets, versus the more volatile stock funds. For tax-free income we sold the **PIMCO CA Municipal Income Fund** (PCQ) at a premium to net asset value, and swapped into the **PIMCO CA Muni III** (PZC) that had declined to a discount. With the use of moderate leverage the fund managers are getting 5%+ tax-free.

Bonds – A soft economy and low inflation were friendly to our investment grade bonds last year, but it's tough to get excited about committing any fresh dollars at the current high prices and low yields. We continue to hold laddered portfolios of individual municipal bonds with staggered maturities for safety and tax-free income. For many clients we are currently holding excess cash reserves as we survey the landscape and patiently wait for opportunities to present themselves.

<u>Income Taxes</u> – For clients with taxable brokerage accounts, we will be mailing your realized gain/loss report during the last week of January. Our report will provide original purchase date and cost basis information to supplement the Schwab 1099. These two documents will give you everything necessary to report sales that occurred in your account during 2005. As always, we suggest you defer filing your income taxes until early March to avoid having to amend your return, as Schwab may be required to issue a corrected 1099.

<u>Wealth Management</u> – Is your estate plan up to date? We work with estate planning attorneys to coordinate the document preparation process. Be aware that the annual gift tax exclusion is $12,000 per individual donor for 2008. This amount may be gifted with no tax consequences to the donor or recipient. The 2008 estate tax exemption amount is $2,000,000 per person, or $4,000,000 per couple with a properly structured estate plan.

We value each client relationship and take our fiduciary duty very seriously. Please let us know if there is anything we can do to help assure your financial peace of mind.

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