Review, Outlook and Opinion April, 2007

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Volatility returned for stock investors last quarter as equity markets worldwide caught their balance after a late February, early March plunge to finish relatively flat for the quarter. We expect slower growth from the U.S. economy, reflecting the combined impact of higher interest rates and the sub-prime mortgage meltdown. The rest of the world remains strong, led by a continued low-inflation boom in China and restructuring growth in Europe. With the Federal Reserve currently on hold, bond yields low, and real estate floundering, growth money is gravitating toward stocks. We remain constructive on equities but recommend balanced portfolios for most clients that incorporate fixed-income securities for diversification, cash flow and safety. In addition to bonds, we add value and extra yield to our fixed-income allocation through the use of closed-end income funds, preferred stocks, and reverse convertible notes (see below for more detail).

We ended the 1st quarter higher, with an average net gain across all client accounts of 1.60%. At 6.40% annualized, we are not satisfied with the results, but understand that above average returns do not happen every quarter. Following the strong returns of recent years, it is not unusual for equity markets to pause and correct to digest the gains. Corporate earnings growth is slowing, but company balance sheets are in good shape and valuations remain reasonable. Entire companies are being taken private with leveraged buy-out (LBO) and private equity deals being announced weekly. Recent intraday declines in stocks have been meant with institutional buying that moves the averages back into positive territory toward the close. The global economy continues to be strong with most foreign markets outpacing the U.S.

The big news this past quarter was the implosion of the sub-prime mortgage industry. The bankruptcy filing of Irvine based New Century Financial on April 2, is not a happy event for their employees or the holders of questionable mortgage backed securities that were created from loans the company made during the real estate boom. The generous lending standards of the past few years along with the proliferation of adjustable rate and interest only mortgages have put many new buyers in a tough spot.

One type of adjustable rate mortgage carries a two-year fixed rate for the payment, but a higher adjustable rate for the principal. The result is negative amortization, with the borrower now owing thousands more on the note than when it started. Roughly $1 trillion worth of adjustable-rate mortgages are due to reset in 2007 and another $1 trillion will reset through 2008 and 2009 according to data from Credit Suisse. With the Fed having raised short-term rates substantially since these loans were taken out, the reset and payment rate will be higher. Refinancing is not an option because the initial down payment was small in many cases and prices have stopped going up, so any equity in the property is questionable. Ironically, the housing problems may extend the business cycle since the Federal Reserve won't have to raise interest rates to cool the economy, which is a good thing for the stock market.

U.S. Equity Funds – The **Wasatch Small Company Value Fund** was our best performer last quarter and has been good to us over the years. This little gem closed to new investors in 2004, but has recently reopened with additional capacity. Our friends in Salt Lake City that run the fund are adept at picking up obscure out-of-favor small caps. Although many have been heralding the demise of small caps after an extended period of out performance, small and mid-cap stock funds continued to better their large company rivals last quarter. After leading the ranks throughout the late 1990's, large-cap growth funds have lagged for seven years, and from a relative valuation standpoint are very attractive moving forward. The **Vanguard Primecap Core Fund** is our top choice for large company exposure. The **Diamond Hill Long Short Fund** has made us money with low risk, but the returns have been mediocre. Unless the results improve soon, this fund will be the first to go when we identify a better opportunity.

International Equity Funds – These funds continue to dominate the top performing positions for our portfolios. Given the inter-related dynamics of our global economy, holding a meaningful percentage in foreign equities continues to make sense. **Dodge & Cox International Stock Fund** is best for large company exposure. Our largest position is in the **Wintergreen Fund**, a global value fund, which celebrated its one-year anniversary with us by posting a 20% gain. Near the end of the quarter, we were surprised by the announcement that Charles de Vaulx had resigned for personal reasons as the lead manager of the **First Eagle Overseas Fund**. Jean-Marie Eveillard has agreed to come out of retirement and will resume portfolio management responsibilities. He plans to build greater depth within the organization and in particular, further develop the firm's already significant research capabilities. Mr. Eveillard managed the fund from inception through the end of 2004. He was named International Stock Manager of the Year by *Morningstar* in 2001. We are pleased to see him return.

Common Stocks – Globalization and the increased flow of commerce between nations has been a favorite investment theme for years. **Seaspan** (SSW) was purchased for many clients as a high dividend play to capitalize on this growing trend. With a dividend yield just under 7%, Hong Kong based Seaspan charters its container ships at long-term fixed rates. Last quarter, the company boosted its quarterly dividend to 44.625 cents a shares from 42.5 cents. This is the company's first increase since initiating payouts in November, 2005, after its public debut in August. The company has 23 ships in operation and another 18 (already chartered for 10 to 12 years) scheduled to be delivered over the next three years. In addition to the rising dividend, the share price has also moved higher.

We have completed selling out of **Chesapeake Energy** (CHK) and **Kinder Morgan Energy Partners** (KMP). Both CHK and KMP have issued more shares via secondary offerings, which tends to dilute earnings per share for existing shareholders. KMP also issued a cumbersome K-1 for tax reporting, which is a hassle we can do without. We still believe that energy deserves a place in our portfolios, but prefer to have exposure from the big integrated majors like **ConocoPhillips** (COP), **Exxon Mobil** (XOM), or **BP Plc** (BP). The **T. Rowe Price New Era Fund** (PRNEX) or the low-cost **Energy Select Sector SPDR** (XLE) exchange-traded fund are two energy sector funds that have worked well for us.

Last quarter we bolstered our position in **General Electric** (GE) and **Starbucks** (SBUX). We also initiated new positions in **Genentech, Inc.** (DNA), a leading biotech company, and **Newmont Mining Corp.** (NEM), the only gold stock in the S&P 500. All of these stocks were purchased well off their highs and offer good growth opportunities. Your holdings may not include all stocks discussed due to different client inception dates and manager discretion.

<u>Preferred Stocks</u> – National Retail Properties (previously CNL Properties) and **Truststreet** preferred were called and redeemed at par last quarter. We're sorry to see them go with dividend rates in the 7 – 9% range, but happy to report we made money on both. **Fremont General** 9% (FMT+) is a position we've held for some clients since the late 1990's. The company had some issues with a worker's compensation division (which was subsequently sold) that gave us the opportunity to pick up the preferred at bargain prices. It subsequently traded back to over $25/share par value where it remained for years, until last quarter. The story has a new twist since ½ of Fremont's business over the past few years has been residential lending, specifically sub-prime. When the preferred started to move down in price last quarter, we picked some up below par believing that their sub-prime exposure was limited due to securitizing and selling off many loans. Also, the company has a profitable commercial lending operation. Well, now it appears we may have underestimated the problems. The firm recently received a cease and desist order from the FDIC and has put their sub-prime division up for sale. Their December 2006 quarterly earnings report has been delayed, and Grant Thornton LLP, Fremont's auditor, resigned last week. While the company will likely survive, in light of the recent news, we have decided to begin scaling out and selling our position.

<u>Bonds</u> – We have continued to buy new issue reverse convertible notes from **Barclays Bank PLC, JP Morgan Chase, ABN Amro, and Societe Generale** in order to capture high above-market yields. With these unique structured products we are relying on the financial strength of the issuer and are betting on the volatility of the underlying common stock. We have purchased notes linked to the common stock of Qualcomm, Yahoo!, Starbucks, Sandisk, Home Depot, ConocoPhillips, Newmont Mining, Peabody Energy, and Whole Foods Market. These are short-term notes with maturities of 6 months or one year that we categorize under bonds in your investment matrix. These notes come with downside protection ranging from 10% to 30%. This protection is from the stock price on the settlement date when the investment is initiated. The key is being in tune with the common stock, it's price history and chart pattern.

These notes have coupons in the 9% to 13% range and pay interest monthly or quarterly. They represent a low risk way to play a stock that's packaged as a bond. The interest rate is a function of the volatility of the underlying common stock that is tied to the note, and is paid by the issuer through the use of option contracts. The worst that can happen is that the downside protection, or barrier price is breached and we get devalued shares of the company stock at maturity instead of our original cash investment. For the issues we own, we view this as a low probability event and are comfortable with the risk.

<u>Closed-End Bond Funds</u> – Since most closed-end funds are structured with 1/3 leverage through short-term borrowings, they can generate higher yields than their open-end counterparts. It has been tough to put any new money to work in this area since prices ran up last year. We seek to buy on the secondary market (not the initial public offering) when shares are trading at a discount to net asset value. Barron's has a weekly review of all closed-end funds and www.etfconnect.com is a great resource for research. Our favorites in this area pay monthly dividends and yield 8%+.

Income Tax – It's tax time and hopefully everyone has completed the filing of their 2006 returns. We endeavor to minimize tax when possible by placing income paying securities in tax-deferred accounts, buying tax-free municipal bonds in taxable accounts, and harvesting losses later in the year to offset any realized gains. If you had any surprises or would like to discuss tax-saving strategies for your account, we would be happy to discuss ideas with you or confer with your tax advisor.

The Last Word – Your returns will vary depending upon your entry date, risk tolerance, personal objectives, and asset allocation. Warren Isenberg and myself work together to preserve and grow your capital. We eat our own cooking as demonstrated by the fact that we personally own many of the same securities found in your accounts. If you have had or expect any material change in your family finances or status, please let us know. Thank you for your continued trust and confidence.