

Q4/Year End Investment Commentary

Fourth Quarter 2007

Fourth Quarter Recap

Once again diversification paid off for our clients as the US stock market saw it's worst fourth quarter in over a decade. Large caps and mid caps were down over 3% while small caps were down over 4%. Our underweighting in REIT's paid off again as they dropped almost 13% on the quarter. Commodity prices moved sharply higher, as they did over the full year. Developed country foreign equities declined, a reverse after a strong advance earlier in the year—but emerging markets fared better. Value continued to under-perform growth in the fourth quarter and was in the red on the year. As recession fears increased, bonds performed well in the quarter and ended up with a solid 7% return for the year—ahead of the broad stock market. Because of solid performances by commodities, bonds, and emerging markets, we were able to mitigate the effects of the sharp decline in the market. This allowed us to not only protect accounts from major losses, but to also capture excellent overall returns for our clients in 2007.

Q4 S&P 500	-3.4%
2007 S&P 500	+5.4%

2007 Recap

Without a doubt, we will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. As credit tightened and the housing market suffered, investors became more and more worried about the overall economy, triggering stock declines in many areas of domestic stocks. Foreign stocks, conversely, delivered great returns with the economies of developing countries continuing to grow at a rapid pace. Related to this was the increased demand for energy and other commodities.

There was action in the bond market also. Investors first worried about inflation and then recession. The best action was overseas as the dollar's drop gave U.S. investors currency gains that enhanced their returns. But outside of the government bond market, perceived credit risk rose, leading to underperformance in high-yield bonds.

For our clients it was another good year. Several of our tactical asset allocation moves added value to investors including investing in commodities, investing in developing markets bonds, a strong allocation to international equities, underweighting of small cap US stocks with a corresponding overweighting in large caps, and a slow increase in overall bond exposure during the last half of 2007. For yet another year, we were able to strongly outperform the market.

2008 Looking Forward

As you know, our investment decisions are generally made based on a multi-year outlook. This allows us to focus on underlying fundamentals and valuations—the factors that ultimately drive returns—and distance ourselves emotionally from the day-to-day “noise” of the markets and the fi-

nancial media. However, we are not totally unconcerned with performance over periods as short as one year because we manage all of our portfolios based on a targeted one-year loss threshold. This loss threshold is something we are thinking about as we head into 2008.

The question most investors are asking at this point is: will the troubled housing and mortgage industries take down the economy? The underlying key is consumer spending. The contraction in the housing-related industries has a direct impact on employment and spending, but it is the related credit crunch and its impact on spending that could cause the most damage.

The impact of hundreds of billions of dollars in loan losses to banks, hedge funds, and other investors means less ability to lend, because lenders have less capital. It also means less willingness to lend because they are unsure about the borrowers and because they have to keep cash on their balance sheets to cover their own potential losses. The problem is that it is difficult to quantify the losses and impossible to confidently forecast how restrictive credit will be and for how long. It is very likely that lending practices will be more conservative, suggesting slower growth in credit for a sustained time period.

On the positive side, although the employment market is showing some signs of slowing it remains healthy. Corporate earnings are still growing. Emerging markets continue to thrive and are a positive for the global economy. A weaker dollar has helped support a boom in U.S. exports. The Fed and other central banks are aware of the economic risks and are using interest-rate policy and other measures to improve liquidity.

The Fed does have influence and room to maneuver. If the economy continues to weaken, the Fed can be expected to continue to lower short-term interest rates to make more capital more available at a lower cost, which should spur the economy. But the financial markets are expecting additional rate cuts, so if the Fed doesn't lower rates this year, the markets are likely to react negatively. Also, additional Fed rate cuts (along with a declining dollar) may spur increasing inflation expectations, which would not be a positive for the economy or longer-duration interest rates.

The bottom line is that the economic outlook is murky. Due to the credit crunch and continued deterioration in the housing market, recession is more likely than it was last year but it is not a foregone conclusion.

As usual, we can't predict what the markets will do, but we can try to look at the valuations of various asset classes and lean away from relatively overpriced areas while putting that money into relatively underpriced areas. While stocks appear fairly priced, some bonds are still a bit undervalued. REIT's are probably fairly valued at this point, after a hard fall in 2007 but they may have continued downward momentum, so they are not a "buy" yet, in our opinion. Commodities are still volatile and still a great diversifier. They don't appear to be under or overvalued but a good hedge against inflation fears and dollar fears. In short, at this point we feel we're well situated and do not expect to be making any asset allocation changes.

Conclusion

Economic risk has risen and recession is a clear possibility, though not necessarily a high probability. However, we are taking a close look at the risk exposure in our portfolios and assessing whether we should increase our defensiveness. Because our scenario analysis suggests that our portfolios can withstand a normal recession without violating 12-month risk thresholds, any moves we make are unlikely to be dramatic. However, clients should understand that the possibility of a rough year lies ahead. They should also understand that this is not an outcome that can be predicted with high confidence. We've been surprised by positive market returns many times over the years. So we focus on doing our best to maintain adequate risk protection over a one-year time horizon based on the risk tolerance of each investor, while keeping our eye on the more important goal of long-term returns. This common sense approach has served our clients well over the years.

If the current turmoil in the credit markets and/or an economic downturn triggers a severe sell-off, we are likely to see tactical opportunities created in several asset classes or at a stock-picking level. In fact, at a stock-picking level we may already be at this point, and our managers are actively working to capitalize. However, given the fear and uncertainty, it is likely to be a while before their stocks reflect their longer-term potential. At an asset-class level we are not there yet—and we may not get there soon—but for long-term investors, market turmoil can create great opportunities.

Sincerely,

Peter, Jason, Bob, Tony, Lucy, Artie

The PWJohnson Wealth Management Team