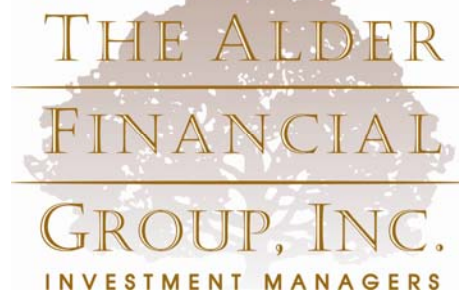


MARKET NEWS

Keeping our Clients Informed

Second Quarter 2007



July 5, 2007

Inflation vs. Growth

As investors pushed the Dow Jones Industrial Average up 27% during the past year, they came to believe in a "perfect world" scenario of steady growth, low inflation and falling interest rates.

This Quarter, as interest rates have surged, the world has begun to appear less perfect.

The immediate problem facing stocks is that market interest rates have stopped falling and started rising. The U.S. benchmark that investors watch, the yield of the 10-year Treasury note, soared to over 5.30% in June from 4.64% just one month earlier.

The turnaround in interest rates began as an annoyance and has become a serious headache, because falling rates were such a big support for the stock gains. Rising rates remove several pillars of the bull market.

Rising rates make it harder for buyout firms to finance takeovers with borrowed money, and buyouts were one of the main supports for stock prices. Higher rates make bonds more attractive alternatives for big institutions such as pension funds. They make it more expensive for businesses and consumers to invest and to buy things, which hurt corporate profits. And higher rates make dividend-paying stocks less attractive compared with bonds.

For stocks' volatility to subside and have prices push higher, investors will need to see bond yields stabilize, or see some sign the economy is strong enough to shrug off higher market interest rates.

Market rates are being pushed higher by inflation fears, both in the U.S. and abroad, and strong economic growth overseas that is prompting foreign central banks to raise their base interest rates. Hopes have evaporated that the Federal Reserve will cut rates anytime soon. Interest-rate-futures contracts recently have signaled growing fears that the Fed could be forced to raise rates.

Home buyers are among the hardest hit by higher

rates because many fixed-rate mortgages are linked to the 10-year-bond yield. Earlier this year, when market rates were falling, mortgage demand began to recover, which helped ease the housing market's pain. Lately, mortgage demand has been falling again. Last week, the Mortgage Bankers Association reported that weekly mortgage-application volume had fallen 1.7% from the previous week.

A lot of investors thought the yield of the 10-year Treasury note would top out around 5%. The last swing above 5.25% shocked people out of that complacency and contributed to the stock declines. The yield's highest level in the past five years was 5.25%, hit about a year ago when the stock market also was swooning. As long as the yield stays below that level, a lot of people will remain calm. But some investors have warned that they could pull back from stocks if it gets much beyond 5.25%.

As hopes for Fed interest-rate cuts have dissipated, fears have grown that some of the market's other underpinnings, such as corporate profits, also could be affected. If so, some people's high hopes for this year's stock performance could be dashed. After double-digit-percentage profit gains last year, consensus analyst forecasts call for just a 3.9% gain for big companies in this quarter.

Many analysts felt the market was overdue for a pullback even without a deterioration in economic news. One way to see that is to look at price-to-earnings ratios, which measure stock prices in terms of companies' underlying profits.

For several years until late 2006, corporate profits were generally rising faster than stock prices. So price-to-earnings ratios were falling, even though stocks were advancing. Compared with profits, stock prices didn't look high at all.

But the stock rampage that began last summer changed that, as price gains exceeded profit gains. After bottoming out late last year at about 15.6 times per-share earnings for the previous 12 months, the P/E ratio for the S&P 500 has been rising again, recently standing at about 17, according to Standard & Poor's.

Investors don't mind seeing P/E ratios rise as long as interest rates are falling, because lower rates make stocks more attractive and justify the higher P/Es. But when rates start rising, stocks lose some luster and pressure grows for P/E ratios to fall. That could help explain the stock weakness.

P/E ratios remain far from the speculative highs of 1999 and 1987, but that doesn't mean that stocks won't fall further. Investors right now can't imagine how the leveraged-buyout boom would end. Rising rates and rising equity valuations could do the trick.

Creative Destruction and the Concentrated Position

One of the few economic truths in investing is that you can get rich by under diversifying but you can't *stay* rich by under diversifying. As such, over concentrated stock positions, regardless of how patiently or shrewdly accumulated, are a form of financial Russian roulette. The hammer may come down on an empty chamber today but every year the trigger gets pulled again.

Just as trees don't grow all the way to the sky, a company's size and value can't rise forever, even if they are genuinely great businesses.

The catalyst for change is as varied as the companies traded. Sometimes the decline is the result of an astonishing fraud like Enron or WorldCom. Sometimes the decline will result from a corporate disaster like Merck's Vioxx. Or maybe the decline takes the form of a slow bleeding from technological obsolescence as was the case at Eastman Kodak.

Where are the Nifty-Fifty of yesteryear? Sears was destroyed by Kmart who was then destroyed by Wal-Mart (whose stock is worth the same as it was 8 years ago). Classic blue chip Coca-Cola is trading at half its price from nine years ago and tech giants Microsoft and Cisco are still less than half their price reached in heady days of the internet bubble.

The list of fallen giants could go on and on. Take a look at the auto makers or the airlines (Pan American actually went to zero twice). When was the last time you rode a train on vacation? The richest man in the world made his billions writing software. Compare that to the men of industry in the past whose fortunes were made in steel and shipping.

This isn't an essay on owning any one stock. It's an essay on owning too much of any one stock. Times change at an astonishingly fast rate now. Globalization has only helped to accelerate that pace of change. It seems that every few years businesses have to react to

these competitive threats by reinventing themselves or the way they do business. Some companies are better than others at adapting and some simply ignore it and do nothing, believing they're too big to be threatened (GM).

The Austrian economist Schumpeter characterized capitalism with the famous phrase "creative destruction", in which the old ways of doing things are endogenously destroyed and replaced by the new. There is no better example of this than looking back at the members of the Dow Jones Industrial index. Over the decades many names have fallen off never to be seen again. These companies were the biggest of the big.

The holder of a concentrated position is not an investor anymore. Instead, he is a bettor. He is betting on the very long shot, against all probability, that the thesis of creative destruction does not apply to him because his blue chip stock is so blue that it is exempt.

Concentrated positions arise out of many situations. Maybe you inherited a big slug of stock that was the foundation of your family's wealth. Maybe you picked a great stock and rode it through thick and thin to wealth. Or maybe you worked for a company for 30 years, bought every share you could through their employee stock purchase plan and ended up with baseball player money.

For whatever reason, if you've ended up with most of your net worth in any one stock, you should congratulate yourself. You've probably achieved the American dream. That being said, you should now give serious consideration to the thought of losing all of it. If the loss of that asset would wreck you financially or even simply keep you from reaching a portion of your financial goals, you should sell every share you can't afford to lose.

Many of these positions are accumulated over a lifetime and passed down from one generation to another. These are families of buy and hold investors and lifetime employees. Thus, this situation disproportionately affects the most conservative investors and older households.

The exposure to the risk from one company is doubly true if your current income is coming from either a paycheck or the pension of the same company whose stock you're betting on.

As the saying goes, "never let the tax tail wage the economic dog" (i.e. don't let the tax consequences drive you to make bad financial decisions). Long-term capital gains tax rates may never be lower than they are now. That cost, certainly, is small relative to the risk you're subjecting yourself to.