
Letter From The Portfolio Managers

December 2007

A Flight To Simplicity

When we gather for Thanksgiving we often reflect on the past year as we give thanks for the health and wellbeing of family and friends. This year, both Rusty and I can report that the conversation at the dinner table inevitably turned to the future as well. Specifically, what was going on in the financial markets and what should we do? In truth, given our line of work, these questions are not uncommon at most family events or other social occasions.



Eric M. Kobren

The typical replies to these questions usually run along the lines that recent market news is typically noise and that the right answer for what an individual should buy or sell primarily depends on their personal financial situation and what they already own.

Needless to say, to craft an answer for an individual in a matter of minutes is difficult to do. It takes a disciplined process to determine and construct an appropriate portfolio (and to monitor and manage it moving forward). No one answer fits all situations.



Rusty Vanneman

The stock market in November certainly had people agitated. Despite a strong last week including the biggest two-day rally in five years, November was a pretty rough month for the stock market. The broad U.S. market had its first official correction (defined as 10% decline from price highs) since 2003. Given that there has been a correction about every year and a half since the mid-1940s, it could be said that this correction was long overdue. It should also be noted that only one in four corrections have lead to a bear market (defined as a 20% loss from the highs). Despite this history, investors are clearly concerned. How should portfolios be changed, if at all?

Getting back to the dinner table questions, exactly what is going on in the markets today? Wasn't the economy still quite strong in the third quarter, and while the subprime mess is grabbing a lot of headlines, isn't it pretty well confined to the housing and financial sectors?

Well, kind of... If you will permit a somewhat more expansive discourse than we could deliver at the dinner table, we'll try to sort it all out.

It All Starts at Home, But It May Not End There

The U.S. economy grew by 4.9% in real terms (i.e., after inflation) during the third quarter of 2007, following real GDP growth of 3.8% in the second quarter. These are very strong numbers and above long-term trends.

However, expectations for the last three months of the year are much weaker. Due primarily to concerns over housing and credit, consensus expectations for fourth quarter GDP growth tend to be around 1.0%. That is clearly below trend.

As long-time clients and readers of our monthly letter know, the housing situation has concerned us for some time now and we still don't see the end in sight, either. A subject for some debate is just how big of

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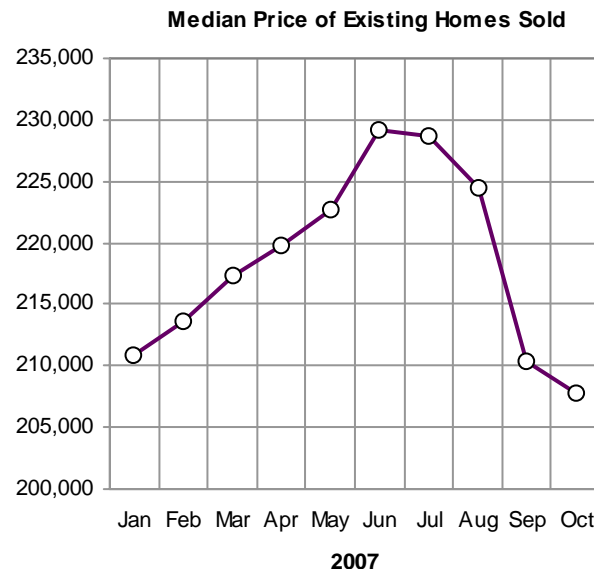
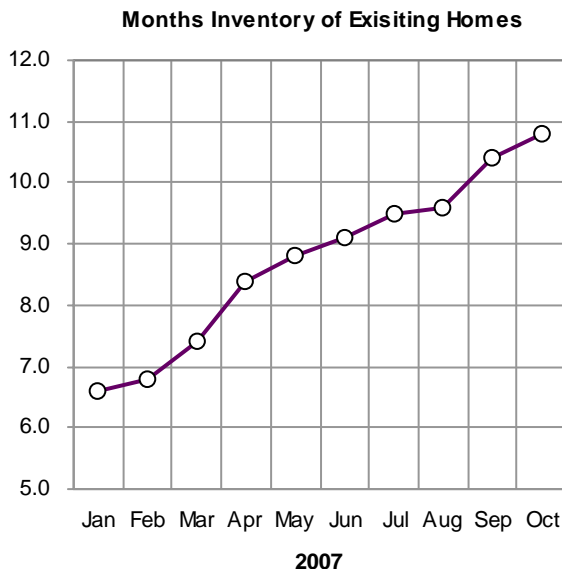
a problem this is for the economy? Analysts who are bullish on the economy often cite the fact that (looking primarily at homebuilders), the housing industry, is less than 5% of GDP. Not such a big deal.

But to us, that is defining things too narrowly. Rather than just focusing on homebuilding, you need to examine the ripple effects of the housing slump on the consumer (remember that consumer spending makes up approximately two-thirds of the domestic economy). And on that basis, we think the impact on the economy will be much larger.

For most of this decade, we enjoyed low interest rates and rising real estate values. This favorable combination allowed homeowners to tap their homes as a source of spending. With your house now worth a lot more, you could take out a new mortgage for a higher amount, pay off the old mortgage and pocket the difference. And because your new mortgage was at a lower rate, your payments didn't increase much, if at all! As one popular radio ad exclaimed "It's the biggest no-brainer in the history of the universe."

Well an awful lot of people agreed, as approximately half of all consumer spending in recent years has come from such mortgage equity withdrawals! We are unlikely to see anything near that level of mortgage equity withdrawals to bolster spending going forward.

The inventory of single family existing homes has increased to 10.8 months (which means given the current sales rate, it would take 10.8 months to sell all the existing homes currently on the market), which is the highest level in about 20 years. As a result, the median price for single family existing homes is now down 6.3% versus 2006, the largest drop on record going back to the late 1960s - and it is down over 9% from the peak in June. It is just simple economics -- higher supply equals lower prices.



Source: National Association of Realtors

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In addition, tighter credit conditions, meaning that it's harder to get a loan to buy a home, should also negatively impact the demand side of the equation for home prices.

Yet something else to consider when connecting the current housing situation to the overall economic landscape is the "wealth effect." This is an economic term referring to changes in consumer spending related to an increase in wealth in either absolute or relative terms. Given that housing is a significant asset to most Americans; it's likely that many aren't feeling wealthier due to home prices of late.

In short, it would be reasonable to expect a significant slowdown in consumer spending in the reasonably near future. In any case, whether the impact from housing is 5% or closer to 50%, it will likely remain a burden on the economy for some time to come.

Not All the News is Bad, However

Outside of the housing situation, however, a lot of economic data is more positive. For instance consider the following indexes of economic activity now and at the onset of the last recession in March of 2001:

	<u>Current Reading</u>	<u>March 2001</u>
ISM Manufacturing Index	50.8	42.6
ISM Non-Manufacturing Index	55.8	50.0
Chicago Purchasing Managers Index	52.9	37.2
<i>(Any reading over 50 on the above indexes indicates expansion)</i>		
Philadelphia Fed Index	+8.2	-20.2

In addition, with the notable exception of housing stock, inventory-to-sales ratios are generally at low levels throughout the economy.

Yet another source of support for the U.S. economy is continued strong growth in the rest of the world. Global GDP has expanded by about 5% in 2007 and is expected to grow just under 5% in 2008. Growth in the developing world (i.e. emerging markets) is expected to be even higher at about 7% in 2007 and in 2008. The combination of strong worldwide growth and a lower U.S. dollar (a decline of 24% since early 2002 on a broad, trade-weighted basis) is powering U.S. exports.

Government spending is another key component of the GDP calculations. In an environment of slowing economic growth coupled with an election year, would you wager on more government spending or less? I thought so, and more government spending is yet another support for domestic growth.

All-in-all, we will likely be looking at a slowdown, but an actual recession is not a given at this point.

It's Not the Economy Stupid (It's Earnings)

While stock prices do move in response to GDP growth, they are more directly affected by corporate earnings growth. Despite the strong quarterly number for U.S. GDP growth, it wasn't pretty for corporate year-over-year earnings growth in the third quarter. Operating earnings in the third quarter dropped 8%, which represents the worst quarter of earnings growth since the fourth quarter of 2001.

The earnings losses weren't necessarily broad-based though. The losses were also mostly contained in economic sectors that have been impacted by the situation in housing: Financials and Consumer Discretionary (one exception is Energy, which also posted year over year losses). It should be noted, however, that growth in Consumer Staples, Health Care, Technology, Industrials, Materials and Telecom remained in double-digit territory. There is growth out there in the economy.

Expectations for earnings growth in the fourth quarter have been reduced. Currently, the expectation for operating earnings growth is +2%. The current expectation for 2008, however, is still +15% year-over-year. To put this into context, the long-term earnings growth average is 6%.

Keeping It Simple

Basically, for the long-term investor, it's important to remember that the economy and markets will always have their ups and downs, but over time they oscillate around an upward-sloping long-term trend. In other words, the market tends to go up over time, so don't worry so much about it!

Still, for some, that's just too long-term. What about right now? At Kobren Insight Management, and to no surprise to long-term clients, we are sticking with the same major investment themes that our client portfolios have been built around in recent years.

First, maintain portfolios that are diversified between stocks and bonds. In our estimation, the expected return differential between stocks and bonds in the foreseeable future will be much less than long-term historical average, which makes bonds an attractive asset class (similar return, but less risk). Maintain strategic allocations to non-dollar investments (though tactically we are hesitant to add to our non-dollar bets in the short-term) and to other asset classes besides conventional stock and bond funds.

Second, continue to emphasize actively managed funds. Remember it's a market of stocks, not a stock market. Good actively managed funds should be able to add value in a variety of market environments.

Third, maintain an emphasis on quality. In terms of stock holdings, emphasize larger companies over smaller companies and emphasize growth stocks over value stocks, as generally speaking they are less sensitive to the economic cycle. As for fixed-income holdings, emphasize govern-

ment bonds over corporate bonds. Maintain a higher credit quality. Utilize inflation-linked bond funds (despite an expected economic slowdown, inflation remains a risk).

So far this year, the markets have rewarded our emphasis on quality. You have probably often heard the saying "a flight to quality." We have another term for it (which we admit we did not coin but read in The Financial Times): "a flight to simplicity."

Simply put, what has caused so much angst in the economy and markets of late has largely been caused by a proliferation of new investment products (CLOs, CMOs, CDOs, SIVs, etc.) each one more complex and opaque than the next. Some of these products are so complex, that they were purchased based mostly on the set of advanced academic credentials and technical tools behind them, rather than how they actually worked!

Many professionals don't fully understand them, and thus cannot even properly value them. Even Fed Chairman Ben Bernanke joked, "I would like to know what those damn thing are worth" when referring to some products in the credit markets.

Now that many of these products are proving to be, shall we put it gently, less than advertised, many investors have returned to simpler portfolios consisting of holdings in the non-exotic realms of well-known established companies and investment-grade fixed-income securities.

A flight to simplicity is fine by us. Our business has always been built around the concepts of diversification and simplification. Our portfolios of mutual funds may not offer the "sex appeal" of complex strategies, but are they understandable? Do they work?

We like to think so and we hope you do too.

Sincerely,



Eric M. Kobren
President
Portfolio Manager



Rusty Vanneman, CFA
Director of Research
Co-Portfolio Manager