

January 30, 2008

2007 Capital Markets Review

Having crossed into 2008 and compiled our customary review of asset class performances for the year past (please find our year-end summary enclosed), we recognize there is much angst about the economy and the markets, more so than in recent memory. The US stock market (as measured by the S&P 500) is 7.7% lower year-to-date and 13.4% lower since the peak of October. Foreign markets are down comparably too. So, rather than dwell only on what happened in 2007, we also want to give you our thoughts about the markets looking forward.

Is it time to panic? No. In our August 2007 newsletter we suggested that the problems in the sub-prime loan market and the decreasing availability of lending to even good borrowers would provide financial drama and continue to challenge the economy.

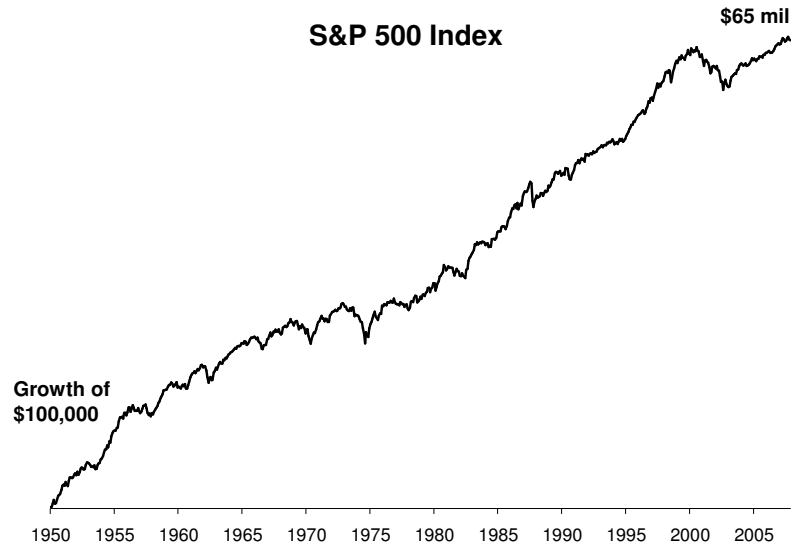
***“step back from the constant . . .
hysterical news and noise from
Wall Street”***

There are cycles to market psychology and investors are in a negative mindset. Much of the mood can be explained by deteriorating economic conditions, which are a natural progression after five years of economic expansion and rising share prices. The mood is made more severe by press reports of rising home foreclosures and bank losses from the sub-prime debt fallout. Still, the mood runs to extremes and the result is observable in daily price swings that otherwise seem inexplicable.

While the business cycle and market reactions are a normal part of investing, you should know what we are doing in light of current conditions. The simple answer is that the largest part of our work is done already. We have helped clients stay invested across many asset categories. That diversification helps reduce portfolio volatility because asset classes do not move in perfect sync. And by staying invested for the long haul, clients avoid the big mistake of trying to time their exits and entrances to the market—something shown time and again to be damaging to client wealth. A backward glance at share prices over the last 50 years shows that each period of contraction and angst, while unpleasant to live through, fades in importance in the context of a chart that shows a clear trend of rising values and rewards for those who stay invested.

*Hoge Building
Suite 800
705 Second Avenue
Seattle, Washington
98104-1711*

*Phone 206/382-4414
Fax 206/382-4412
www.ftkutscher.com*



Another part of our investment management work involves making occasional tilts among asset classes based on opportunities. Our views on major asset classes are summarized later in this letter. Many of the managers we use are delighted to have the opportunity to pick up shares of good companies at attractive prices. One of our favorite managers, Tweedy, Browne Company, stated the issue so clearly in their year end report just issued:

While our current holdings are not immune to the volatility in the general market, as businesses, we think they are, in general, well positioned to weather a weakening economy and over the long term we expect them to do quite well. In the meantime, Wall Street's excessive focus on the short-term may, on the one hand cause unpleasant markdowns in share prices among our holdings, but on the other hand create opportunities to buy into businesses with sustainable long-term outlooks. We think it is critical to step back from the constant, and in many instances, hysterical news and noise from Wall Street at times like this and focus on trying to buy into a business at a bargain price. We think this is the essence of successful long-term investing.

It is with this frame of mind that we approach the questions of value and risk presented by the markets as we currently find them.

Domestic Equity

By many traditional measures, the US equity market, in general, is priced around fair value, leaving little room for above-par returns in the broad markets. Having said that,

we believe (and our managers report) that price declines for certain companies and sectors have been excessive and provide opportunities for better returns. We also expect the equity market to stay volatile for some time until the economic environment becomes clearer. As a forecasting tool, the stock market will tend to rise in anticipation of growth. But to get there, the market first must sense the depth of the economic bottom, which yet hangs on employment figures, further consumer reactions to the housing crisis and whether the credit markets calm sufficiently. The presidential and general elections and the potential for expensive promises and tax increases also add to anxiety. Finally, increased credit spreads have caused significant diminution in buyout activity and falling corporate profits will eventually affect corporate share redemption programs, both of which are negative for equity prices.

Given the declines the market has experienced from October 2007, it is evident these concerns have been significantly reflected in current stock prices. However, some further retreat in equities, especially if the economy softens considerably, would not be surprising. Still, over a horizon of two-to-five years, we believe stocks offer the prospect of good returns.

In evaluating the domestic equity asset classes, we continue to believe that small cap stocks are expensive relative to large cap stocks. Also, large-cap stocks should be better able to weather the economic downturn and borrowing constraints of the present economic environment. Growth outperformed value in 2007 for the first time in many years. The relative pricing of growth and value stocks are near their historical mean, so neither is presenting a "fat pitch" at the present time.

International Equity

European equity markets have performed very well for a number of years, especially in US dollar terms. Because European stocks started in 2002 from a position of significant discount to US equities, their relative pricing to US equities has only recently climbed to historical norms. We expect the decline of the dollar to moderate and there is even a growing chance that the dollar will gain on developed foreign currencies in the near-term, especially if the European Central Bank and the Bank of England follow Federal Reserve rate cuts with their own as their economies begin to slow.

While Japan's economy continues its slow and tortured transition from deflation to normalcy, its equity markets continue to struggle. Although "cheap" by some measures, it is still anyone's guess as to when Japanese equities will begin to appreciate significantly. Asia ex-Japan and emerging markets generally have had several years of steep growth buoyed by strong exports and rising commodity prices. The continued development of those countries is a long-term trend, but we believe these markets are ahead of themselves.

Bond Market

With the onset of the sub-prime mess, the bond market has experienced a “flight to quality,” causing a rise in the value of US Treasury securities and a corresponding fall in yields. Simultaneously, spreads on investment-grade corporate debt and junk-rated debt have widened considerably from extremely low levels in early 2007. In this environment, our managers are seeing little room for Treasuries to appreciate in price, but are finding opportunities in the investment grade corporate bond market that were not present in 2007 when spreads were much thinner. Pricing on junk-rated debt is not yet attractive, but opportunities may yet arise if the credit contraction causes spreads to widen sufficiently.

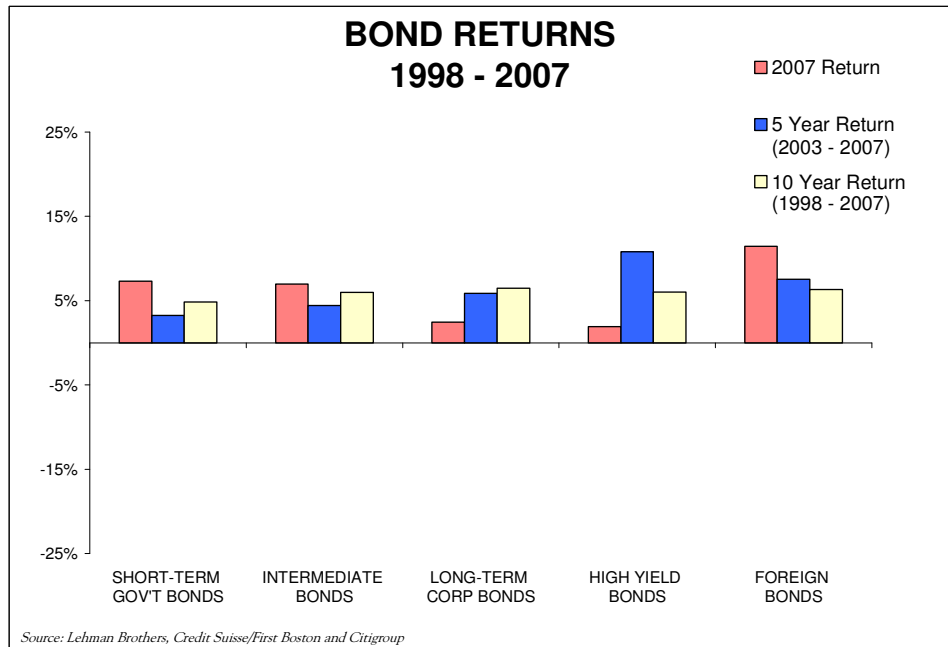
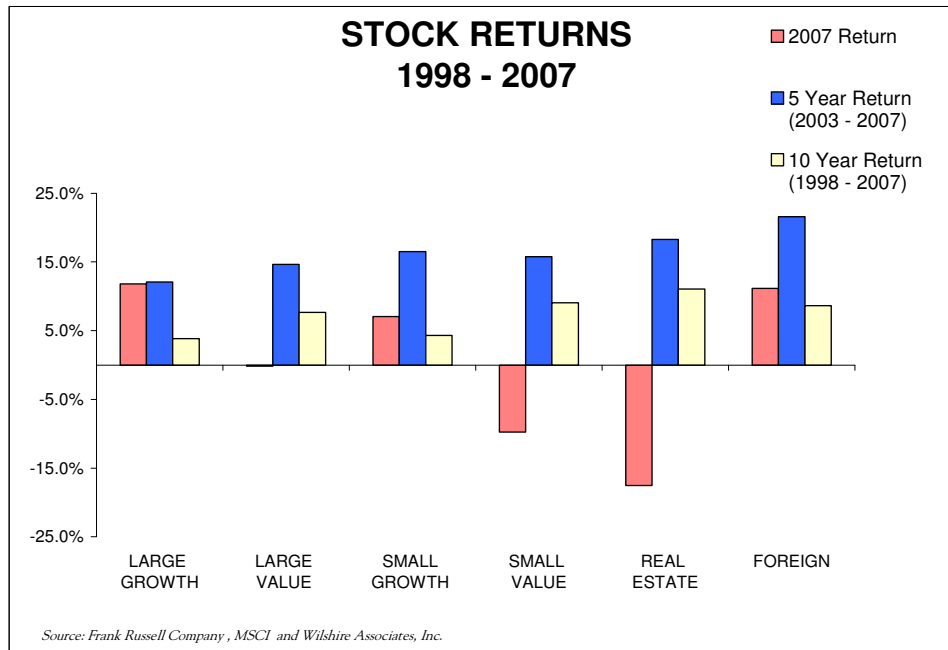
Commodities

Commodities performed extremely well in 2007. Crude oil, of course, gained considerably, as did most foodstuffs. Industrial metals were largely flat or somewhat down. If the economy heads into recession, we expect that commodities should not provide as much protection as bonds. However, in a “stagflation” environment (which is a recent possibility), commodities tend to perform better than either stocks or bonds. Consequently, we maintain our current level of commodity exposure for now.

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We hope that this letter has been helpful and informative. As always, we encourage your questions and comments.

CAPITAL MARKETS REVIEW



TOTAL RETURNS (annualized)

EQUITIES (Stocks & Real Estate)	1 year (2007)	5 years (2003-2007)	10 years (1998-2007)	COMMENTS
US LARGE-CAPITALIZED GROWTH COMPANIES	11.8%	12.1%	3.8%	After a long bout of underperformance, large capitalized-growth stocks, with an outsized exposure to technology (↑) and an underweight to financials (↓), pulled ahead of small-capitalized company stocks and value style stocks in 2007.
US LARGE-CAPITALIZED VALUE COMPANIES	-0.2%	14.6%	7.7%	After many years of outperforming growth stocks, large-capitalized value stocks stumbled in 2007. The break-even results for the year were largely attributable to value style's high financial sector exposure. But past years have been so good that 2007 did not reverse value's successful five and ten year track record.
US SMALL-CAPITALIZED GROWTH COMPANIES	7.1%	16.5%	4.3%	Although investors favored larger capitalized growth stocks over smaller ones, small growth stocks held up fairly well in 2007 due to their greater representation in technology companies.
US SMALL-CAPITALIZED VALUE COMPANIES	-9.8%	15.8%	9.1%	Exposure to the weak financial sector and domestic housing hurt small cap-value stocks resulting in a 10% loss for the year. Nevertheless, over five and ten years, value still outpaced growth.
REAL ESTATE EQUITIES	-17.6%	18.3%	11.1%	The real estate sector's long winning streak came to an end with investor's concerns about the housing market decline, inflation, and a tightening credit environment. The 17%+ loss in the real estate market was in some respects a reversion to the mean as well as a reflection of how investors viewed the immediate future of the real estate markets after the loss of easy credit.
FOREIGN STOCKS	11.2%	21.6%	8.7%	Foreign stocks outperformed the general US market, but not in local currency terms. Although the broad foreign market ended the year up 11%, which was led by the strong German, Asian and emerging markets, the weak US dollar boosted the 4% return (in local currency terms) up another 7%.

TOTAL RETURNS

(annualized)

	1 year (2007)	5 years (2003-2007)	10 years (1998-2007)	COMMENTS
CASH EQUIVALENTS				
CASH – MONEY FUNDS	4.6%	2.6%	3.3%	Although the Fed decreased short-term rates in response to the credit crunch as the year went on, money market rates still returned a respectable 4.6% for the year.
BONDS				
SHORT-TERM GOVERNMENT BONDS	7.3%	3.2%	4.9%	Many investors concerned with the outlook of the general economy fled to short-term government bonds. This demand increased the price of short-term government bonds, which added to an already fairly healthy interest payout. Consequently, this class returned 7% for the year.
INTERMEDIATE BONDS	7.0%	4.4%	6.0%	Adding 3% to the index return in the last quarter of the year, intermediate bonds ended the year with a 7% return. Due to a “flight to quality,” (investors buying “safe” investments) Treasury bonds performed particularly well with a 9% return for the year, but investment grade corporate bonds only returned 4.5% reflecting the market’s concern over the subprime market and subsequent credit tightening.
LONG-TERM CORPORATE BONDS	2.5%	5.9%	6.5%	Although default rates were low and corporate balance sheets were strong, gloomy market sentiment trumped these positive factors to bring down corporate bond returns to end the year with a modest 2.5% return.
HIGH-YIELD BONDS	1.9%	10.8%	6.0%	Reflecting investors’ revaluation of risk and fear of the US tipping into recession, the high-yield bond index ended the year at 1.9% — a fraction of last year’s spectacular return of 11.9%.
FOREIGN BONDS	11.5%	7.5%	6.3%	Similar to last year, currency factors boosted mediocre foreign credit market returns of around 4% up to 11.5% for the year.