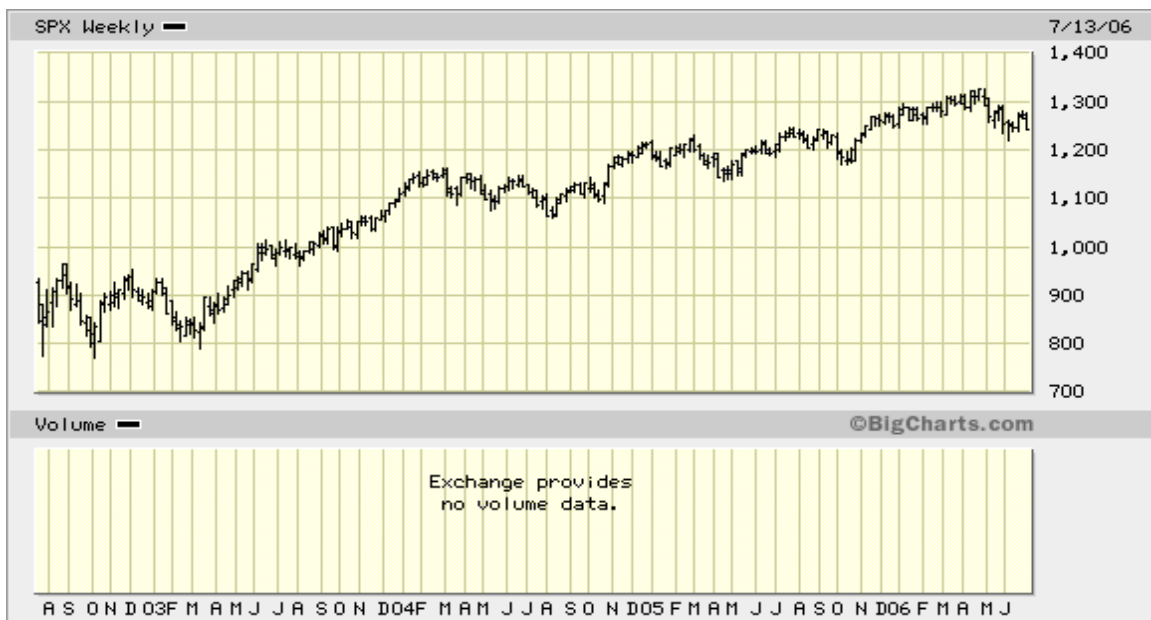


In times of doubt, turn your thoughts to hard analysis

Years ago when I started writing these quarterly letters to you, one of my hopes was to deviate from the standard recital of the previous months activity which offers little or no insight of future value. Instead, my goal was to do my best to offer a future prognosis based upon objective and realistic assumptions, but not a “Johnny Sunshine” perspective. The pitfall to anticipating the future on your behalf is the simple fact that unanticipated events can’t be predicted and while my analysis may be on target the timing of events may be off.

The prime culprit for the decline in stock prices commencing in late May was an unexpected series of statements made by Fed Chairman Bernanke and other Fed Governors. These statements didn’t derail our 2006 investment thesis predicated upon the end of Federal Funds interest rate hikes, but they did postpone the finale from the anticipated peak of 5% to 5 ½ % or 5 ¾%. My belief is Chairman Bernanke statements were an attempt to talk down the commodities markets with threats of “fighting inflation” as opposed to further prolonging the rate hikes to the end of the year.



If you’re nervous, just look at this chart. It’s a 4-year graph of the S&P 500 that shows the two-steps up, one-step down nature of the stock market since the market bottom in 2002. Each “one-step down” coincided with high investor fear and nervousness...and selling into the abyss of fear was a big mistake in every case.

So we have numerous headline worries that have placed investors on edge and antacids on my desk. But if there's one lesson that experience reinforces time and time again it's: Never panic and remain objective.

Average U.S. Stock Market Reaction & Recovery to War/Crisis

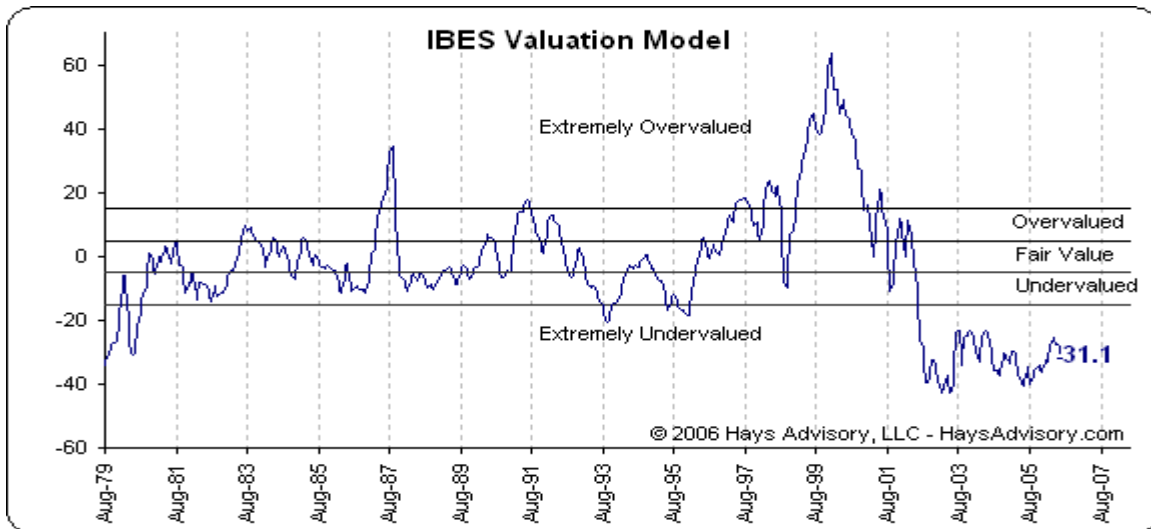
Date	Initial Market Reaction	25 trading days post-bottom	65 trading days post-bottom	125 trading days post-bottom	250 trading days post-bottom
1940-2002	-7.8%	+4.3%	+7.1%	+14.3%	+19.1%

Data by Russell

As you can see, markets generally react negatively to war and crisis but then rebound.

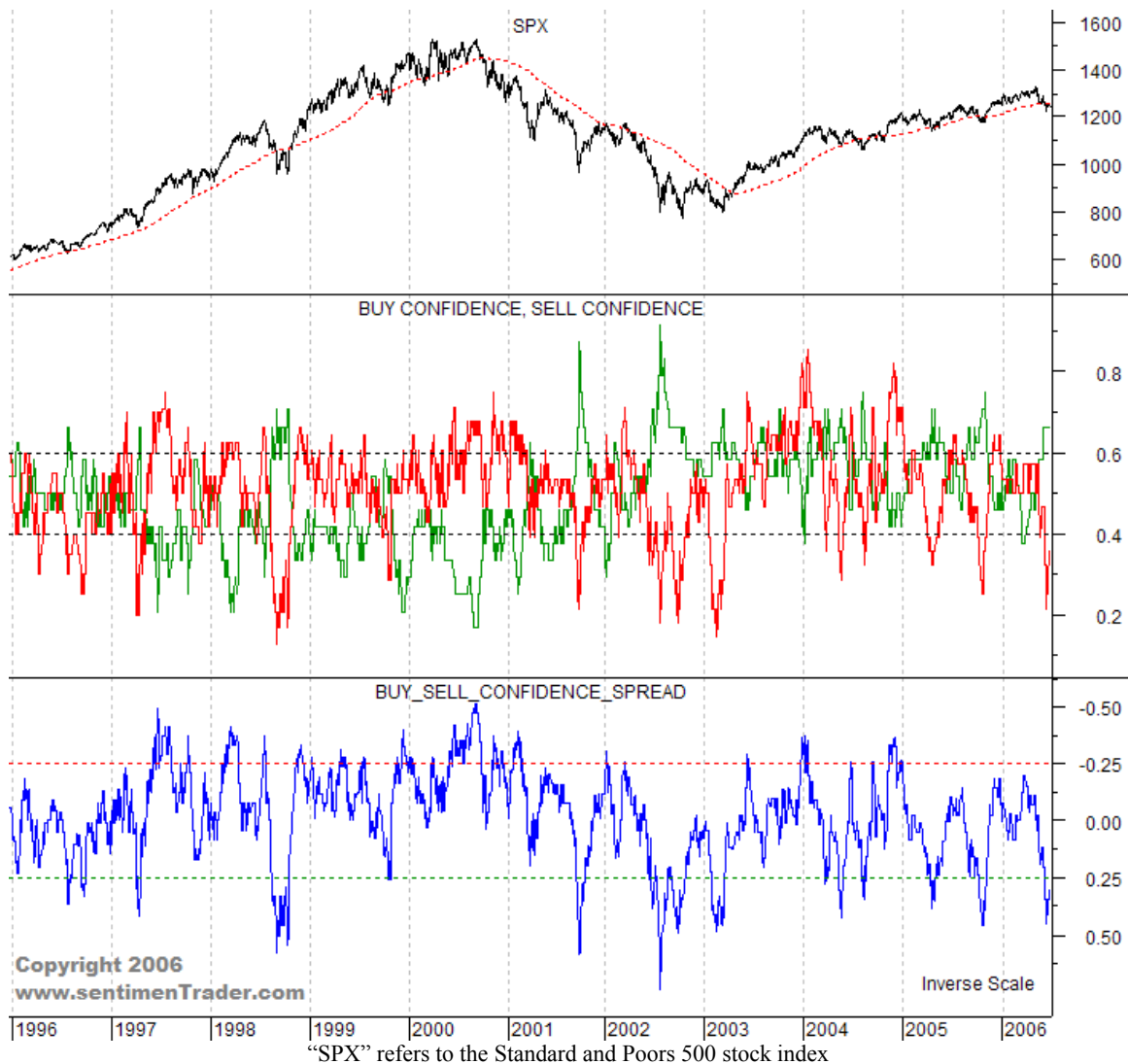
So why do I remain very enthusiastic about future stock returns? Below are my three basic pillars of the decision making process: Stock/Bond Valuation, Market Psychology and Monetary Policy.

Point 1: Stocks remain historically cheap, which significant upside potential and limited downside risk once calm and objectivity returns to the mindset of investors.



Sooner or later, stocks will revert to their mean relationship to interest rates. At present, they're undervalued by 31.1%. An undervaluation that hasn't been seen since the late 1970's, this means there's a big move up in stocks somewhere in the future. The prime potential catalyst remains the end of the rate hikes initiated by the Federal Reserve, which could be imminent (see Point 3).

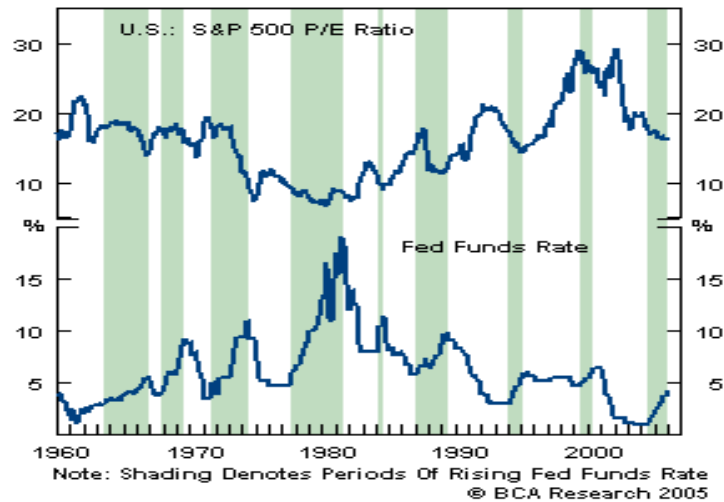
Point Two: Investor fear is already very high, enough for a major rally. Markets tend to bounce between two basic human emotions, fear and greed. I use objective measures of these emotions to either increase or decrease stock exposure by acting contrary to investor sentiment. When fear is high as it is today, major rallies are not far off.



Jason Goepfort of SentimenTrader.com has done exceptional research in graphing the emotions of fear and greed into usable data. Goepfort uses data that monitors the actions of “smart money” (professionals) versus, ahem...”dumb money” (investors who buy at tops and sell at the bottom* see below for a more extensive definition). When the line dips to the green dotted line it means fear is rampant and the smart money is buying heavily while emotional wrong-way investors are selling. This data strongly correlates to the top graph (SPX), which represents the Standard and Poors 500 stock index. As you can see, when the blue line in the bottom graph dips to the green line, market selloffs tend to segue to market rallies and visa versa. These occurrences are somewhat rare but we’re in the “smart buying” zone now. The time to lighten up holdings is when the graph rises to the red zone, which indicates excessive investor enthusiasm. My regret this year is that investor enthusiasm did not heat up to the level where cutting equity exposure was warranted.

Point Three: Current Monetary Policies are negative but the Federal Reserve has either finished raising interest rates or will very soon, as early as August 8th. It has taken an agonizing 16 consecutive to reach the point we are today, this is the longest series of rate hikes since 1979. The economy is cooling and the hottest sectors of housing and inflation may have reached a point the Fed may be comfortable with. In the most recent statement by Chairman

Bernanke he cites economic “moderation” which is the type of language expected to precede a finale to three years of raising rates.



This past January I showed you this chart that shows how the PE ratios of the stock market rise when the Fed stops hiking interest rates. With the only exception of the 2001 period (where stocks were wildly inflated in place, see my first chart above) stocks rally strongly even if there’s zero earnings growth in the economy. Once the Fed halts its current course of raising rates, there is a high probability that we’ll next see talk of *cutting* interest rates, then we could see a huge move in traditional growth stocks. Since 1980 the Fed has waited on average 4.7 months to start lowering interest rates once they stop raising rates. This is the best of all environments as the data below reveals:

*From 1960-1988: When the Fed is Restrictive (raising the Fed Funds rate, as they are currently) the mean monthly return is .3761% or just **4.5% annualized** (non-compounded).*

*When the Fed is Expansive (lowering the Fed Funds rate) the mean monthly return leaps to 1.644% or **19.72% annualized** (non-compounded).*

Data provided by “The role of Monetary Policy in Investment Management” Jensen, Johnson, Mercer.

What I’m attempting to say is that we will soon be transitioning from “Restrictive” to “Expansive” and stock values should follow suit.

As the chart above shows there are several historical precedents for markets reacting like a coiled spring when the Fed is finished raising rates. Perhaps the most similar precedent to today is 1994, but 1998 wasn’t too bad either: The Fed didn’t actually finish raising rates till very early in 1995, regardless markets sensed the end of the rate hikes and took off. See the chart below:



In 1998 the Fed embarked on another short series of rate hikes, yet despite the small number of hikes the stock market's reaction was the same once the Fed was finished.



Summary: When you analyze what I consider are the three most important elements to stock returns, you have an extremely bullish scenario laid out for us. In the meantime, we must cope and deal with the negative headlines without allowing emotions to overrule proper judgment. Headline risks are an ever-present influence that can affect change, but generally have impact only in the short term. Since we focus on the long term of 1-3 years our time frame continues to look very bright.

I cannot tell you exactly when investors will suddenly decide to view the stock market as half full from half empty, but it could be very soon. Within just a week or likely two

investors will be forced to anticipate the next Federal Reserve meeting August 8th. This means the very same stocks that have been sold, must be considered for buying all over again. If the Fed does signal that they've gone to neutral Technology, Industrials, Banks will emerge as leaders, their earnings are not nearly as bad as the stocks are being treated.

When the switch occurs, factoring in the high degree of current negativity we are to see a rapid rise in prices that could eclipse our recent losses and endure through 2008.

So sit tight, this period will pass.

Warmest Regards,
Brad Pappas

* "Buy confidence reflects the willingness of large, smart-money traders to be exposed to the market, on a scale of 0% to 100%. The higher the confidence, the more likely the market will rally.

Sell confidence reflects the willingness of small, dumb-money traders to be exposed to the market, on a scale of 0% to 100%. The higher the confidence, the less likely the market will rally.

The Buy/Sell Confidence Spread is simply the difference between the smart money and the dumb money. It is plotted on an inverse scale to more easily see its correlation to market movements. When the spread is at the upper end of the graph (above the red line), that is bearish and the market usually falls – when it is below the green line that is bullish for the market. Jason Goepfort of Sentiment Trader.