



## **QUARTERLY COMMENTARY**

### **Second Quarter 2008**

The second quarter was extremely unprofitable for most investors. Almost all bonds lost money. Common stocks declined for the third quarter in a row. Short-term cash equivalents provided very little return. In that difficult context, it is a pleasure to report that our portfolios grew nicely.

Wary of the potential for interest rates to rise in response to increasing inflationary conditions, we avoided all bond holdings in the quarter. Those assets not invested in common stocks were kept productive in short-duration insured certificates of deposit and top quality commercial paper. The returns from that portion of the portfolio were well above the returns from treasury bills or other commonly used cash equivalents.

In recent quarters the most important contributor to our strong portfolio performance has been the equity segment. Despite stock market declines in excess of 20% since the October 2007 highs, our stocks have risen over that period.

In our first quarter commentary, I pointed out that it was reasonable to expect stocks to attempt to rally off the mid-March lows. When market conditions made such a rally highly probable, we increased equity exposure by buying Standard & Poor's 500 Depository Receipts (SPYders) and holding them through the bulk of the second quarter's rally. We sold them in early May when the market advance began to labor. As was the case in early 2007, the strategic assumption of additional equity risk through the SPYders purchase boosted overall portfolio performance.

From mid-May, U.S. and virtually all world stock markets declined aggressively through the end of the quarter. The unrelenting nature of these declines has created an aura of short-term pessimism that normally spawns at least a decent countertrend rally. At the same time, however, bad news continues to flow from the beleaguered housing market, and an increasing number of giant financial firms are being forced to rebuild their capital after monumental write-offs of subprime mortgages and other flawed debt. With investor confidence as fragile as it is, a surprise shock to the financial system could precipitate a landslide stock market decline. Predicting even mini-stock market crashes is a perilous proposition, and we are not venturing out on that limb. The potential for a crash does exist, however, and it would be foolhardy not to recognize that possibility.

A growing number of common stocks are declining into a range at which they represent historically attractive values relative to overall market valuations. As a result, we are adding

more stocks to our portfolios. Because of still worrisome economic and market conditions and an S&P 500 price-to-earnings ratio again above 20, however, we are limiting the overall equity

percentage in our flexible allocation portfolios to a level below its long-term average. Accordingly, in most instances where we add new equity holdings, we are reducing the size of some of our larger existing holdings. Should the market experience a sharp decline, we remain ready to build the overall equity position once severe selling appears to be exhausted and enthusiasm reappears on the buy side.

How economic and market scenarios will play themselves out in the long run is highly uncertain. Much will depend upon whether the Federal Reserve and other world central banks win or lose in their attempts to reliquify major financial institutions and reenergize established world economies. There are many hurdles yet to clear, and the final answers may not be known for another few years. Investment flexibility, not traditional static asset allocations, will be preferable in such an uncertain environment.

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