

It was hopeful that by the time this update was released, some semblance of direction might have returned to the financial marketplace, particularly the rudderless (some might say foundering) U.S. equity markets. Such is not the case, as of yet.

Economic fundamentals continue to improve and yet the stock market persists in its doldrums, searching for a so-called sustainable 'bottom' from which to rebuild. There have been days when the market has been flush with optimism but these temporary spates have typically been followed by several sessions of dramatic downward movement. A movie about the stock market's current schizophrenic mood could easily paraphrase a 1960's film moniker and be aptly titled, "If It's Tuesday, I Must Be Bullish".

Markets are driven by both economic and psychological factors, and not necessarily in that order. The current market's bearish behavior is being influenced by the latter, specifically fear and a lack of investor confidence. No wonder. Consider the recent litany of bad news on the political front; ongoing concern over future domestic terrorist attacks, U.S. officials saying there is little that can be done to prevent such, the Middle East reaching flashpoint level on a daily basis, and India and Pakistan playing poker with nuclear war. Not the stuff that leaves investors feeling warm and fuzzy.

Additionally, high-profile scams and mismanagement, accounting firm scandals, and egregious conflicts of interest on Wall Street all have investors understandably on edge and wondering who/what they can trust. This mistrust is contributing to hair-triggered market swings at any hint of negative news or downward earnings surprise. For confidence to return, time will need to pass without new ethical irregularities being reported on a weekly basis and corporate earnings will need to tick up. Both will occur. In the meantime, it is important to remember that, despite the expanding rogue's gallery of corporate crooks and charlatans, most companies and their executives do indeed play by the rules, preferring to remain in narrow pinstripes as opposed to the broader black and white variety.

Meanwhile, the U.S. economy is looking up. U.S. manufacturing capacity has increased for four straight months, with May's rate being the best in two years. Accompanying this improvement is continued high productivity, which in turn enhances corporate earnings and indicates inflationary factors are in check; both important factors in a long-term economic recovery. May's new home sales also surged 8.1% and the 0.6% increase in durable goods orders far surpassed expectations.

Unemployment numbers remain around 6% and may even creep slightly higher. But this is still rather benign compared to unemployment rates in other recent recessions which neared 8% in 1992, 11% in 1983, and 9% in 1975. Additionally, employment improvement typically lags other economic recovery indicators by six months or more, so the current figures are no surprise. The dollar's weakening versus other currencies can have some negative impact but will also improve the attractiveness of U.S. exports. All in all, economic fundamentals are gaining solid footing.

However, the pace of this recovery will be slower and more disciplined. There is not going to be a big bounce, either in the economy or the markets. Alan Greenspan noted in mid-June that the U.S. economy's recovery from the recent recession would be less than dramatic because it was recovering from the shallowest recession of the past fifty years. No boom, no bust...and that is a good thing.

But the stock market and the economy do not move in lockstep, so an economic turnaround may not be immediately reflected in market performance. The unfounded optimism and outrageous valuations of the not-too-distant bull market had nothing to do with economic fundamentals and everything to do with human psyche. Conversely, just as it was critical not to be swept up in the siren's song of that market's unrealistic expectations, it is equally important to realize that the greedy, unethical actions of a small minority do not indicate the economic sky is falling.

This raises the point debated daily by Wall Street pundits and financial network talking heads. When will the overall market reach a bottom? We believe, and countless studies have shown, it is futile to try to guess when a bottom will occur. Market bottoms are only truly identified when looking backwards. Likewise, different stocks, industries, and sectors will turnaround (or not) at different times, so defining a 'market bottom' is really of very little consequence.

Alternatively, Roof Advisory Group prefers to focus on controllable strategies that ultimately add value to client portfolios. These include customizing investment policy standards for each client's financial objectives and risk tolerance, evaluating relative return versus risk based on tangible data, and strictly monitoring portfolio adherence to benchmark parameters.

Outlined below are a few tactics currently being used to help build and preserve client assets in these challenging times. Each client situation is unique and addressed accordingly but certain guiding themes apply throughout.

- For the majority of our clientele, we remain at the minimum equity allocation as defined by their personal investment policy, if not below. We have been at the low end of a client's equity allocation since yearend 2000. In March 2001, the firm made the unprecedented move of reducing equity levels to *below* minimum policy standards due to extenuating market circumstances, only moving back toward minimum levels at the end of September 2001 because of improved equity valuations. This reduction of equity exposure has helped preserve portfolio value in the declining market.
- As always, diversification remains an important priority in our management approach. Equities are diversified based on industry group and market sector. This has prevented our clients from being overexposed in the areas most impacted by the bear market's decline. Likewise, fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region.
- We continue to weight a portfolio's balance toward *value* style equities, while maintaining some *growth* style exposure through outside managers. In appropriately sized equity portfolios, individual stocks of companies with strong bottom-line fundamentals, attractive valuations, and consistent dividend yields have been selectively favored. These are often blended with managed funds that are complementary to the portfolio's objectives and enhance diversification.
- For large fixed income positions, individual bonds are used to control risk through both quality and maturity. A client's tax bracket/account type determines whether taxable or tax-free bonds are more advantageous. We typically emphasize short to mid term maturity investment-grade bonds, though reduced yields have pushed some maturity timeframes slightly longer. Currently, the maximum maturity considered for use in a portfolio is approximately ten years.
- Our leaning towards larger cap stocks with strong balance sheets remains. Mid/small cap "growth" stocks/funds were reduced when the markets began deteriorating. Mid/small cap "value" exposure was increased but most clients remain toward the lower end of their overall policy range for this category. Any international exposure has been minimal and will continue to remain so until it can be clearly determined that the relative risk/reward is attractive when compared to domestic alternatives.

This overview outlines just a few of the ways we continue to respond to ever-changing market conditions on your behalf. We truly value your business and appreciate our ongoing relationship.

**E. Jeffrey Roof**