INVESTMENT UPDATE

August 2007

Special Update

‘Taking a Reef in the Main’

Experienced sailors will tell you that it is always best to reduce the amount of sail you have aloft *before* you are being tossed about in the throes of a storm. Judgment is clear, actions are deliberate, and the ship’s course can remain steady as conditions worsen.

Such was the case when we reduced the target equity positions in our clients’ portfolios to ***one-step below maximum*** at the end of June in anticipation of the possible near-term negative market swings. We have continued to pare below that point and, more importantly, realign portfolio equity exposure on a very selective basis during the past few weeks in an attempt to buffer our clientele from the unpredictable swings of the current market, while also positioning portfolios for the opportunities ahead.

The last paragraph of the *Economic Conditions & Market Outlook* section in our July 2007 *Investment Update* (excerpted below) proved to be more insightful than we may have hoped:

> *“Moving forward, it is likely that increasing volatility will continue to haunt the stock market for the next several months. A lack of clear direction often is the beginning of notable day-to-day price swings, like the spinning needle of a compass trying to find true North. Additionally, many market observers have been suggesting some form of price correction is long overdue after a rather prolonged period of not having one. Are current prices out of line with fundamentals…we don’t think so. But the market often has the ability to create its own self-fulfilling prophecy, particularly when feeling a bit nervous and jumpy. Like the proverbial pig in a python, don’t be surprised if the market has periods of discomfort until the reach and impact of the sub-prime problems are better digested.”*

During the weeks that followed, exceptional market volatility was indeed the norm. As an example, the Dow Jones Industrial Average (DJIA) started July at 13,408, hit the much-anticipated 14,000 mark near mid-month, and then limped into August with a closing price of 13,211. Though a better indicator of the broader equity markets than the DJIA, the Standard and Poor’s 500 Index suffered a similar fate.

Despite this notable fluctuation in end-of-day closing prices, the true volatility of the markets was clearly evidenced in the daily market moves between opening and closing bell. Daily price swings, both up and down, of several hundred points in the DJIA were not uncommon, often exacerbated by a flurry of activity during the last hour of trading. While some traders may argue that it is possible to garner gains in periods of wild daily market fluctuation, our view is that the ability to truly succeed in such speculative guessing is akin to trying to catch a rapidly falling knife.

The major factors contributing to this current market uncertainty were clearly outlined in July’s *Investment Update*. Nothing much has changed since then. The fallout from the sub-prime lending market has yet to be fully felt and the housing market will remain weak into the foreseeable future. The so-called ‘credit crunch’ will limit the easy money that fueled ongoing corporate buyout activity/speculation that helped push stock prices higher earlier in the year. More high-profile hedge funds that are over-exposed to risky mortgages will either implode or just disappear, hurting their large institutional investors and casting a dour pall.

Despite these factors, most broad-based economic indicators remain relatively strong and balanced. We expect that once the current uncertainty is fully priced into the markets and the street again accepts the inevitable periodic negative surprise as being relatively benign, appreciation in stocks has the potential to continue smartly. Until that wind shift occurs and the financial seas calm a bit, we prefer to soften the ride.

(over)

Tactical Changes

As always, Roof Advisory Group's disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the specific tactics we are using in the current volatile market to add value and cushion fluctuations:

- For the majority of clientele, after increasing target equity exposure in early February to a *maximum* equity allocation as defined by each client's individual investment policy, targeted allocation levels were reduced to *one-step under maximum* equity allocation at the end of June. Ongoing market volatility has temporarily shifted our theoretical portfolio target to a ***mid-point equity allocation*** but most portfolios remain positioned slightly above this level. Market conditions during the next few weeks will dictate whether the move to *mid-point* equity allocation is completed versus returning to the prior level.

- Notable appreciation continued in some stocks during the market run-up in early July and equity concentrations and positions were ***rebalanced to target levels*** around mid-month to help preserve gains made in those positions.

- Diversification remains a priority in both equity and fixed income portfolios. While the firm does not make deliberate industry sector bets, concentrations above/below the benchmark can result from our equity selection process. As a result, ***Financial Services, particularly Brokerage and Investment Banking,*** are currently ***under benchmark level.***

- We have ***eliminated individual equities deemed most vulnerable*** to negative moves in the current market, i.e. Lehman Brothers, J.P. Morgan, etc. The firm has ***not held individual Home Building or Sub-Prime Lending stocks***. Positions in value-oriented ***mutual funds with Financial Services exposure have been reduced***. Some proceeds have been redeployed to specific stocks in areas deemed less vulnerable to the current credit concerns, such ***Defense and Technology***, but not at above overall benchmark levels.

- ***Individual bonds of Financial Service sector companies*** that are presently held in client portfolios currently have a ***minimum S & P quality rating of 'A'***, a rating system that deems any holding above 'BBB' as investment grade. The firm ***does not use "junk bonds"*** to enhance yield.

- ***Concentrations in short-term fixed income positions***, particularly money market funds, will be ***higher than the norm***. This is tactically beneficial in the current situation for two reasons: it reduces portfolio volatility and allows for rapid redeployment when the opportunity is presented.

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