



INVESTMENT UPDATE

June 26, 2008

SPECIAL UPDATE

Economic Conditions & Market Outlook

While it would be a rarity indeed to find a Charles Dickens' novel on any recommended list of light summer reading, diving into his *A Tale of Two Cities* might be rather apropos for investors trying not to lose their heads in this topsy-turvy economy. Similar to this classic tale's contrast of London and Paris during the French Revolution, the breadth of current economic forecasts span the spectrum from benignly reserved to spinning wildly out of control. Only time will tell which prognosticators were more correct.

In the meantime, it appears that the mob may have already taken to the streets in the investment markets. Earlier this week, our firm had tactically shifted to the *minimum equity allocation* per each individual investment policy in order to cushion the current turmoil and avoid possible further bloodletting. Given today's dramatic market downturn, this move appears both prudent and prescient.

But before examining the market factors prompting this reduction in equities, let's focus on the broader economic view. Present indicators support the idea that we may indeed be living a 'tale of two economies'. On one side, history may show that this was the most widely anticipated recession-that-never-was. Despite the predictions of a recessionary shift since late 2007, a just-released restatement of gross domestic product (GDP) for the first quarter 2008 indicates that GDP rose at an annual rate of 1% during the period, a slight revision upward from the earlier data. Certainly not robust but net overall growth nonetheless.

Likewise, notable consumer spending during the month of May, coupled with modest business expenditure and continual demand for U.S. exports abroad, practically assure a positive GDP number for the second quarter of 2008 as well. The receipt of tax rebates and economic stimulus checks is credited for some of the increased spending by U.S. consumers last month but existing home sales, hardly a rebate or stimulus induced purchase, also ticked up smartly during the period. This improvement in the sale of existing homes occurred despite much tighter lending requirements and the acknowledgement that many other buyers-to-be are waiting on the sidelines hoping real estate prices will fall further.

On the flip side, sales of new homes and housing starts continue to decline, with no indication of a turnaround anytime in the foreseeable future. Similarly, higher fuel and food costs have coupled with declining real estate valuations (and incessant rhetoric from campaigning politicians regarding our dire straits and the need for change) have helped push consumer confidence to its lowest level since 1992. Economists often include the caveat with consumer sentiment measures that what people 'do' does not always correlate directly with how confident they 'feel' but common sense would suggest that the specter of rising household expenses will keep the average consumer wary and cautious.

Globally, the economy is a mixed bag as well. Despite a lingering worldwide credit crunch (negative), increased demand, growth, and expansion (positive) have pushed commodities prices to the inflationary level (negative). Europe's largest economy (Germany) appears to be stagnating, Ireland's business boom has stalled, Japan is again in a funk, and India is wrestling with inflation. Meanwhile, China keeps spending and Brazil keeps growing. Per usual, there are economic winners and losers on the international front; and next year's category leaders will almost assuredly be different than those there today.

So who's correct in the long run - the economic Cassandras or Pollyannas? Probably neither. The U.S. and global economies will most likely continue to slog on through this challenging period without either imploding due to lack of growth or exploding due to rampant inflation. Frankly, absent some data mentioned above and the Federal Reserve's recent decision to leave interest rates untouched, not much has changed in the macro-economic picture since our last Investment Update in early May.

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What *has* changed is our perception of overall stock market sentiment and our evaluation of relative market upside versus downside in the near term; both of which look less favorable now than they did in early May. It was this reassessment that prompted our initial allocation shift to *one-step above minimum* two weeks ago, followed by the subsequent move to ***minimum equity allocation*** on Monday/Tuesday of this week.

Specific factors contributing to this move to minimum equities include:

- Ongoing uncertainty as to when the defaults/write-offs coming from the financial sector will end.
- Concern that the high price of crude oil (whether driven by demand or speculators is immaterial) will continue to fuel inflationary concerns and pressure future corporate profits, as well as weigh on overall economic growth and consumer spending, as outlined earlier.
- A diminished probability that there will be a significant second half recovery in the equity markets.
- The belief that increased bearishness in the markets will tend to overly punish negative corporate earnings misses much more than reward positive upside surprises; reducing the risk-reward ratio.

Our Tactical Investment Stance

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 in response to changing market conditions to optimize client portfolio performance. Some of these are outlined below:

- As noted, the firm has returned to a ***minimum equity allocation*** as defined by each client's individual investment policy. This formal change was made Monday morning and implemented over the next two days. This shift occurred after a previous move to *one-step above minimum* two weeks prior and a gradual softening of that position until Monday morning's shift.

Selective stock buying opportunities will continue to be evaluated but ***current allocation bias is negative***. We will be particularly cautious during the next several weeks due to ***near-term market volatility***.

- Diversification is always a priority in the firm's portfolios, with that strategy once again demonstrating value in unstable market conditions. While the firm does not make significant sector bets, we do look to add value by slightly overweighting areas in favor and underweighting those that are not. In our opinion, ***avoiding untimely sectors and poor performing stocks*** is essential to long-term growth and risk control.

Our current portfolio position is a ***slight overweighting in Energy, Utilities, and Basic Materials*** sector stocks, with ***notable underweighting in Financial*** sector companies. This underweighting resulted from the recent move to minimum equity allocation. The firm ***does not hold any individual Home Building or Sub-Prime Lending*** stocks and has not done so throughout the entire credit crunch/mortgage crisis.

- Positions in stocks with significantly ***lowered or at-risk earnings remain pared***. Some individual equities that were previously repurchased/enhanced were ***again eliminated/reduced***, including Citigroup, Bank of America, J.P. Morgan, General Electric, and several others. We still see long term value potential in many of these holdings but need evidence of sustainable price stability before adding significant new dollars.
- ***International and global exposure*** has been ***proportionally reduced*** as part of the overall reduction in equity allocation. While this exposure provides ***some currency hedge*** against the weakened U.S. dollar, foreign equity performance has ***faired no better*** than domestic U.S. markets of late.
- ***Short-term fixed income investment levels*** will be ***temporarily higher than normal*** due to the tactical shift in equity allocation. The firm will be maintaining a ***balance between enhancing overall yield*** via opportunistically increasing average maturities while ***preserving sufficient liquidity*** to re-deploy as the equity markets invariably improve and interest rates are pushed up by the Federal Reserve later this year.

E. Jeffrey Roof