Q4 2007 Quarterly Investment Commentary

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Winter is bringing with it both turbulent weather and turbulent markets. The fourth quarter of 2007 was a difficult time for the Equity markets. Undiversified investors in the U.S. stock market were disappointed, while investors with international stock and additional asset class diversification had mitigated losses. The U.S. S&P 500 lost 3.3%, while Large U.S. Value and Small U.S. Value were negative by 5.8% and 7.3% respectively. With Growth-oriented stocks outperforming Value-oriented stocks, Large U.S. Growth declined 0.8%, beating value by almost 5% in this quarter alone. Offsetting these negative asset classes were positive returns for Emerging International stocks, Commodities, and Fixed Income, gaining 3.7%, 4.7%, and 3.1% respectively. Commercial real estate owned through Real Estate Investment Trusts (REITs) paralleled the difficulty in the national housing market, declining 13.5% in the fourth quarter. Although we increased our allocation slightly part way into this quarter, we continue to be underweight in Real Estate as the housing market continues its correction. We will continue to diversify through manager and asset class tilts, with an eye on the economy for proactive moves.

Q4 Portfolio Performance

Opes Portfolios performed as we would expect in a down market, reducing volatility and risk while not immune to lower markets. Although we could not avoid a losing quarter, all of our 9 portfolio models either beat our blended benchmark, or were within .5%, beating the -3.3% loss of the S&P 500. Asset Allocation and diversification strategies continue to work as they were designed.

Our third quarter letter estimated that the credit crunch and weak housing market would continue as major influences for at least the upcoming six months. In fact, the decline in equity pricing in Q4 2007 and into 2008 can be largely attributed to the financial sector, particularly since the financial sector amounted to approximately 20% of the S&P500 in October. As Q4 unfolded, the unwinding of subprime mortgage derivatives caused huge losses at some of the U.S.'s most prestigious banks and brokerage houses. Household names like Fannie Mae, Freddie Mac, Washington Mutual, Countrywide Financial, Citigroup, Merrill Lynch, and Bear Stearns were among the firms caught in the mortgage market meltdown. Through early January, over $100 Billion in asset values have been written off by banks and brokerages; by itself, the Financial Sector was down by 14.4% in the fourth quarter. In addition, other sectors of our economy were influenced by the concern that consumers would be adversely affected by the effect of the sub-prime induced credit crunch, with its higher lending rates and more stringent borrowing guidelines. Consumer spending in December and early January was weaker than expected, further extending market declines into many other sectors of the economy as worries of a recession began looming large.

2007 Recap

For the first time since 2002, the Lehman Brothers Aggregate Bond index beat the S&P 500, returning 7% vs. 5% for the S&P. This is exactly the kind of market in which additional asset classes such as Fixed Income and Commodities offer added stabilization. In equities, diversification also provided value, with Growth stocks outperforming Value (Large Growth +11.8% vs. Large Value -.2%, and Small Growth +7% vs. Small Value -9.8%). International markets were strong for the entire year due to Emerging Market economies and the weakness of the dollar (Emerging Markets +39.8% with Developed Markets +11.6%). REITs had a painful year after several years of strong performance, losing 18.2%, while commodities did well, reflecting worldwide demand and returning 15.8%.

For 2007, the Opes Portfolios performed near their respective blended benchmarks, however performance would have been considerably better without the underperformance of a significant asset class: Fixed Income. Our fixed income allocation is comprised of a portion of U.S. fixed income and an allocation to international fixed income. As emerging and international economies become a larger percentage of the world's economic output, international fixed income should provide additional return potential, greater diversification, and a further value added when the U.S. dollar falls; 2007 fulfilled that expectation. Our U.S. fixed income exposure underperformed however. Our strategy had historically shown solid risk-adjusted returns, but the unprecedented disruptions in the 2007 bond markets significantly hurt these strategies, leading to losses in an asset class where Treasury bonds rallied, creating commensurate positive returns. We intend to add further diversification in our U.S. bond managers after some discounted positions rise.

2008: The U.S. Economy and the American Consumer

What are we expecting in 2008? As we write this commentary, U.S. markets have fallen over 10%

since January 1. Much of the market's fear centers on the affect lower house prices and higher energy costs will have on U.S. consumer spending. If consumers have less cash and feel poorer than in the past, they are likely to cut back on spending. With consumer spending making up about 70% of the U.S. economy, a spending decrease would adversely affect the U.S. economy, which is why Congress and the President are discussing measures to put additional money into consumers' pockets. Offsetting these legitimate fears for the domestic economy are strong exports, which are being fueled by a lower dollar. In the third quarter of 2007 (4th quarter data is not yet available), housing subtracted approximately 1% from GDP growth, while exports added about the same amount. When housing declines begin to moderate (or at least the rate of decline slows), the positive effects of exports may begin to overtake the negative effect from housing on U.S. GDP. Thus far, wage growth has been growing at a solid 5% annually, providing spending power in spite of higher costs. The troubles in residential housing and finance are increasing unemployment, which rose from 4.7% to 5%. However, as long as employment does not crater (don't forget that 5% unemployment = 95% employment!), we believe the economy will slow significantly but not fall into a serious recession. I'm not sure anyone during the time can feel the difference between a very slow growing economy and a mild recession. There is definitely potential for further downside in the markets, though we expect lower rates triggered by the Federal Reserve and diminishing write downs from financial companies to eventually restore better market liquidity and generate psychological support to investors in the world markets.