



March 2008 Market Update

Author: Mark Duvall, Principal and Chief Investment Officer, CFA®

Even though our quarterly letter went out just about 40 days ago, there is enough volatility in the markets that we wanted you to know our thoughts and actions in these rough market times. This is the first time we've been through this type of market together at Opes, and we felt that an update would also provide some orientation in the face of all the concerns of the marketplace.

2008 Portfolio Performance

Opes Portfolios have generally performed as we would expect in a down market, reducing volatility and risk while not immune to lower market returns. The Market started the year off with a strong selloff. From January 1 through January 22, the market as represented by the S&P 500 returned -10.6% and if we go back to October 9th of last year through January 22, 2008, the S&P 500 fell by 15.7%. After a rally early last week, Friday's down day brought us back to -9.4% for 2008.

We speak often about our commitment to Asset Allocation, and the sound application of its principles. Diversification is designed to smooth out severe volatility and to provide greater long term returns. We own numerous asset classes for the sake of generating solid returns with less volatility than a single asset class such as Large US Stocks. We also make tactical portfolio tilts to further control our risk. Examples of tilts in portfolios include the changes we have made in the past year to decrease the allocation to Emerging Market stocks, Real Estate, Small Cap stocks and U.S. Value stocks, while adding to U.S. Fixed Income, Foreign Fixed Income, Large U.S. Growth and cash. Although we have not avoided losses in 2008, our diversification in bonds and commodities have helped partially offset U.S. stock market losses. Positive contributions to portfolio returns in January 2008 came from U.S. Fixed Income (+3.3%), Foreign Fixed Income (+2.1%), and Cash (+0.3%).

2008 U.S. Economy: Credit Problems Plus

As we wrote in our last Commentary, much of the market's fear centers on the effect lower house prices and higher energy costs will have on U.S. consumer spending. When consumers have less cash and feel poorer, they are likely to cut back on spending. Certainly the ability to refinance a home, generating cash for additional consumer spending, is much harder in 2008 than it was in 2006, due both to home price declines as well as mortgage credit tightening. With consumer spending making up about 70% of the U.S. economy, spending declines are adversely affecting the U.S. economy, which is precisely why Congress and the President very quickly agreed to temporary tax rebates and faster business tax deductions

for certain capital spending.

The ongoing credit crisis, begun with securitized subprime mortgages last August, continues to plague the worldwide financial system. The most recent concern has been around the monoline insurers, though recent reaffirmations of their credit ratings are beginning to diminish the market's worry about their likely future insurance payouts. Like prior credit crises, credit tightening for a year or more will slow our economy, followed eventually by credit easing that will re-stimulate the economy.

While these forces have probably pushed us into recession, concerns around inflation still persist, with high energy and food costs beginning to show their effects in more of the economy. Strong global economic demand for commodities has remained high thus far, both pushing up those prices for U.S. consumers as well as providing an offset to the weaker domestic economy. Rising U.S. exports augmented by a lower dollar are moderating other current negative economic effects, leading us to believe we'll see a mild recession rather than a more extreme downturn. Signs of inflation are indicative of the elements that will pull our economy out of the likely current mild recession.

While there is clearly potential for further downside in the markets, 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. We expect the recent uncertain economic conditions to linger through at least the 3rd quarter and possibly longer, yet eventually the economy will improve as it always has. Economic cycles are inevitable; as the credit excesses of the past several years are worked off, we will once again return to a growing economy and a profitable stock market.

Your Assets

While the last seven months have been volatile and tough times in the markets, this is part of the inevitable market cycles. We trust the mechanisms of diversification and economic cycles to help protect values in down markets and bring back rising markets later on. For many people, it is hard to stay the course during volatile times, and yet that is precisely what is most important. Although these are difficult times, they are necessary part of normal business cycles. Our strategy of reducing volatility and protecting portfolio value through asset allocation is working as it was designed to do.