



"Capital adequacy is a necessity of life for economic growth"
-EHJ

July 14, 2008

Dear Client:

The quarter just ended produced some of the worst equity returns in more than 15 years with the S&P 500 index declining 8.4% during the month of June. The stock market buckled under a sharp increase in negative sentiment reflecting a wave of speculative buying in energy and food related commodities, further credit impairments in the banking sector and continued erosion of real estate values. Despite these headwinds, the economy still maintained buoyancy with 1% real growth reported for the first quarter and a likely continuation of that rate in the second.

We expect a pattern of sub par GDP growth for the balance of 2008 with a reasonable likelihood that the economy will begin to trend upwards by year-end thus avoiding recession. However, the structural problems associated with the banking system and real estate will require more purging and contraction before credit conditions ease and restoration of value begins. Conditions appear to be set for the eventual recovery of these hard hit sectors beginning in the latter half of 2009.

Successful capital raising by the major money center banks and the Federal Reserve orchestrated rescue of Bear Stearns by JPMorgan have begun to restore capital ratios and confidence in the ability of some sectors of the capital markets to begin functioning within a degree or two of normalcy. Capital adequacy is a necessity of life for economic growth. As we pointed out in previous letters, there is a mountain range of cash available for restoration of balance sheets, but only at a price. We now feel that this stage has been reached and valuations are attractive enough for investors to take on this risk albeit at the expense of diluting existing shareholders. To date, over \$100 billion has been raised via dilutive deep discount rights issues with more to come.

The next phase will see more balance sheet shrinkage via reductions in credit lines to leveraged clients and adjustments to non-performing loans. Thus, credit conditions will likely tighten before they begin to relax. Although the global margin call will continue to move ahead, we do not believe that its pace should cause further shock to the capital markets.

When the banking system is rebalanced, what then is required to boost economic growth? The simple answer is a reallocation of credit so that it favors business development which in turn creates economic growth: jobs, capital investment and corporate profits. The credit cycle that has both crashed and imploded was bent to fund financial engineering and leverage based on a variety of black box devised products, most of which have more than eradicated all the implied gains of the creators. Unfortunately, vast amounts of this capital were paid out as incentive compensation and will never be recovered.

Assuming the capital rebuilding continues apace, the next item to rebuild is confidence. At present, negative sentiment and the momentum driving it are at historic extremes amplified by food, energy, and service inflation and the fear of losing household wealth because of declining real estate values and the savaging in the stock market.

If one believes in Sir Isaac Newton, this too will pass. Newton's Law of Action and Reaction states that for every action there is an equal and opposite reaction. We have witnessed the action on the upside and now on downside in the stock market driven to extremes by excessive short selling. Statistical evidence arrayed by the Bank Credit Analyst shows the level of short positions in the financial sector at an all time high of 15% in the US and 22% in the United Kingdom.

The Bank Credit Analyst goes on to say, "Banks are priced for Armageddon." We concur with this observation. The restructuring of the banking sector is largely in place with many bank equities priced at 50-75% of book value and at price-earnings ratios of 3-7. Although we cannot rule one or two more headline failures in the months ahead, valuations are such that a sudden change in sentiment for the better would result in substantial gains.

There are several possible catalysts for a positive change in investor confidence. First and foremost, there is a lot going for the economy: a record \$100 billion-plus of grain exports, machinery and capital goods exports continue to rise on the back of the lower dollar, foreign takeovers appear to be accelerating, massive insurance claims from flooding will turn into reconstruction spending and constructive government action to reschedule home mortgages and allow people to keep their homes and the value they have built up. These all add up to definable positives. Now we add in the probabilities of the unquantifiable factors: a correction in energy and food commodities due to market rationalization, a harmonizing of margin requirements across the board for all cash and futures markets, the specter of political change, genuine progress in Iraq and we have the tinder for what could be the largest short cover rally in the history of the stock market. When might this happen we are not sure, but as each week passes, we see the odds growing.

In conclusion, we have stayed the course, and we continue to believe in global growth and the rewards of investing in the stocks of strong global companies committed to profit and dividend growth. This is the best way we know to beat inflation which is likely to be a more troublesome issue in the years ahead than it has been for the past two decades. Although we do hold fixed income assets in portfolios where appropriate, we caution against long maturity bond commitments given our concerns about the future. The secular decline of the U.S. dollar against other major currencies reinforces our commitment to the global diversification of our clients' portfolios.

As always, please let us know if there have been any changes in your financial situation or your investment objectives that we should know about. Please feel free to contact anyone on our team if you have any questions or concerns. Thank you.

Sincerely,

A. Cushing Titcomb
President & CEO

Eric H. Jostrom
Co-Chairman & CIO

Alexander M. Colby
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