



Index	Quarter Return
DJIA	-7.0
S & P 500	-9.4
NASDAQ	-14.1
Russell 2000	-9.9
MSCI EAFE	-8.9
Lehman Bros. Aggregate Bond	2.2
Consumer Price Index	1.7



First Quarter Investment Commentary

Short-term volatility is precisely what investors are getting paid to endure for the sake of long-term results that are greater than T-bills, and this is a terrific trade-off for anyone with a long-term investment horizon. Indeed, during the first quarter, we saw record volatility and there were few opportunities for positive returns as all sectors declined except for energy and other commodity driven businesses such as agriculture. Large cap stocks were off by 9.5%. Smaller company stocks were down roughly equivalent levels of approximately 10%. International stocks also had a rough quarter with markets overall down about 8.9%. The credit crises continued to roil the markets and claimed its most prominent victim, Bear Stearns. While the intervention by the Federal Reserve to broker the sale of Bear Stearns to J. P. Morgan continues to make headlines, it was clearly a bold and necessary step to stabilize the markets. As a result of this and other sometimes unique moves by the Fed, fixed income investments calmed down and, in aggregate, bonds provided a 2.2% return. Over the last 12 months, lower quality bonds have suffered significant declines. This, however, is an area that we have purposely tried to avoid over the last several years.

Looking Ahead

Though the label is unimportant, it's probable that we are already in a recession or on the verge of entering one. It's clear that the severely troubled housing and credit markets are having an impact on the health of the overall economy. The ability to borrow money at a reasonable cost to support consumer spending and conduct business is essential for a healthy economy, and the bottom line is that credit markets in general are not functioning properly at present. In light of the need to correct this, probably the biggest positive for the economy in the near term is the aggressive action of the Fed. Though the Fed's moves may not have been as effective as they would like, they have made it clear that they will do whatever it takes to stop a major downturn and they still have weapons in their arsenal, such as directly buying mortgage securities in the public market. These actions show that the Fed finally "gets it" with regard to the credit quagmire which includes many mortgages that ultimately will not get paid. These actions appear to have settled the equity and financial markets so that the financial

Armageddon scenario no longer seems plausible and whatever the small possibility of it occurring appears to be priced in the markets.

Although the Fed has focused more on the deteriorating economy, commodity driven inflation has become troublesome for both businesses and consumers and this is perhaps the greatest near-term threat to the economy. Hopefully the Fed's stimulus packages will provide an interim economic boost in the second and third quarters and buy some time for the monetary stimulus and other potential catalysts such as lower commodity prices, stabilizing home prices, and greater credit availability to materialize. As in any downturn, it is easy to get whipped into a bearish frenzy and the popular press is adept at adding fuel to the fire. We understand the negatives impacting the economy and the various investment markets, and we believe that the sluggish economy is likely to be with us for a while as the housing and credit excesses are purged.

On the other hand....

As always, the future is not clear cut. There are just too many major variables impacting the economic future to form an absolute opinion about the next year. While we do not agree with the conclusion that foreign economies will "decouple" and not feel the U.S. economic slowdown, we do believe that there will continue to be significant economic growth in many parts of the world that will positively impact both U.S. and foreign companies. And, outside of the financial sector, companies are generally flush with cash, especially relative to debt-service needs. Balance-sheets are surprisingly healthy for this late stage in an economic cycle. There is also a lot of cash on a worldwide basis that needs to be invested. Finally, when we look at equity markets, especially the U.S., we see valuations that appear reasonable in comparison to other asset classes, such as real estate and fixed income.

Do today's economic stresses have longer-term economic ramifications?

There are two potential long-term ramifications. First, as the Fed and policy makers attempt to solve problems in the credit markets, the amount of stimulus that is being required increases the potential for higher inflation down the road – not 1970s style inflation, but more than we've been accustomed to based upon historical standards. Longer-term, the increased supply of dollars has to go somewhere, and that raises the risk of inflation. It also undermines the dollar's value relative to other currencies. That's also inflationary as imported goods cost more. The second ramification is the likelihood of continued deleveraging on the part of households for several years, resulting in less borrowing in the next recovery. If consumers borrow less and spend less, economic growth and corporate earnings growth will be slower than they would otherwise be. All this raises the risk of some stagflation in the next economic cycle.

Conclusion

As we write this, market volatility continues and we suspect this will continue to be one of the more challenging investment environments we've faced, at least for a while. We believe investors may still be underestimating the losses yet to be written off by the financial sector and the resulting economic ripple effects. But stocks are reasonably valued now, and if they fall much further, it will represent a very attractive buying opportunity for long-term investors. And while we believe it is important for us to discuss the more negative possibilities, we reiterate that it is possible that we are close to a bottom, or that we have already reached a bottom. We can't know what the near-term is going to bring, but at times like this when economic uncertainty is high, our discipline and research process keep us grounded and give us confidence in our ability to make sound long-term decisions.