

INVESTMENT COMMENTARY

A PUBLICATION OF LARRY THOMPSON & ASSOCIATES, INC.

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4th Quarter 2007

The Markets

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	(3.23)	5.77	5.77	9.08	13.43	6.20
Russell 1000 Growth	(0.77)	11.81	11.81	8.68	12.10	3.83
Russell 1000 Value	(5.80)	(0.17)	(0.17)	9.32	14.63	7.68
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	(3.55)	5.60	5.60	11.09	18.21	9.91
Russell MidCap Growth	(1.70)	11.43	11.43	11.39	17.90	7.59
Russell MidCap Value	(5.97)	(1.42)	(1.42)	10.11	17.92	10.18
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	(4.58)	(1.57)	(1.57)	6.80	16.25	7.08
Russell 2000 Growth	(2.10)	7.05	7.05	8.11	16.50	4.32
Russell 2000 Value	(7.28)	(9.78)	(9.78)	5.27	15.80	9.06
<u>International Equity</u>						
MSCI World ex US	(1.62)	12.44	12.44	17.40	22.12	8.99
MSCI World ex US Growth	0.06	18.03	18.03	18.14	20.59	6.87
MSCI World ex US Value	(3.38)	6.95	6.95	16.57	23.54	10.86
MSCI Emerging Markets (Gross)	3.66	39.78	39.78	35.60	37.46	14.53
<u>Real Estate</u>						
Nareit Equity REITs	(12.67)	(15.69)	(15.69)	8.50	18.17	10.49
<u>Domestic Fixed Income</u>						
LB Aggregate	3.00	6.96	6.96	4.56	4.42	5.97

This edition of Investment Commentary is being published later than usual. Although the commentary is largely focused on 2007, we could not ignore the events of the first few weeks of 2008, and withheld production until we could present a clearer picture of where we stand today.

When investors look back at 2007, they will remember it as the year of the sub-prime mortgage. The issue dominated news headlines in the second half of the year and caused investors to forget how good the markets had been during the first half of the year. Looking

Investment Commentary is a newsletter dedicated to the issues, trends, and strategies surrounding both the individual and institutional investor. It is published quarterly by Larry Thompson & Associates, an independent investment management consulting firm based in Dallas, Texas.

back at our 2nd quarter 2007 Investment Commentary, there was little evidence of the impending financial crises. The Russell 1000 (domestic large cap) was up over 7% for the first six months of the year, the Russell 2000 (domestic small cap) was up over 6% and international markets were showing double-digit returns. For large cap and international equities, the returns looked similar at the end of the year, but small caps experienced a tremendous sell off, particularly on the value side.

By the end of the third quarter, the panic involving sub-prime mortgages and the declining housing market had largely calmed, as it appeared that the damage would remain in the financial sectors. The calm was short lived as investors faced new and even more challenging issues. Oil began to approach \$100 per barrel, unemployment began to creep higher and consumer spending appeared to be slowing. The markets reacted negatively and ended the 4th quarter lower.

Most of the negative news centered in the financial sector, which contains mortgage companies and banks – many holding large sub-prime loan portfolios. Consumer sectors were also hit hard. It is not surprising that these two sectors turned in the lowest returns of the fourth quarter. Large cap Financials fell 13.3%, while large cap Consumer Discretionary lost 10.3%. As usual, there was still money to be made in the market and the large cap Utilities and Energy sectors were the two strongest performers during the quarter, up 6.7% and 5.0% respectively. Although the discretionary consumer goods companies lost ground in the quarter, the makers of everyday consumer items (consumer staples) rose 3.6%.

The continuing decline of the U.S. Dollar remains a boost for international equities. However, when you remove the impact of the weakening Dollar, international equity markets fared no better than domestic markets. In *local* currencies (after removing the impact of the Dollar), the MSCI World ex U.S. index returned -2.8% in the 4th quarter. The Dollar was also a factor in domestic equity returns, as companies with large international revenues and large exporters tended to outperform companies with largely domestic revenue sources.

For the first time since 2002, domestic fixed-income markets outperformed equity markets. Domestic bonds were helped by three Federal Reserve rate cuts in 2007 that totaled a 1% decrease. At 4.25%, the Fed Funds rate finished 2007 lower than they had been in two years, but still much higher than the 1% rate seen for over a year in 2003 and 2004.

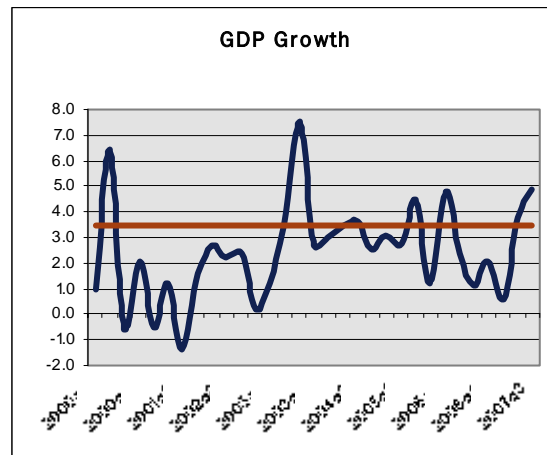
The Economy

There is no doubt that the financial markets are linked to our economy. However, the economy and the market do not always move in lockstep with one another. Short-term movements in our markets are normally the result of news, often news that is associated with a single company. Maybe the news has some significant bearing on the overall economy, perhaps the news is telling of problems in a particular economic sector, or maybe it is just a company specific issue.

We probably should not concern ourselves too much with company-specific issues. There will always be some company that announces unexpected bad news and while this may inject some volatility into the financial markets, this is normally a short-term problem. The demise of an entire economic sector, however, cannot only wreak havoc on our markets, but can change the complexion of our entire economy. For example, we know that the real estate markets (particularly residential) are struggling. We also know that the financial sector is problematic, in part due to imprudent real estate lending. If this was all there was to it,

investment managers could simply avoid these areas during portfolio construction and everything would be fine. In fact, many successful managers *have* avoided these areas and were rewarded because of it. The question is this: How much will the growing problems in the housing and financial sectors affect (or is it “infect”) other parts of our economy and how might this unfold?

Looking at the growth of our gross domestic product (GDP) through the third quarter of 2007 (the latest information available), it is hard to envision a slowing economy. Our GDP rose at an annual rate of 4.9% in the third quarter, after rising 3.8% in the second quarter. Both of these numbers are higher than the historical growth rate of 3.4%. However, consider the economic landscape that precipitated the robust growth of 2004 through early 2007.



It seemed that we had the perfect environment for robust spending. Interest rates were generally low and loans were easy to come by. Low interest rates allow consumers to manage a higher level of debt and continue their spending. Our housing market was strong. Coupled with low rates, this created a very favorable mortgage-refinancing environment – another source of funds to spend. We were still feeling the benefits of favorable tax policies – same story. Unemployment was remarkably low and wage increases were strong. When people have jobs, they generally feel better about the future and continue to spend today. Consumers were confident with their employment status and that future wage increases would be available to help pay off their higher debt levels. Finally, we were in the midst of a roaring bull market for global equities. Think about it. You are employed and getting good raises. The value of your home is increasing way beyond your expectations and your financial assets are increasing in value at double-digit annual rates. How much better could it get? Accordingly, the American consumer increased their spending at a rate significantly higher than the historical average. Let’s not forget that the falling U.S. Dollar’s positive impact on exports – further benefiting our economic prosperity. How could anything go wrong?

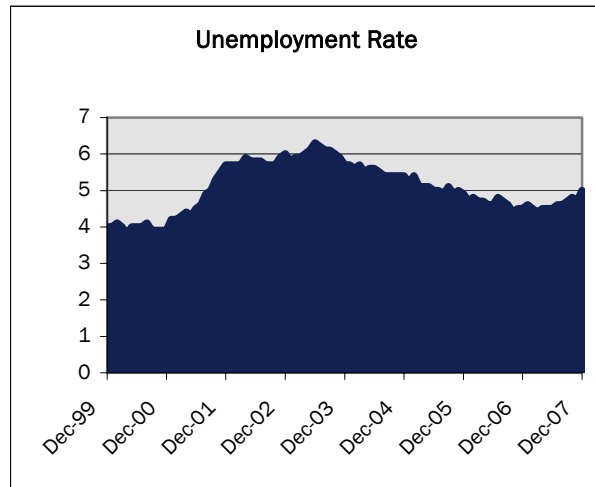
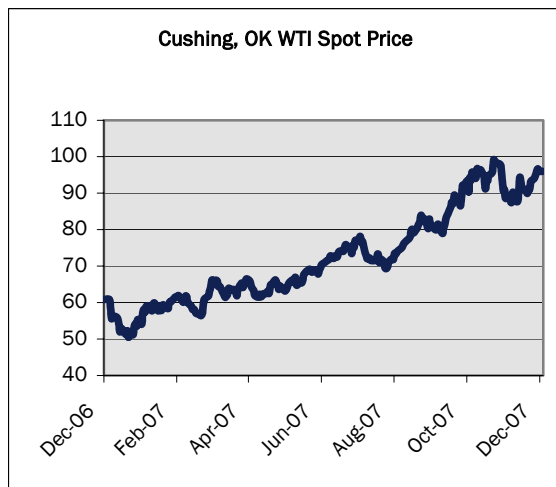
As we already know, problems in the sub-prime mortgage area served as the catalyst for our current market and economic problems. Questions arose regarding the creditworthiness of these riskier mortgages, especially in light of upcoming interest rate hikes on many of the adjustable rate mortgages. Credit ratings and the rating agencies themselves were questioned. It did not take long for investor confidence to be lost, leaving institutions holding billions of dollars of securities with no liquid market.

Financially vulnerable institutions were driven to bankruptcy, while the behemoth money center financial institutions took (and are still taking) unprecedented hits to their balance sheets. Senior executives were booted and the stock prices of financial companies were driven lower and lower. Lending institutions began “sitting on their hands” fearful of making loans to just about anybody – irrespective of the borrower’s creditworthiness. In essence, the Fed was becoming more accommodative, but the financial institutions were superimposing their own restrictive policies.

Increasing foreclosures, primarily the result of upward interest rate resets, added to the inventory of unsold homes. Restrictive lending practices and higher rates further reduced housing demand. Simple fear of how deep the real estate rut might be kept able buyers on the sidelines. Virtually every facet of the residential real estate market was being impacted – from builders to furniture and landscaping companies.

We have always held the belief that consumers can usually accept a certain degree of negative news at any given point in time without seriously affecting their sentiment and habits. However, we have limits and it is when we experience the “piling on” effect that we oftentimes seek a protective course of action. It seems that investors and consumers are simply scared, partially in light of what they know and in part because what they do not know – which is what the future may bring.

Contrast the current state of affairs with the environment outlined a few paragraphs back. Although energy prices are currently off their highs, oil hit \$100 a barrel and the consensus is that upward pressure on energy prices will be persistent. Although 2007 was a decent year for most equity markets, the fourth quarter and certainly the early days of 2008, have pulled financial assets lower across the board. Home values are depressed and the entire residential real estate sector is in turmoil. Unemployment numbers are still OK, but both November and December reports were discouraging. Holiday sales were a disappointment and even the business sector seems to be curtailing investment. It is no wonder that consumers are finding it difficult to spend with the same level of exuberance as they did only a few months earlier.

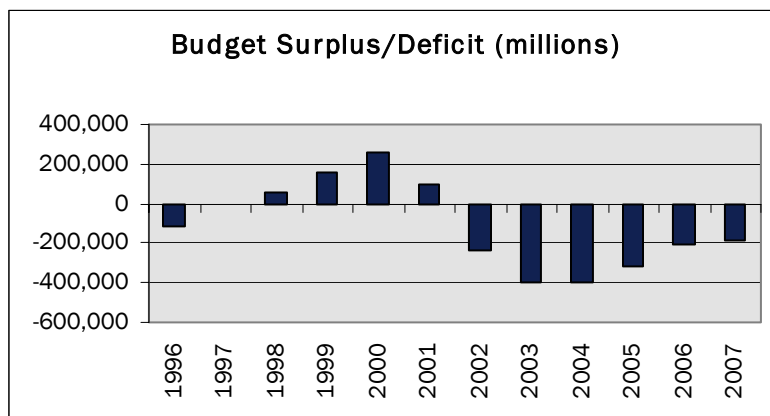


What is a Fed to do?

The Federal Reserve has two macroeconomic objectives – to promote maximum sustainable employment and to affect price stability. Rescuing the stock market is normally *not* in their job description and Federal Reserve Chairman Bernanke has been quite vocal that controlling inflation was his number one objective. However, on January 22, the Fed took a rather aggressive step and cut the Fed Funds rate by 0.75%. This was the first time that the Fed had cut rates at a time other than their regularly scheduled meeting since the September 11, 2001 terrorist attacks. It was also the largest single rate cut since 1984. More cuts are anticipated at the Fed’s regular meeting at the end of January.

Congress, meet the President

More amazing is that Congress and the President showed that they could sometimes work together; agreeing that some type of fiscal stimulus was warranted. It looks like the package will be around \$150 billion and may be in the hands of the American public by early summer. If it drags out much beyond that, it will be too late. The topic of “fiscal policy” and “fiscal stimuli” could easily warrant its own article. Accordingly, we will not attempt to dwell on the subject too much at this point. However, it might be fair to draw a comparison between a dose of fiscal stimulus with a dose of a very powerful drug.



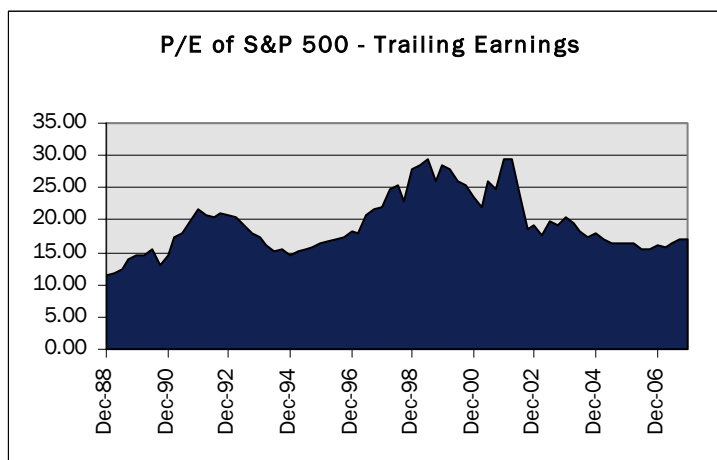
It would be nice if you did not need either of the remedies. Good personal health and good economic health would be the better choices. Like many of the drugs used today to treat our most serious of illnesses, there can be side effects – and sometimes these are not pleasant. Although our budget deficit has been shrinking of late

– a good thing – doling out \$150 billion dollars is a definite step backwards. Taxes are the source of funds for running our government and taxes are how we will repay this “gift”.

Perhaps the bigger problem is the potential moral hazard that may accompany this stimulus package. After all, a significant part of our current economic woes is associated with irresponsible spending in concert with accommodative lenders. Since many conventional lenders have gone by the wayside or are too scared to make loans, the government is coming to the rescue. Now that we have become financially ill, there is no doubt that the fiscal stimulus medicine is needed. Just do not be too upset if you are left with a nasty rash – or worse.

What should (or needs to) happen going forward?

Our equity markets do not currently appear to be overvalued based on historical valuation metrics. Depending on what minute of what day you look at them, price-earnings (P/E) ratios are in the 14x to 15x range – far lower than the 29x they reached in late 1999. However, the “E” part of the formula is critical. Corporate earnings need to remain strong or at least solid. For this to happen, consumers need to calm down and



resume “consuming”. Likewise, investors need to relax and regain confidence in our financial markets. It will take time for the housing market to work its way back – particularly in areas like California and Florida. It is our belief that employment trumps housing with respect to the economy. Basically, home owners can tolerate some pullback in the value of their home much more readily than they can tolerate unemployment. Accordingly, we are focused intently on employment numbers. November and December job numbers were not too exciting, but the overall employment picture is still good – despite what the current political rhetoric might have you believe.

This may be a tough market for a while as investors attempt to outguess consumer sentiment and try to interpret every small piece of financial data that now flows freely to us every minute of every day. However, we do not believe that our economy will fall into a tailspin. The fiscal stimulus package should help kick-start the economy, despite the longer-term impact that it might have. More accommodative monetary policy should also be beneficial. However, low interest rates alone will not do the trick. The lending institutions also need to step back up to the plate and actually lend to qualified borrowers. Although the short-term outlook for the economy and the markets is bleak, our longer-term outlook remains positive.

Company News . . .

Larry Thompson & Associates has recently redesigned our webpage. Please take a look at the new site at www.larrythompson.net. We welcome your thoughts!