

QUARTERLY REPORT

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EYES WIDE OPEN

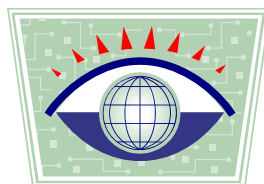
We are pleased to report that our emphasis on high quality stocks and bonds served our clients well in 2007 allowing us to avoid major pitfalls such as homebuilders and subprime mortgages both of which collapsed in value.

In our “2008 Outlook”, we look ahead to what the economy and the financial markets may hold in store during this election year. The financial markets, always dynamic,

also create vocabulary along with new risks and opportunities. To find out more, please turn to our article entitled, “The Growing Lexicon of Finance.”

Cordially,

Kathy Wimmer CFA, CIC
President



2008 OUTLOOK

Although 2007 saw healthy returns for those who avoided housing stocks and financial companies, we are concerned that the “credit crisis” which arose from imprudent lending and borrowing will have a spillover effect onto the rest of the economy. As financial institutions regroup and recapitalize after taking nearly \$150 billion in write-downs on collateralized debt obligations (CDOs), it shouldn’t be a surprise to find that loans to small and midsize businesses have become more difficult to procure. This “credit spillover” may likely be exacerbated as consumers begin to default on other forms of debts, e.g., credit card and car loans, while striving to stay current on their home loans.

The New Year has revealed that December’s price inflation hit an annual rate of 4.1%, which is the highest seen since 1990. The weaker dollar (which raises the cost of imported goods), along with higher costs for energy/materials, health care and food are stoking the flames of inflation. Furthermore, The Federal Reserve has accelerated the easing of monetary policy in a bold effort to ward off or mitigate the economic fallout from an anticipated recession. The 75 basis point “emergency” rate cut on January 22nd was the largest in the past twenty-five years. Another 50 basis points soon followed. The reduction of interest rates, also referred to as the easing of monetary

KEY FACTS FOR 2008

- *Annual gift exclusion*
\$12,000
- *Estate tax exemption*
\$2.0 million in 2006-2008
- *Highest marginal estate tax rate*
45% in 2008
- *IRA contribution limits*
\$5,000, plus another \$1,000 for those over fifty
- *401(k) contribution limits*
\$15,500, plus another \$5,000 for those over fifty
- *SEP IRA contribution limits*
25% of compensation or maximum of \$46,000
- *Top Federal tax rate is 35%*
on income over \$357,701.

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2008 OUTLOOK

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“We can’t keep a straight face when we hear that oil prices have “collapsed” below \$90 a barrel and remain steadfast in the belief that energy demand from the rapidly modernizing economies of China and India will dwarf what is a seasonal or wintry drop in US demand.”

policy, is geared to stimulate the economy while at the same time relieving pressure on the “credit crisis” by helping homeowners whose mortgages would otherwise reset at higher interest rates. Unfortunately, in theory, as well as in our present predicament with lower interest rates comes higher inflation.

We are sympathetic to families threatened with the loss of their homes and understand policymakers’ efforts to forestall foreclosures with interest rate cuts that may allow some homeowners enough leeway to remain current on their mortgage debt. However, the Federal Reserve is compounding its previous error of taking interest rates too low which will only delay the painful, but necessary, correction of home prices. Although the Fed lowered the Fed Funds rate to a low of 1% in 2003 in an effort to spur economic expansion, the unhealthy side effect was rapid inflation in home prices, oil and materials costs. The Fed’s two rate cuts in January further reveal the shift in policy bias to warding off a possible recession rather than fighting inflation.

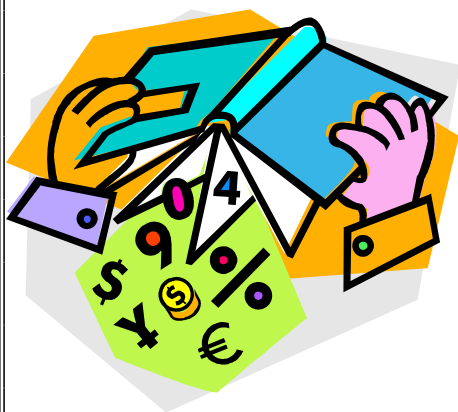
“Don’t fight the Fed!” is a longstanding Wall Street maxim which connotes the old phrase, “Don’t fool with mother nature!” Financial stocks, which have swooned over the past year, account for 23% of the S&P 500 index. It remains an axiom to invest in financial stocks when the Federal Reserve’s mood is to cut interest rates as banks inevitably benefit by borrowing at lower rates and lending at higher rates. We will look to add positions in financial stocks selectively as conservatively managed

firms will be rewarded while their counterparts suffer. Certain bank stocks with dividend yields in excess of 5% may be considered a viable alternative to Treasury issues. Indeed, the ten-year Treasury note now yields less than 3.5%, which is below the underlying inflation rate.

We think the Federal Reserve has overreacted to current economic conditions and note that market “corrections” and even the dreaded word, “recession”, are inevitably followed by recovery and economic expansions. The 1990 and 2001 recessions were short-lived and were followed by long periods of economic growth. While it is to be expected that the economy may pause or slow down after more than four years of continuous expansion, we are not likely to abandon our long-term investment strategy in the face of short-term market volatility. Fortunately, our clients tend to be insulated from much of the “credit crunch” which has started to “freeze out” individuals and small to midsize companies with borrowing needs. We can’t keep a straight face when we hear that oil prices have “collapsed” below \$90 a barrel and remain steadfast in the belief that energy demand from the rapidly modernizing economies of China and India will dwarf what is a seasonal or wintry drop in US demand. We have a penchant for large, well-capitalized multinational companies, which should benefit from a weaker US dollar and strong Asian demand, while precluding much of the “pain” other investors may realize in the current year.

THE GROWING LEXICON OF FINANCE BY WARREN R. WIMMER

Sovereign Wealth Funds (SWFs), now totaling an estimated \$1.5 to \$2.5 trillion, are investment funds that invest the national savings of sovereign or national governments such as Saudi Arabia and China. Here in the States, we have a similar operation, the Alaskan Permanent Fund Corporation, that invests and manages Alaska's oil royalty wealth for current and future generations. Sovereign wealth funds derive the bulk of their monies from a surplus of balance of payments, which for Middle Eastern



funds is sourced from oil and for Asian funds from cars, electronics and Wal-Mart sales. Most sovereign funds receive their funds in dollars, thanks in part to America's structural reliance on imported oil and an addiction to cheaply-priced goods made overseas. For many years and to this day, foreign governments have invested their surplus U.S. dollars in United States Treasury Bonds which benefit from the backing of the full faith and credit of the U.S. government. However, in recent years, U.S. Treasury Bond yields have appeared miserly to sovereign investors, as there is usually excess demand for United States-backed

debt. As a result of all of the factors cited above, sovereign wealth funds have pursued new avenues in a quest to earn higher returns in the long run for their constituents.

It is perfectly appropriate for governments to manage their immediate liquidity needs and foreign currency requirements with short-term Treasury investments. However, as sovereign wealth funds are seemingly growing on a long-term structural basis, it is appropriate for investments to be made with a long-term view. Just as homeowners take out thirty-year mortgages to finance what is seen as a long-term asset, and shoppers use their credit cards for monthly purchases, so should central banks match their long-term funds to long-term investments, which would include real estate and corporate stocks and bonds. Now much can be made of national security concerns when sovereign funds invest in the United States (witness Congress' prohibiting the Chinese from buying the Unocal oil company and Abu Dhabi not being allowed to invest in U.S. ports). SWFs have already succeeded in making billions of dollars of investments in U.S. financial behemoths such Citigroup, Merrill Lynch, Bear Stearns and the Carlyle Group. One cannot simply dismiss security concerns about strategic investments from sovereign funds but blind protectionism should not either be endorsed. With some analysts anticipating sovereign funds to top \$10 trillion in the next ten years, one may expect a continued flogging from protectionist pundits, increased Treasury Department scrutiny (in July, Congress passed the Foreign Investment and National Security Act of 2007) and a call for re-

Concerned about energy consumption? Measure your own carbon footprint at the website shown below:

www.nature.org/initiatives/climatechange/calculator

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We're on the web
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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

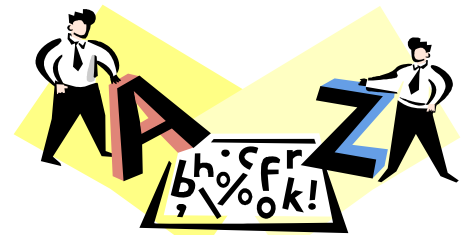
THE GROWING LEXICON OF FINANCE BY WARREN R. WIMMER

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reciprocity for U.S. overseas investments and transparency of the holdings of these sovereign funds.

Credit Default Swaps (CDSs) are "synthetic" risk management tools that financial institutions use to offset the potential that a bond or bonds may default. CDSs are financial derivatives or "insurance policies" for loans or debt instruments that according to Bill Gross, Managing Director of PIMCO, totaled \$43 trillion or *"more than half the size of the entire asset base of the global banking system (italics mine)."* CDSs are real obligations that a third party will guarantee repayment should an underlying loan obligation default.

CDSs generally don't require reserves as do bank loans and obligations. Legendary investor, Warren Buffet, has referred to financial derivatives as "financial weapons of mass destruction." Our concern is that similar to subprime mortgages, it is likely that central banks and regulators, as well as the financial institutions that hold CDSs, are in the dark as to the ultimate level of risk undertaken under the contractual obligation of the credit default swap. It is possible that just as a number of large international banks have been forced to raise additional capital to shore up their balance



sheets in the wake of the subprime crisis, so too may we relive the same scenario with CDSs! The weakened state of many financial institutions introduces "counterparty" risk or "guarantor" risk which is in addition to the underlying loan risk. It is our fervent hope that Credit Default Swaps are not soon featured in news headlines as the latest financial disaster.

Disclosure: "Be careful about reading health books, you may die of a misprint." Mark Twain Keep that in mind as you read these articles. We obtain data from sources we believe are reliable but they should not be relied upon for making life-changing decisions.