Market Commentary and Review

April 3, 2008

"Experience is the best of schoolmasters,
only the school-fees are heavy."
– Carlyle, Miscellaneous Essays

SUMMARY:
We outline the issues facing the economy. We don't expect a quick turnaround, but we think the stimulative actions taken by the government will eventually work.

We remain defensively positioned.

U.S. stocks are undervalued but a volatile period should be expected until the economy stabilizes and financial stocks quit hemorrhaging.

We're excited to announce the addition of Gary Powell as our Director of Financial Planning.

Dear Clients and Friends,

2008 began with the worst quarterly performance in the stock market in over five years, and volatility increased dramatically. One hundred to three hundred point swings in the Dow Jones Industrial Average have been common. Bonds had modest gains and commodities were up sharply.

The following table summarizes returns for the first quarter and the last few years:

	1st Qtr 2008	Last 3 Yrs Annualized	Last 5 Yrs Annualized
Large Cap (S&P 500)	-9.3%	5.8%	11.3%
Large Cap (Dow Jones Industrials)	-7.2%	7.6%	11.3%
Mid Cap (S&P 400)	-8.7%	6.7%	14.8%
Small Cap (S&P 600)	-7.7%	5.1%	15.5%
Nasdaq 100	-14.6%	6.5%	12.1%
Foreign Stocks (EAFE)	-8.4%	13.2%	21.2%
Bonds (Lehman Aggregate)	2.3%	5.3%	4.5%
Emerging Markets	-10.6%	27.4%	33.0%
REITs (Vang. REIT index)	2.1%	11.7%	17.8%
High Yield Bonds (Vang. High Yield)	-3.0%	3.9%	6.1%
Commodities (AIG Index)	9.2%	12.1%	15.5%
Alternative Assets Group (AAG) (11 Fund Avg)	-0.7%	7.8%	10.3%
65% Equity/ 35% Fixed-Benchmark	-5.4%	5.7%	9.1%
50% Equity/ 50% Fixed-Benchmark	-3.6%	5.7%	8.2%
35% Equity/ 65% Fixed-Benchmark	-1.9%	5.6%	7.1%

Despite the drop over the last five months, the returns over the last five years have been very good, some extraordinary. Foreign stocks in particular have shown spectacular results. With five good years behind us, but five lousy months more recently, and a recession looming what do we expect for the remainder of the year and going forward?

In This Letter

In our year end newsletter, we suggested 8 factors that would drive investment performance this year.

1. *Politics*. The primary goal of most politicians is to be re-elected. This purpose creates an economic cycle around election cycles. During election years governments usually act to stimulate the economy in some manner. This year is no exception. The government has passed a stimulus package that will give most Americans free money. They are also actively working on more programs to help homeowners unable to afford their mortgage payments. These stimulus packages have not yet made their way into the economy, but they will later this year.

2. *Federal Reserve Policy*. The Fed has been more aggressive than ever before. They were late getting started, which made the problem worse than it had to be; but some of the actions they've taken have been creative and necessary to avoid more serious financial market problems. We expect these efforts to succeed eventually, which is why we are not in the Armageddon camp.

3. *Credit Crisis*. We predicted this would subside during the first half of the year, and the largest write-offs probably will be finished. However, the de-leveraging of the system and a pullback in lending from financial institutions will probably slow economic growth for a few years compared to the last five or ten years. This also means the Fed will not be able to raise interest rates very quickly even after the economy stabilizes.

4. *High Oil Prices*. No change. A continued drag on the economy.

5. *Slow Economic Growth, Rising Inflation, Rising Unemployment*. No changes yet.

6. *Slower Earnings Growth*. Only beginning to be reported. We don't know yet what earnings are going to be. Estimates range from a decline of 5% this year to an increase of nearly 20%.

7. *Housing*. This is the big one. Until housing stabilizes, numbers 3, 5, and 6 will continue to be problematic.

8. *Foreign Trade*. This continues to be a bright spot. American corporations are benefiting from the weak dollar.

Three investor concerns not listed in our year end letter are i) the continued decline in the dollar; ii) the spike in commodity prices; and iii) inflation.

Where do we stand on these issues?

The dollar has been pressured over the last several years by a consistent trade deficit, and more recently by lower interest rates in the U.S. According to most economists, the euro and the yen are very overvalued, but we believe there is little reason to expect a turnaround any time soon. A reversal depends on U.S. economic expectations stabilizing and the worst of the banking problems being behind us.

Commodity prices finally corrected after a relentless climb of 35% in six months. Oil, grains, and metals all advanced. Conditions became very stretched and were well beyond supply and demand fundamentals. Once again, speculators drove prices too far. Nevertheless, after a near-term correction, the longer term outlook remains favorable due to the supply, demand and liquidity trends.

But what of slowing economic growth and its impact on inflation? Many economists expect core inflation to remain subdued because of a recession, and we agree that if inflation couldn't get any momentum in a strong economy it seems doubtful it can get traction during a slow one. But, the impact of these factors may be smaller than before due to the global factors at play now. Global inflation is an increasingly important driver of domestic inflation. Globalization, deregulation and the IT-led productivity boom had all been disinflationary forces pushing inflation lower. However, these factors may have recently turned inflationary instead. Global inflation, pulled higher by these factors, will tend to pull domestic inflation up along with it.

Perhaps the biggest risk to the structural inflation call comes from the behavior of volatile commodity prices. Sharply falling commodity prices would indeed take inflation down with them, but this would probably require a dramatic slowdown in emerging markets and a global recession. If commodity prices stay flat, their elevated level may result in some price and wage adjustment as compensation for producers and workers. Finally, not all commodities can be thrown into the same bushel – oil, hard and soft commodities are all expected to behave differently. A decline in all three would undoubtedly lower inflation, but the dramatically weaker global economy that would have to be the precursor to these moves does not seem the most likely outcome.

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Strategic Allocation Decisions

In September we reduced equity targets by 5% and by another 5% in November. These moves softened the downturn we've experienced somewhat. In many cases, client portfolios have even higher cash balances as we have been slow to reinvest the proceeds from sales. Because of the extreme volatility in the markets, this position makes us feel very good or very bad depending on the movement of the day. As we pointed out in our special January letter, when the market finally turns the initial gains tend to be very high. On April 1st, for example, stocks rose over 3%! Think about that. It takes years to earn that much in a Treasury bond and stocks did it in one day.

But we believe the issues facing the economy are sufficiently worrisome; therefore, we are maintaining our underweighted stance to equities. As described more in the bond section, we believe bonds remain overvalued so we are not increasing our allocation to bonds. Strategic changes we are most interested in making include moving more of our international allocations into emerging markets and international small caps.

Performance

Similar to the markets, our accounts had losses in the first quarter. A sampling of balanced accounts showed an average loss of 4.4% (every account is different, so your portfolio may be higher or lower than these averages), and the equities were down 10.0% on average. These returns reflect a somewhat more aggressive posture for the equities, but a more conservative position for the overall portfolios. There were winners – notably energy and commodities (and bonds to a lesser degree), but their portfolio weightings were not high enough to offset the losses in the other categories. Nonetheless, a decline of 4.4% on average is acceptable during a correction of this magnitude.

Asset Class Recap

U.S. Stocks:

According to our multi-factor model the market is now 20% undervalued. The problem, however, is that the earnings estimate is so uncertain. Due to the write-offs from the financial companies, 2007 S&P earnings were $83. This compares to $88 in 2006 – the first annual decline since 2001. The current estimate from Standard & Poor's for 2008 is $96 – an increase of 17%. We believe this is impossible in a slow growth/recessionary economy. Therefore, we have shaved this estimate to $85 – higher than 2007 but below 2006. Using this estimate, our models indicate the market is 20% undervalued, and trades at a P/E of 15x. Using consensus estimates for the Dow Industrials results in a P/E of 13x.

Barring a significant outbreak of inflation, we believe these valuation levels provide a floor under the market at about current levels. However, until the economy stabilizes, and until the financial companies end their write-offs, we don't expect a meaningful advance in the indexes.

Having said all that, this year will probably turn out to be an excellent time to buy stocks. Opportunity is here. Many of our favorite companies are trading at discounts to our estimated intrinsic values. We have also identified a few highly rated preferred stocks with dividend yields of about 8%. It's likely to be a bumpy ride, but we are finding good stocks to invest in.

Investment-Grade Bonds:

Treasury bonds yield 2.75% for five years, and 3.75% for 10 years. Considering the inflation risks discussed earlier, we find these yields uninviting. Values *can* be found in government agencies and in municipal bonds. Municipals are particularly inviting, but the supply is sporadic and there are risks.

For example, we recently bought some E-470 (the turnpike on the east side of Denver) for several portfolios. These had a tax free yield of 6%, equivalent to 10% for someone in the highest tax bracket. They are rated AAA, but there are three risks. First, they get their AAA rating because they are insured. The insurance company though, MBIA, is under a cloud due to risks they are exposed to from sub-prime loans. Second, the bonds aren't due for 25 years; and third, the issuer is facing short term financing problems. This isn't the type of bond usually associated with AAA muni buyers; but for someone with more risk tolerance, this appears to be an opportunity created by the credit crisis.

Dividend / Defensive Group:

As mentioned earlier, we have invested in three preferred stocks in this strategy. The three companies are Wells Fargo, Fannie Mae, and AIG. Each of these has a credit rating of AA or better. By investing in the preferred stock, we are taking a little more risk than in their bonds but less than with their common stock. And, we are getting paid an 8% dividend. We believe that in a year or two as the credit crisis recedes we will likely see appreciation from these securities in addition to the yield.

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Alternative Assets Group:
During the first quarter, commodities and contrarian funds outperformed. The commodity index fund, for example, was up 9.2% and gold was up 6.5%. The worst performers were high yield (-4.9%), the Franklin Income fund (-7.0%), and international REITs (-6.4%). Surprisingly, some natural resources funds were down (Ivy Global Natural Resources -7.5%). Overall, as shown on page one, the returns and risk characteristics continue to be what we strive for. They dropped about 1% last quarter, but had a compound annual return of 10% the last 5 years. We believe this is better than most hedge funds with significantly lower fees and fewer risks.

Model Equity: *Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.*

The model equity account performed in line with the S&P 500 during the first quarter, falling 9.7%. Every sector declined – consumer staples and energy the least with 3% drops, and technology and financials the worst (-19% and -14% respectively). There were a few winners (Burlington Northern +11%, Chesapeake Energy +18%, and Zimmer +18%), but these were more than offset by the losers. The biggest decliners were Google (-36%), Apple (-28%), and Helix Energy (-24%).

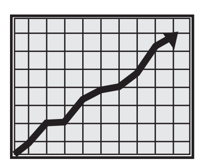
We made several changes during the quarter. Our strategy for this account is shorter term than in most client portfolios, so these changes are likely to be different than in your accounts. We sold companies exposed to the slow housing market, weak consumer, and deteriorating financials. These included Franklin Electric, Affiliated Managers, and Wells Fargo. We invested in financials of higher quality/strength: Lazard and U.S. Bancorp. And finally, we added a pharmaceutical research company, Covance.

Foreign Equities and Fixed Income:
Our recent research in these areas has led us to some new ideas that will find their way into many portfolios. We have added two small cap international funds to our approved list, and additional emerging market funds (including an emerging markets bond fund). We think these asset classes will continue to grow in importance over time, but there will be and has been significant risk in investing there. In our last letter we warned of the speculation in China. Evidence can be shown by the 41% drop in the China fund (GXC) from November of last year to March this year.

Company News:
Last quarter we announced the addition of Dick Stebbins to our investment committee, and this quarter we're happy to announce another addition. Gary Powell brings over 35 years of accounting, tax, and financial planning experience to our firm. He was a partner with KPMG along with several other stops in his career. He becomes our Director of Financial Planning, and has made an immediate impact in helping us work on a number of estate planning, tax, and financial planning issues. If you have questions in these areas, call us and we'll introduce you to Gary.

As we previously announced, 2008 is our 20th anniversary. We thank those of you who provided names of people for us to contact and remind the rest of you we have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses, it is important for us to continue to grow so we can keep adding the resources to provide you the best possible service and performance. If you know of anyone who might be interested in our services, or simply receiving our newsletter, please have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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