Commentary - 2nd Quarter 2006

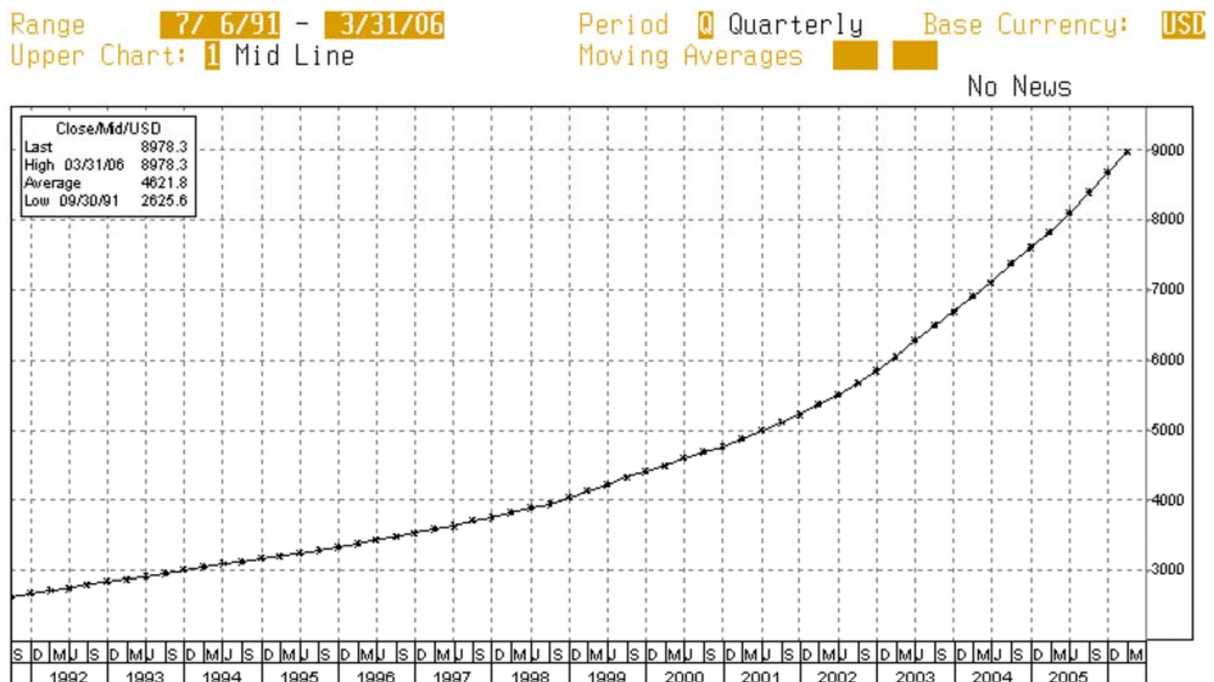
We hope you are enjoying your summer and are able to visit some of the extraordinary places in our fine country. My family recently returned from a visit to the theme park center of the universe, Orlando, Florida. While riding some of the stomach-churning roller coasters there, I thought that the second quarter's volatility in the stock market was pretty similar. The market rocketed higher in late April and early May when the new Federal Reserve Chairman, Ben Bernanke, indicated that the FOMC had a sanguine outlook on the economy and did not think inflation would get out of hand. Just when we thought the Dow Jones Industrials were going to make a new high, Bernanke told a CNBC anchorwoman at a cocktail party that the market had misperceived his comments and that the Fed would raise rates aggressively to head off inflation, thus the roller coaster peaked and we screamed down at high speed into some sharp turns and hair-raising 360 degree loops. The second half of May and early June were as ugly a market as we had seen since the bubble burst. In fact the Dow dropped 8% from May 10th to June 13th and the NASDAQ fell for eight straight days – a decline not seen in twenty years. When commodity prices fell and the dollar strengthened, the market regained some upward momentum and we experienced a few more ups and downs before ending back at the starting gate. I know I was ready to get off the rides and put my feet on solid ground for a while. So how's that for a good analogy? For the quarter, the Dow gained 0.94% and the S&P 500 declined 1.44%.

The stock market is facing the possibility that inflation may go higher than the Fed can accept, so the Fed may raise interest rates and force the economy into recession. Our Goldilocks economy that we wrote about in the first quarter may not last if commodity prices do not settle down. Unfortunately, the Fed is trying to slow the economy with monetary brakes that work with a six to nine month lag. It is apparent that the economy is slowing, especially in the housing sector. Retailers who sell primarily to lower income consumers are seeing slow sales growth as higher energy prices are reducing disposable income. As homeowners with adjustable rate mortgages face higher monthly payments, income left over for other purchases will be reduced. (I heard a report yesterday that home foreclosures in Oklahoma were up 45% over last year.) If the domestic economy slows to a more sustainable growth

rate of around 3% in GDP, that should reduce inflationary pressures. But we need to see some slowing in international demand for commodities so supply can catch up. Gold prices traded over $715 per ounce in May before falling to $543 in June. Now they are back up to $630. Gold prices are the most closely watched inflation indicator, and if they continue trading higher, the Fed will be forced to keep raising rates. It may be a few more months before the Fed's previous rate increases take affect and dampen the inflation scare. Until then, it's still summer, and the roller coasters are running.

We mentioned the higher payments that homeowners with adjustable rate mortgages are facing. The Fed has raised rates 17 straight times by 0.25%. The graph below shows total mortgage debt. It has grown from less than $4 trillion dollars in 1998 to $9 trillion dollars in March, 2006. (It almost looks like the NASDAQ price graph from 1996 through 2000.) Adjustable rate mortgages represent almost 40% of total mortgages issued over the last five years. So if mortgage payments go up 1%, it could represent almost $20 billion of increased payments. That might hurt consumer spending, just a little.

Graph 1. U.S. Total Mortgage Debt Outstanding



So our outlook is cautious until the previous interest rate increases by the Fed take effect. Economic growth should slow and that will reduce inflationary pressures. If the economy can maintain growth in the two to three percent range, corporate earnings should be resilient and the market can regain upward momentum. Corporations have reasonably clean balance sheets with lots of cash to put to work. Recently announced mergers and acquisitions indicate that corporations believe the global economy will continue growing. We plan on taking a defensive approach until the Fed is finished raising rates.

Here's a look at the sectors we cover.

Large Cap Stocks: Our Blue Chip Strategy gained 0.93% in the second quarter versus a drop of 1.46% in the S&P 500 Index. Year to date, the Blue Chips are up 5.62% versus 2.76% for the S&P. Large cap stocks actually outperformed small cap stocks in the second quarter, and as long as the Fed continues to raise rates, we think that will be the case. As the world's central banks raise interest rates, risk premiums increase. Since small cap stocks are deemed riskier than large cap stocks, money flows should migrate from the riskier asset classes to the safer asset classes. Large cap stocks should benefit from this repricing of risk. For the quarter, the best performing holding was General Motors, up 41%. GM's restructuring is starting to work, and their asset sales should raise enough cash to see them through this tough period. It didn't hurt that in the last week of June, one of GM's biggest shareholders suggested that GM consider an alliance with Nissan and Renault. If an alliance is consummated, GM could take direction from Carlos Ghosn, the CEO of Nissan and Renault that has gained widespread acclamation for turning around both of those companies. The weakest performer was Home Depot, falling 15%, as a weakening housing sector is expected to impact their earnings. Microsoft was the second weakest performer, down 14%, as they delayed the introduction of their new operating system, Vista. The whole PC sector should benefit when Microsoft finally launches Vista in 2007. Again, we are cautiously optimistic on the large cap sector. Mergers and acquisition activity is on the upswing, capital spending is growing, and global demand for our goods is increasing.

Small Cap Stocks: The Small Cap Value Strategy experienced a tough quarter, falling 7.22% versus a 5.29% decline for the Russell 2000 Index. Year to date, the Small Cap strategy is up 0.32% versus a 7.64% gain for the Russell 2000. Our move into some defensive positions with

high dividend yields has not paid off yet. The best performing position in the strategy was Energy Transfer Partners that gained 18% including dividends. The weakest performer was Hawaiian Holdings, who fell 34%. Energy Transfer continues to execute on their growth strategy and raised their quarterly distribution for the tenth straight quarter. Hawaiian had a disappointing quarter as rising fuel costs and a new inter-island competitor caused them to fall below expectations. We sold our positions in Lance and Nobel Learning in the second quarter. Lance met our valuation target and since they made a large acquisition, we felt there was some execution risk with the merger of the two entities. Nobel Learning has not exhibited the earnings potential that we anticipated. The for-profit education sector has proven attractive for post-secondary schools, but competing against the public education monopoly has not been as successful in the preschool through high school sector. We still believe that if consumers had a choice about where to send their kids to school and vouchers were available, many would choose Nobel over poor performing public schools. We added three new positions to the strategy in the second quarter. Citadel Broadcasting is one of the largest radio broadcasters in the country. Old media outlets are struggling to compete with new media sources like satellite radio and the internet. But at some point radio broadcasting will still have growth potential and Citadel pays a 7% yield on our purchase price. Markwest Hydrocarbons is the publicly traded general partner of Markwest Energy Partners, a Denver-based master limited partnership that operates natural gas gathering systems and processes natural gas. After two large acquisitions in 2004 and 2005, Markwest Energy is experiencing significant growth in their distributable cash flow. Markwest Hydrocarbons, due to their ownership of the incentive distribution rights as general partner of Markwest Energy, will grow at a faster rate than Markwest Energy. Markwest Hydrocarbons is paying a 3.3% yield on our purchase price and could double that payout over the next two years. In May, they increased their dividend by 54%. Our final purchase for the quarter was Superior Industries, a manufacturer of aluminum wheels that supplies automotive manufacturers. Superior has no debt and pays a 3.4% yield on our cost. Their margins have been hurt by rising aluminum prices, but management states that most of the cost pressures are behind them and expect profitability to improve. The dividend yield on our Small Cap strategy is approximately 4% now and we think in a slower growth environment, dividends will become more desirable. Research Summaries on the three new positions are enclosed for clients invested in this

strategy.

Convertible Securities: Our Convertible Securities/High Yield Strategy gained 3.5% in the second quarter versus a decline of 0.87% for the Merrill Convertible Index and a gain of 0.15% for the Merrill High Yield Index. Since the end of last year, the Convertibles strategy is up 11.32% while the Merrill Convertible Index is up 4.48% and the High Yield Index is up 3.01%. We realized a nice gain on our position in American Axle and Manufacturing of 26% when the company triggered a bond covenant that required them to pay the put option in cash at par if the company's debt was downgraded by one of the major ratings agencies. We added two new positions to the portfolio at attractive yields: Encore Capital at 8.90% and Fairfax Financial at a 12.70% yield to put in 2008. Encore Capital is consumer debt workout firm similar to the old CFS in Tulsa. They purchase defaulted receivables from banks and credit card companies and attempt to workout payment plans with the debtor. Subsequent to our purchase, the company announced that they had hired investment bankers to review their strategic alternatives since the board believed their stock was undervalued. Our position gained 11% on the news. Fairfax Financial is a property and casualty insurance company with some reinsurance operations. Their profitability was hurt by last year's hurricanes, but premium rates have been raised as a result. One of the risks that we face in this strategy is that if the Fed raises rates too much, lower credit quality companies will have difficulty obtaining funding. Default rates on junk bonds are at historical lows. If the economy slows too much, default rates will rise and that might affect our portfolio. We are cognizant of this risk and are attempting to manage the credit risk accordingly. Even though we have experienced some bankruptcies in this strategy in the past, our portfolio composite has only experienced one down year in the last nine years, and it was down less than one percent. That is a good risk reward tradeoff.

Intermediate Bonds: Our Intermediate Bond Portfolio gained 0.59% in the second quarter while the Citigroup 1-10 Year Government/Corporate Index rose 0.18%. Year-to-date the Intermediate Bond Portfolio is up 1.61% versus a decline of 0.14% for the index. We benefited from a nice improvement in our GM bond position; it was up 14% for the quarter. The Fed raised rates twice in the quarter, so we were pleased that we were able to generate a positive return. We are still holding our short maturity positions, expecting the Fed may

raise rates one more time, but we are also looking for opportunities to purchase longer term maturities. The yield curve has inverted slightly again. Typically a yield curve inversion predicts an economic slowdown. We are positioning our portfolio for interest rates to stabilize and potentially fall if the Fed's tightening leads to some kind of financial crisis. We continue to own Treasury Inflation Index bonds to protect us against a rising Consumer Price Index and we have substantial short term maturities to protect us if the Fed tightens again. The long term maturities we purchased have short term put options so if interest rates go higher we are protected against price declines. If interest rates fall, our put bonds will benefit from their long maturities. We anticipate gradually increasing our exposure to longer maturities as the opportunities arise. Our Intermediate Tax Exempt Bond Portfolio gained 0.28% in the second quarter versus a 0.17% gain in the Merrill 3-7 Year Insured Bond Index. For the first six months, our Tax Exempt Bond Portfolio gained 0.60% versus 0.10% for the index. We are taking the same approach in this strategy, gradually extending our average maturities.