

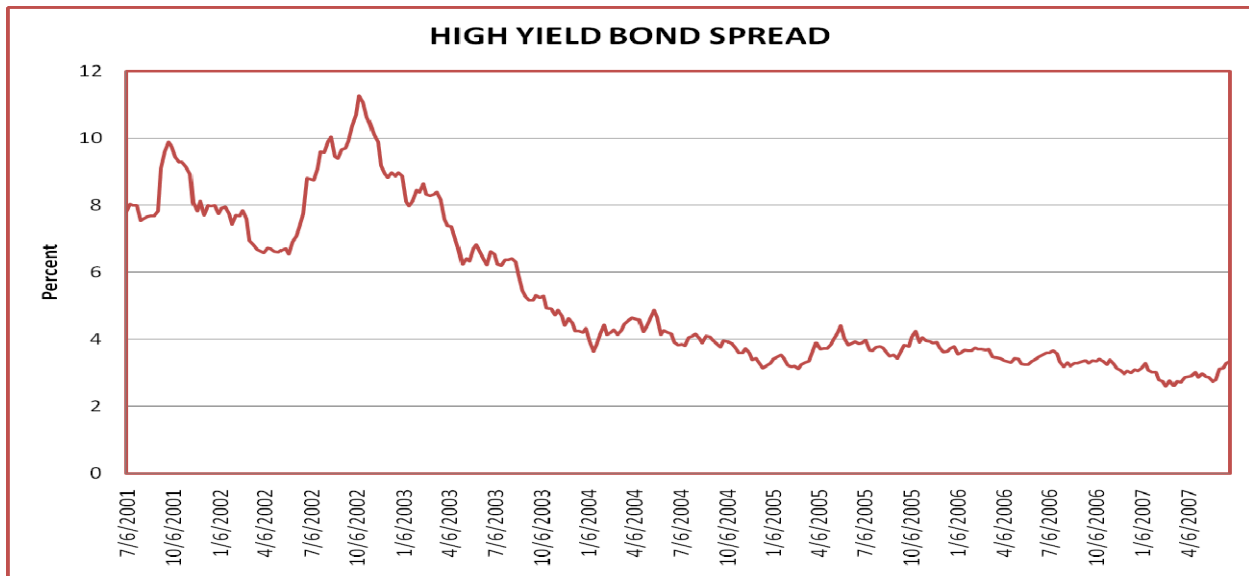
Commentary - 2nd Quarter 2007

As we return from celebrating the Fourth of July, it is a good time to consider the strengths of our country. Capitalism, personal freedom, property rights, and the rule of law encourage the individual to use his or her talents to the best of their ability. This model supports the individual's "animal spirits" to maximize their potential and benefits not just the individual but the whole society. It has produced the most prosperous economy in the world's history. Some may focus on what is wrong with the country, but let us not forget the wisdom of our founding fathers and the exceptional building blocks they put in place. The path to prosperity isn't always straight; we experience the ups and downs of economic cycles, misinformed policymakers, and foreign influences, but we have the best roadmap of those available. That is why the stock market rises four out of five years historically and investors can become wealthy.

The second quarter of 2007 definitely helped build investors' wealth. The broad market gained approximately 6.5% bringing the gain for the year to 7.0%. The anxiety the market suffered in the first quarter was not completely alleviated, but earnings for the first quarter came in better than expected and economic growth picked up from the first quarter's slow pace. April and May saw strong advances in the major stock markets. In June the markets consolidated their previous gains as problems with some hedge funds and volatility in the bond market increased risk, overshadowing some investors' optimistic expectations. Mergers, acquisitions, and private equity takeovers have provided strong support for the market this year. The Federal Reserve has provided capable guidance for the bond market and the financial system regulators have not overreacted to the problems in the subprime mortgage market. There are still plenty of risks that could cause problems for the markets, but as long as policy makers do not make any problems worse, we should be able to endure the declines and make advances.

There have been many comments that this market is liquidity driven. Let's examine that idea. Liquidity is the difficulty or ease of executing a transaction. When liquidity is plentiful, it is easy to complete purchases and sales because the difference between bid and offer prices is small and there is a large amount of volume on both sides of the transaction. In other words, many buyers and sellers are competing to make transactions happen. Low interest rates support liquidity because when the cost to borrow money is low, there are more places to invest to earn a higher return than the cost of funds. Sources of liquidity include central banks pumping money into the financial system to influence interest rates and currency values, and strong economic activity generating income and wealth. The Japanese central bank is probably the biggest source of liquidity in the financial markets since it has been targeting short term interest rates near zero for the last decade. The Chinese economy is another source of liquidity as millions of Chinese citizens see their standard of living

increase and the country generates excess savings. Our Federal Reserve was a huge source of liquidity when they lowered the Federal Funds rate to 1.0%, but with the Fed Funds rate currently at 5.25%, they are in a neutral position now. The price of gold and other commodity prices indicate that there may still be an excess of liquidity in the global economy. Excess liquidity can also be seen in market “bubbles”. As stated above, when the cost to borrow funds is lower than returns on potential investments, many investors use leverage to increase their bets and asset values can appreciate to extremes like the U.S. stock market bubble of the late 1990s. The housing sector may have been in a similar situation until the last year, as credit was easy to obtain by less than desirable borrowers. The Chinese stock market may be undergoing a liquidity-driven rise currently. As asset prices rise, risk premiums decline. Risk premiums are the amount of excess return on a riskier asset that an investor expects to earn versus a risk free asset like U.S. Treasuries. As an example, high yield or “junk” bonds are bonds that are issued by companies that are below an investment grade rating by one of the major credit rating agencies. These companies must pay a higher rate of interest to investors because the investors take on more risk that the bonds might not be repaid. Typically, high yield bonds pay interest that is three to six percent higher than Treasuries. The graph below shows the historical spread between the high yield bond sector and Treasuries since 2001. After the Enron and Worldcom implosions, high yield bonds paid more than ten percent over Treasuries in 2002. Currently, high yield bonds pay only about three percent over Treasuries, so the risk premium is relatively low. This is another indication that there is plenty of liquidity in the market.



Recent events suggest that easy liquidity may be coming to an end. The mortgage market is self-policing by tightening lending standards in the wake of the subprime mortgage problems. Hedge funds that specialize in mortgage, bond, and loan derivatives are suffering losses. High yield bond investors are forcing new issuers to pay higher interest rates and of-

fer more covenant protections. Foreign central banks and governments (especially the Chinese) are indicating that they will be investing some of their fiscal surpluses into investments other than U.S. Treasuries. And many central banks are raising short term interest rates. Interest rates on two year maturity Treasuries have increased by almost half of one percent since our last writing. These factors will make it more difficult for our stock market to rally in the short term, but they should protect us against another bubble environment and the subsequent market rout.

Another reason to have a positive long term outlook is our opinion that the new Chairman of the Federal Reserve, Ben Bernanke, seems to have a steadier hand when it comes to managing interest rates. The previous chair of the Fed, Alan Greenspan - sometimes called the "Maestro", micro-managed interest rates. His reaction to any volatility in the financial markets was to lower interest rates and flood the system with money. This came to be known as the "Greenspan put". Whenever the market suffered a sharp decline, he would lower interest rates and thereby support the market. This over-protective behavior led to many market imbalances, some of which are just now being worked out. The Fed is currently worried about inflation running too high because Greenspan kept interest rates too low for too long. Bernanke has had a few opportunities to follow in Greenspan's footsteps by lowering rates to protect the stock market, but he has not chosen that option. He has focused on containing inflation and letting the market correct itself. In the long run, this should be a much more effective policy than Greenspan's tinkering. Maybe he is a stronger believer in capitalism and the ideals of our founding fathers.

Here is a look at our various asset class strategies and how they have performed:

Large Cap Stocks: The Blue Chip Strategy gained 8.88% in the second quarter, fully recouping the first quarter's decline. For the first six months of 2007, the strategy is up 8.57% versus a gain of 6.99% for the S&P 500 Index. Intel was the biggest gainer in the quarter, rising 24.73%, followed closely by General Motors and Honeywell. Intel appears to have worked through some of their inventory problems and can now focus on expanding margins. GM has rallied on the prospects of lowering their production costs with a settlement with the UAW and Delphi. Their financial performance has improved too. Proctor and Gamble was the only holding that declined in the second quarter, falling 2.57%. You may notice a small position in Citadel Broadcasting in your portfolio. Citadel acquired the ABC Radio subsidiary of Disney. The transaction was completed through a spin-off of ABC Radio from Disney to Disney shareholders. ABC Radio was then acquired by Citadel in a share exchange transaction. We hold Citadel in our Small Cap Value strategy. Our outlook for the Blue Chips remains positive as global growth will support their overseas operations. The global economy has finally reached the position where growth is strengthening almost everywhere. The global economy is not as dependent on the U.S. as it was five or ten years ago. This is another positive factor for the long term outlook. As standards of living rise globally, capitalism is more likely to take hold.

Small Cap Stocks: Our Small Cap Value Strategy gained another 13.16% in the first quarter, bringing the year to date gain to 26.40%. (We actually had a decline of 1.93% in June!) The comparison index, the Russell 2000, gained 4.42% in the second quarter for a year to date gain of 6.45%. Our biggest gainer was Winn-Dixie Stores, up 66%, after they reported better than expected earnings. Winn-Dixie exited bankruptcy late last year and investors were concerned they would have a difficult time competing. Their recent report showed strong cash flow and better than expected same store sales. Genco Shipping rose another 32% in the second quarter as the strong global economy supported shipping rates and they acquired more vessels. American Pacific gained almost 32% in the quarter as they issued another strong earnings report and a positive outlook. Value Vision declined 8% as their report was disappointing. American Home Mortgage, one of our recent purchases, fell 8% as they lowered earnings expectations. Citadel Broadcasting completed their merger with Disney's ABC Radio and paid a \$2.41 dividend. You may notice the market value of Citadel is lower than your original cost basis, but the large one-time dividend makes up most of that difference. Two of our old positions were sold during the quarter. Synagro Technologies was taken private by management and a private equity firm. Federal Agricultural Mortgage Corporation was sold to make room for another financial sector company, MVC Capital. MVC is a publicly traded private equity/LBO company. Our portfolio purchases in addition to MVC were American Home Mortgage, a mortgage REIT that is dealing with the turmoil in the mortgage market, and Imperial Sugar, a sugar refiner and processor. All three additions to the strategy pay nice dividends. Research summaries are included for clients in the Small Cap Value Strategy.

Convertible Securities: Our Convertible Securities/High Yield Strategy gained 3.86% in the second quarter for a first half gain of 8.56%. For comparison the Merrill Lynch Convertible Index rose 4.01% for a first half gain of 6.50% and the Merrill Lynch High Yield Index eked out a gain of 0.31% to bring its first half rise to 3.00%. We received nice gains from two of our convertible preferreds, Ford Motor and Owens Illinois. Our Continental Airlines convertible bond was the weakest position as fuel prices increased and passenger revenue levels declined. For taxable accounts that own master limited partnerships, our swap from Alliance Resources to Alliance Holdings paid off this quarter as Alliance Holdings gained 27%. We expect the recent volatility in the bond market and tighter credit conditions to produce some opportunities for new purchases. Corporate default rates are at historic lows, but with interest rates moving higher and lenders raising their standards, we foresee a rise in the default rate and more distressed bonds.

Intermediate Bonds: Our Intermediate Bond Portfolio declined 0.09% in the second quarter bringing the first half gain to 0.71% versus the Citigroup 1-10 Year Government/Corporate Index decline of 0.18% in the quarter and 1.39% gain for the first half. The Intermediate Tax Exempt Bond Portfolio fell 0.10% in the second quarter versus the decline of 0.19% for the Merrill Insured Muni Index. Interest rates rose dramatically in June as the bond market sold

off after the May employment report showed a strengthening economy. Ten year Treasury yields hit their highest levels in the last year. The increase in bond market volatility also stressed the derivatives market as hedge funds that invested in mortgage backed securities, collateralized debt obligations, and collateralized loan obligations discovered that their hedges did not work as predicted. Many hedge funds suffered losses with two Bear Stearns funds facing liquidation. It seems like some smart folks in the bond market have to learn the same lesson repeatedly, that leverage is dangerous in a volatile market. We believe that there are still many losses to come in the leveraged derivative marketplace. Many funds merely put off taking losses since their portfolios are hard to value. When the Bear Stearns funds faced margin calls, they found out that their portfolio valuation models were highly optimistic versus the real market valuations. Maybe that is why portfolio valuation models are sometimes referred to as "black boxes". No one really knows how they produce the prices they do. Unfortunately when it comes time to sell, the only price that counts is the real bid price. Ouch! The bond market correction that began in early June may not be completed yet.

Again, there may be some short term issues for the market to overcome, but if Washington can remain in gridlock and Bernanke can resist micro management, the animal spirits of the American investor should produce a positive long term result.