
INVESTMENT MANAGEMENT UPDATE

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MARKET UPDATE & OBSERVATIONS

<u>Market Index Returns</u>	<u>1st Qtr</u>	<u>1-Year</u>	<u>5-Year</u>
S&P 500 Index	-9.4%	-5.1%	11.3%
Russell 2000 Small Cap	-9.9%	-13.0%	14.9%
Foreign Stock Index - EAFE	-8.2%	.7%	23.5%
Taxable Bond Index	0.6%	4.0%	3.2%
Municipal Bond Index	0.2%	2.5%	2.7%

Volatility again dominated the investment markets during the 1st quarter of 2008. Some of this occurred in markets that frequently experience cyclical volatility, such as domestic and foreign stocks. However, one of the most surprising developments was the broad sell-off in tax-exempt municipal bonds; whereas, U.S. Government bonds staged a strong rally due to interest rate reductions by the Federal Reserve.

Let's look at some of the themes and issues triggering this volatility and related valuations:

- **Interest Rates.** The Fed made cuts to the Fed Funds rate lowering it from 4.25% to 2.25% since January 1. In response, all interest rates declined, but short rates dropped the most. Our own indexed Money Market rate dropped from 4.3% to 2.5%.
- **Mortgage Defaults & Housing Values.** I look at these two issues in tandem because they provide a great illustration of the impact of a fundamental economic principle: supply & demand. Five years ago, there was a huge supply of cheap mortgage loans due to low interest rates, most of it to qualified borrowers, but some of it to sub-prime borrowers. This supply of money drove homeowners, builders and real estate speculators to bid up the prices and corresponding supply of real estate. We're now suffering because the demand for this housing has subsided due to several factors:
 - An excess supply of housing that's been built
 - Higher loan rates, especially for adjustable loans
 - High real estate prices, although they're dropping nowHowever, I believe recent interest rate cuts will probably have the best chance of any stimulus to help soften the U.S. housing problems. Unfortunately, many borrowers overpaid for homes or used the cash to overspend on other consumer goods and debt. Recovering some of their lost equity will take awhile, but only if struggling homeowners manage to keep making their payments.

- **Recession.** This term scares elected officials, citizens, investors, and business owners. Whether or not we meet the technical definition of a recession, we are certainly experiencing a slow-down in our overall economic activity. But, this is part of the normal business cycle and patient, long-term investors will recover, and may likely have the chance to reap rewards from these price declines, whether it's in stocks, bonds or real estate.
- **Financial Stocks.** The sector taking the biggest hit has been banks and other financial institutions that rely on financial leverage. This even trickled into the muni bond market when leveraged positions hit bond insurers MBIA and AMBAC. While nearly all financial stocks are down, the strong ones will survive, recover and continue to provide lending and liquidity services that are important components of our economic system.
- **Foreign Stocks.** There is no doubt that the boom in the global economy is real and will continue, perhaps for dozens of years. But, whether the stocks of these countries are good values at the moment is another question. It is crucial for investors to diversify globally, but problems within the U.S. and Europe tend to filter to other parts of the world. I urge caution and careful selection of foreign stocks, bonds, mutual funds and investments tied to foreign economies and currencies.
- **As always, the best solution is a well-diversified portfolio of solid funds in allocations suited to clients' objectives and timeframes.**

FUND & ASSET ALLOCATION UPDATE

Our recent portfolio performance has been . . . well, average! We have had some excellent holdings, but some funds have continued to lag and our patience with these managers is waning. However, even some of our best managers, such as Dodge & Cox and Mutual Beacon, have suffered losses.

Some of these equity losses have been buffered by strength in the bond market. This illustrates the importance of diversification as no sector, firm or manager will perform well in all markets and cycles.

Our Investment Committee is currently analyzing several changes to our investment models. We'll keep you posted as we make adjustments to our security selections and allocations that we deem prudent for our clients.