



INVESTMENT MANAGEMENT UPDATE

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MARKET UPDATE & OBSERVATIONS

<u>Market Index Returns</u>	<u>4th Qtr</u>	<u>1-Year</u>	<u>5-Year</u>
S&P 500 Index	-3.3%	5.5%	12.8%
Russell 2000 Small Cap	-4.6%	-1.6%	16.2%
Foreign Stock Index - EAFE	-1.6%	14.4%	23.8%
Taxable Bond Index	1.6%	4.5%	4.0%
Municipal Bond Index	0.9%	2.6%	3.1%

As I sit down to write these comments and reflect on the past year, I usually sneak a peak at what I wrote last year or, perhaps, even several years ago. I always fear that I put something in print, which was either terribly brash, silly or embarrassingly wrong.

Well, we didn't do too badly, although we didn't exactly have a crystal ball on the markets, but our concerns and perspectives about the valuations and opportunities turned out to be valid.

In particular, I cited Bill Gross' forecast for lower interest rates. The world's largest bond manager (PIMCO) predicted that rates would drop to around 3% by the end of 2007, due in large part to a slowing economy. Well, 5 and 10-year Treasury rates have dropped to 3.1% and 3.8%, respectively.

At that time, I was perplexed by other forecasts of rising rates and runaway inflation. We've endured inflation in energy, commodities and food prices, but the costs of housing, technology and U.S. currencies have softened. I am still perplexed, but take comfort in having Mr. Gross managing a fair portion of our clients' fixed income assets.

Just as I observed in October, the 4th Quarter again threw a little of everything at us in terms of financial and economic stimuli, forecasts of doom and positive trends, including:

- Just 90 days ago, we had record highs for the Dow and S&P, but in recent weeks we've seen quick sell-offs.
- Volatile inter and intra-day swings in securities prices.
- Dire economic forecasts due to mortgage foreclosures & sub-prime loans.
- Forecasts of consumer cutbacks due to excessive debt and spending with consumer loans and credit cards.
- Declining interest rates that have triggered the return of the traditional, upward slope of the yield curve.

As always, the solution is a well-diversified portfolio of solid funds in allocations suited to clients' objectives.

FUND & ASSET ALLOCATION UPDATE

Our overall portfolio performance was somewhat disappointing this past year. However, I was most surprised by the broad disparity in performance, profitability and valuation of different market segments.

Our leaders were:

- Foreign managers: Templeton Foreign Equity and American Fund's Capital World Growth & Income
- Large-cap growth funds: Growth Fund of America and Vanguard Growth Index
- Taxable bond funds managed by Bill Gross and his team at PIMCO.

Our laggards were:

- Value managers: Dodge & Cox, Legg Mason, Mutual Beacon and Goldman Sachs
- Small & Mid-Cap funds: Ariel and Buffalo
- Tax-Exempt bond funds managed by Vanguard.

We have not added any new funds or market sectors, but we believe the timing is right to rebalance portfolio allocations from the stronger performers into underperforming sectors.

MARKET OUTLOOK

While we don't make market predictions, we do try to identify trends that have some bearing on our asset allocation and fund selection strategies:

- We are reluctant to buy and own U.S. government bonds that will be earning only 3.8% over the next 10 years.
- Foreign stocks have shown strong earnings and performance the past few years, but a portion of this performance is attributable to the falling U.S. dollar. If the dollar bounces back from recent lows, foreign stocks stand to face a significant headwind.
- Lower interest rates may give some relief to the troubled mortgage and real estate markets, but will this trigger another round of problems 3 to 5 years from now?
- Energy, gold, grains and other commodities have been a profitable hedge, but they may be too expensive and unpredictable now. We are still comfortable owning energy-related stocks and bonds, but we are cautious about the size and diversification of those holdings.

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