

Howe and Rusling emphasizes high quality and liquidity in our fixed income investment approach. We do not invest in structured fixed income products that are easily bought but difficult to sell. We invest in bonds where value is transparent and market value is clearly identifiable.

require additional premium in yield to buy bonds that potentially are subject to an erosion of value because of LBOs. As the yields of these bonds go up, the price goes down and performance suffers.

As we reach a point in this economic cycle where companies are issuing more debt to finance purchases of other companies, stock buybacks, or expanding their lines of business, we expect investors will demand higher yields for corporate bonds and this sector will lag in performance. We have decreased our allocation to corporate bonds over the last year in anticipation of increased credit risk. We believe that the financial sector of the corporate bond market is more susceptible to this risk than the industrial sector. We are not suggesting completely exiting the corporate bond market, but rather underweighting additional allocations to this sector and financial institutions in particular.

Liquidity – What is it and why is it important?

We place a high degree of importance on liquidity when purchasing fixed income products. But, what determines liquidity? The “textbook” definition of liquidity is:

The speed in which an asset can be converted to cash, through sale or borrowing.

The more buyers and sellers there are for a given asset of relatively known value, the easier and faster it is for a transaction to take place; the asset is liquid. Conversely, if it takes longer to bring together buyers and sellers to transact at an agreed price, the asset is less liquid.

The reason for (once again) addressing the issue of liquidity is that often investors do not place a high enough importance on how liquid (or illiquid) an asset may be when evaluating its purchase price. In some instances, this importance is not recognized until the investor tries to sell an asset with little liquidity. Ultimately, the selling price has to be reduced to entice a buyer to transact. The same can be said of borrowers that use a less liquid asset as collateral for a loan. Lenders will require more of a discount for collateral that is less liquid. This is no different than your bank giving you a loan of less than the full value on your auto or home. Banks do this as “protection” in the event they need to liquidate the collateral in case of a default.

Howe and Rusling emphasizes high quality and liquidity in our fixed income investment approach. We do not invest in structured fixed income products that are easily bought but difficult to sell. We invest in bonds where value is transparent and market value is clearly identifiable. Recently, the importance of liquidity has received more attention in the bond market, especially as it relates to hedge funds,

“sub-prime” mortgages, and collateralized debt obligations (CDOs). We want to emphasize that none of the above are in and of themselves inappropriate for investors who understand the risks and do not just look at performance. The concern with sub-prime mortgages is that they are home loans to individuals that do not qualify for “conventional” loans; they are riskier borrowers. The banks and mortgage companies that originate these loans do not normally keep them as investments; they prefer to sell them. However, these loans are less liquid. To create liquidity for this type of loan, many brokers “securitize” these loans and make a market (buying and selling) for the securities, providing liquidity.

The securities that normally contain a large amount of sub-prime loans are called CDOs. With the recent increase in sub-prime loan defaults and delinquencies, some of these CDO securities have not performed as anticipated, and in some cases have lost a lot of market value. The liquidity issue (or lack of liquidity) has been recently brought to light by the problems relating to some of the hedge funds managed by Bear Stearns & Co. These funds, like most hedge funds are leveraged (they can borrow).

Leverage is a powerful tool, used to improve marginal returns and increase net cash flows. Leverage, when used prudently, allows the fund to pledge assets to lower the cost of borrowing so that the fund can immediately reinvest the proceeds from the loan into higher yielding assets. This is similar to buying securities on margin. However, the amount that can be borrowed on margin is limited by regulations established by the Federal Reserve Bank, while hedge funds are not regulated.

It is apparent that the Bear Stearns hedge funds are highly leveraged and that they have pledged CDO securities as collateral for loans made to the funds. As the value of the sub-prime mortgages and CDOs decreases, the lenders holding this collateral are at risk and have threatened to liquidate the collateral to pay off the loans made to the Bear Stearns hedge funds. The fear held by many investors of CDOs is that the lack of liquidity will expose the true value of these securities and force them to make downward adjustments to the securities’ value on their balance sheets. This would also have the effect of alerting investors in CDOs that the market yield for these securities should be a lot higher, reducing the price paid and thereby affecting the profit margins on these securities. Just imagine, a very profitable sector of the fixed income market could be done in by the lack of liquidity.

Our belief is that this episode of high leverage and lack of liquidity will not have a major negative effect on Bear Stearns. They have many other sources of revenue that should keep them viable. However, this will serve as a “warning shot” to all highly leveraged funds that liquidity is important.

If you are interested in learning more about our affiliate, SouthernSun Asset Management, and their small-cap portfolio management, please contact your portfolio manager or Craig Cairns, President of Howe & Rusling.



2nd Quarter 2007 Stock Market Overview

Providing professional investment management to individuals, retirement plans, and charitable organizations since 1930.

AT A GLANCE

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Bond Market Overview

Heading into the New Year, we believed 2007 would be a good year for stocks. Based on the economic data—moderate inflation, a growing (albeit slowing) economy, reasonable corporate valuations and strong corporate balance sheets—we believed the year would produce better than average returns for the stock market, which we felt good about especially coming off a strong 2006.

We did not expect that much of these returns would be accomplished in just two months of the quarter just past. April was the strongest month for the domestic stock market since 2003 and May was nearly as strong. Contrary to investors' desires, investment return is not obtained in a straight line and in June the stock market took back some of the gains. We have learned that investors tend to think of their portfolios in terms of the highest point rather than from where they started. However, if we had announced that investors could put away their statements and by June 25th (the date of this writing) the S&P would be up nearly 7% for half the year, most investors would have been satisfied.

There are many reasons for the stock market strength, but none more important than global liquidity and the number of leveraged buyouts (LBO's). An LBO is where a group of investors borrows some portion of the purchase price in order to buy a company. The purchaser could be a private equity company or company's management team. In the case of a public company, the investors make an offer to the shareholders to buy the company, typically at a premium price.

Last year, 2006, was the best year for LBO deals in a decade. As the chart below illustrates, the number of deals in 2006 has

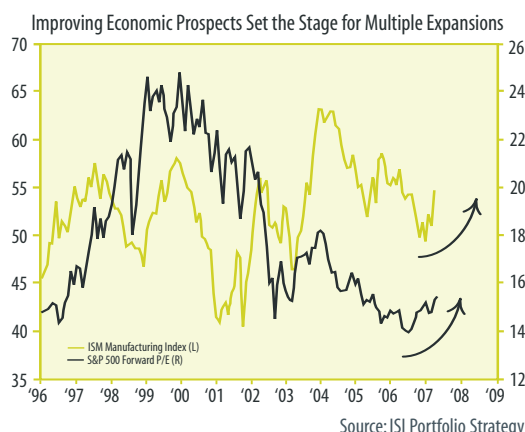
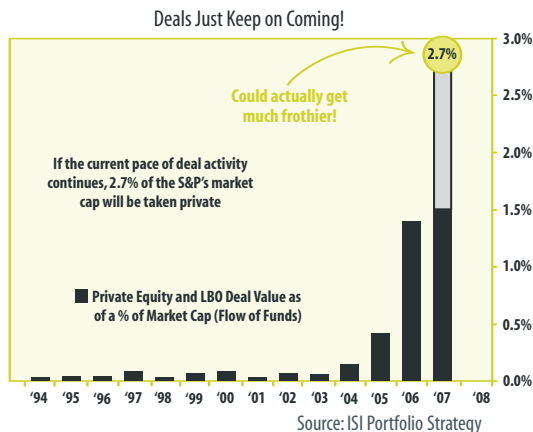
already been surpassed in 2007 in less than half a year. The environment is favorable to LBO's for several reasons:

- 1) Corporate balance sheets are in good shape. Cash is at historic highs and averages 13% of corporate assets.
- 2) Corporations are producing strong cash flows to cover interest payments.
- 3) The Price/Earnings ratio of the stocks on the S&P 500 is estimated to average 16 times earnings which is reasonable.

The desire of investors to buy companies in this way at least makes a case for the market being undervalued. In our client portfolios, we are fortunate to have owned three companies that received LBO offers. The Howe & Rusling style is conducive to uncovering candidates for buyouts because we look for companies with growing earnings, producing strong cash flows while maintaining strong balance sheets which are selling for less than what we perceive to be fair market value.

Global liquidity has also grown rapidly as global broad money growth is approaching 10% on a year over year basis. When the money growth is as strong as it has been the past year, the money has to go somewhere. The chart from ISI below graphically depicts that "when the financial system is awash in this much liquidity, U.S. stocks are typically rewarded by a higher multiple."

The increase in stock prices can be seen as a function of supply and demand. Supply is decreasing because of the



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record number of LBO's plus companies buying back their own shares. Demand is increasing because of the need for the liquidity to find a home in an investable asset. These forces have lead to increased stock prices.

The growth in corporate and global liquidity has helped stock prices increase, but corporate and global liquidity becomes even more powerful when supplemented by economic growth. ISI identified two episodes in the past 18 years where all three variables rose together with the leading indicators 1997 and 1999. Equity returns were 31% and 20% in each of these two years.

However, it remains unclear whether the economy is going to continue slowing or reaccelerate. We found it interesting to chart the increase in oil prices with the slowing of the U.S. economy. In January 2004, the price of oil was \$34.27 a barrel. Oil closed at \$65.08 on June 1st of this year. According to the St. Louis Federal Reserve, that is a yearly increase in cost of \$2,156 per household for oil. In that same period—when the Federal Reserve's short-term interest rate increases the yield on the 10-year Treasury note to 4.95% (and higher in June) from 4.30%—US gross domestic product growth dropped from a healthy 3.9% in 2004 to 3.2% in 2005, 3.3% in 2006 and 0.6% in the first quarter of 2007. Certainly oil prices are impacting the economy which is growing much more slowly than in previous years.

Other economic data have been mixed, but seem to point toward further slowing in June as unemployment claims climbed for four consecutive weeks, homebuilding was at it worst since 1991 and a number of companies were concerned about the outlook for the immediate future.

Another concern for the markets is the looming potential for a financial crisis. The subprime scare (where lenders made loans to individuals of below average credit and then packaged the loans for sale to investors only to see a large increase in non-performing loans in 2007) is probably not over, exemplified by the issues with the Bear Stearns hedge fund in June. Derivatives based on bonds and loans climbed by \$15 trillion in 2006, a 100% increase over 2005, according to the Bank for International Settlements. (The total derivatives market climbed to \$415 trillion in 2006). This derivative boom may spell disaster for some investors who did not understand exactly what they were getting into.

Finally, inflation is always a looming concern especially if the economy reaccelerates. On the one hand commodity prices including oil have increased, the dollar continues to weaken, utilization rates are fairly high and there is a lot of liquidity as we described above. On the other more important hand, inflation remains in the range of acceptability for the Fed (albeit the high side) and because of global competition there continues to be downward wage pressure.

Even given the concerns, we believe the environment remains healthy for stocks. We believe the strong stock market gains of the first half of the year were justified by global liquidity and the reasonable valuations for stocks. The economy has slowed reducing inflation concerns, but is still growing which makes it a healthy environment for the stock market. If there were to be a financial crisis affecting hedge funds or some of the investors in derivatives gone bad, there may be a broad impact on markets initially. However, we believe investors sort through information more quickly now as they did when the Chinese market fell in February or the increasing defaults in the subprime market spooked investors for a short time. Pain will come to the affected sectors, but after a short time will not have a large impact on the broader market.

With commodity prices surging, the dollar trending lower and high utilization rates, there's plenty to worry about on the inflation front. However, the Fed has to feel encouraged by last week's proposal by GE to give pay hikes of just 2.5% in both 2008 and 2009 and then just 3.0% in 2010.

Stocks will ultimately resume their march higher in the face of rising bond yields for five key reasons. They include: 1) Stocks and rate expectations have been moving down in tandem in recent years; 2) the S&P 500 is slightly undervalued; 3) LBO activity is accelerating; 4) excess global liquidity is explosive and abundant; and 5) leading indicators are picking up.

The big action was in derivatives, packages based on bonds that sliced and diced risk to lower corporate interest bills and to give investors, such as insurance companies and pension funds, investments that appeared to match their risk and reward needs of their portfolios. Derivatives based on bonds and loans climbed by \$15 trillion in 2006, a 100% increase over 2005, according to the Bank for International Settlements. (The total derivatives market climbed to \$415 trillion in 2006). Unfortunately not every bank or investment house that looked for a piece of the profit from this boom knew what it was doing.

However, wages seem like they are under control with many large companies negotiating either modest raises or cuts with their unions. GE average hourly earnings y/y peaked at 2.6% in 2006, then slowed to just 1.8% in May.

Globalization, the global glut of labor, technology and competition are all keeping inflation lower than it otherwise could be. Labor at home and in Europe is under pressure.

Bond Market Overview

The Tide has turned ... for now

After six quarters of positive performance, dating back to September 2005, the bond market hit a "speed bump" in the latest quarter. The biggest factors of the poor performance were revised expectations of an imminent easing of monetary policy by Federal Reserve and continued "jitters" over housing related loans and bonds.

The table below shows the quarter-to-date returns for the intermediate term bond market (1-10 years) and the major sub-sectors.

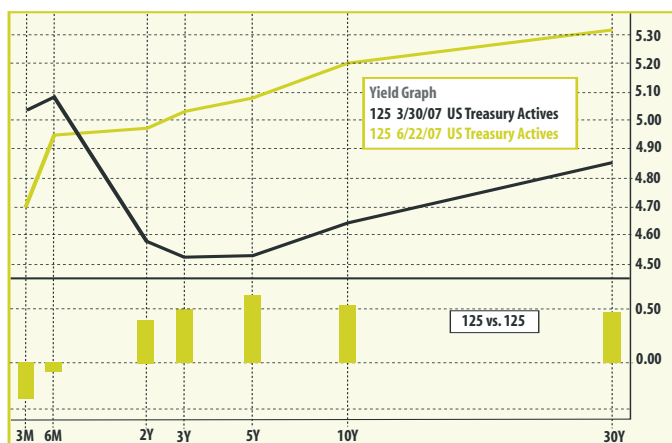
Index	Return for Period	Annualized Return
Intermediate U.S. Government / Credit	-0.68%	-2.96%
U.S Treasury: Intermediate	-0.59%	-2.56%
U.S. Agency: Intermediate	-0.32%	-1.39%
Intermediate: Corporate	-1.02%	-4.41%
Invest. Grade: Industrial - Intermediate	-0.97%	-4.20%
Invest Grade: Financial Institutions - Intermediate	-1/08%	-4.66%
Intermediate Utility	-0.94%	-4.08%
Municipal Bond: 1-10 Yr Blend (1-12)	-0.60%	-2.59%

Source: Bloomberg, 2007

While the above returns leave a lot to be desired, intermediate bonds have relatively outperformed bonds of longer maturity. The worst performing sector of the Lehman Aggregate index was the U.S. Treasury: 20+ Year which has returned -4.587% quarter-to-date.

The following yield graph provides a visual explanation of why longer maturities have performed poorly. The change in the U.S. Treasury yield curve from quarter end to now shows how longer maturities have increased more than those of shorter maturities. As of this writing, the current yield on the 10 year Treasury note is approximately, 5.20%. This is the highest it has been since the end of June 2006. Because longer bonds are more price sensitive to changes in interest rates (higher or lower) the effect on performance will be more pronounced.

YIELD GRAPH



Source: Bloomberg, 2007

Interestingly, what is also significant is the shape of the curve. We have been reporting for about one year how the yield curve has been inverted (short rates higher than long rates) and the dark line in the graph above illustrates that. However, notice that as of this writing the curve is no longer inverted (light colored line). This is attributable to a couple of market sentiments that have changed: little probability of the Federal Reserve easing monetary policy and inflation expectations that have not diminished. Howe & Rusling has been making the case for neutral monetary policy for some time now and we see nothing on the horizon that would change our point of view.

During the second quarter, economic data indicated that measures of inflation had not fallen to the level that the Federal Reserve Bank is targeting.

Various Fed governors made public statements that managing the rate of inflation was their top priority. These statements carried little weight with the bond market in the recent past. Why is the market paying attention to the Federal Reserve now?

Many analysts and investors had previously anticipated that the Federal Reserve would ease in the near future to alleviate slowing economic growth. However, because of this inflationary data, and the sentiments that Fed members have expressed, many analysts have changed their forecasts for lower Federal funds rate this year. For example, Bill Gross, who manages the world's largest bond fund at PIMCO, stated that he was mistaken in forecasting an imminent rate cut. Chief economists, David Rosenberg of Merrill Lynch, and Jan Hatzius of Goldman Sachs, had both predicted at least 3 rate cuts in 2007. Recently, they both recanted, and now neither anticipate any ease this year.

Reawakening of Credit Risk

Another factor that contributed to the negative returns in the bond market had to do with credit risk. We can clearly see from the sector returns in the preceding table that corporate bonds have underperformed the higher quality Treasury and Agency sectors. It would appear that the market is reawakening to the notion of risk. Investors have been perfectly content buying securities based on their nominally high yield in spite of the credit risk associated with the actual companies issuing the securities.

The re-emergence of LBO (Leveraged Buy Out) transactions, where companies take on a great deal of debt to acquire the stock of another company, makes the existing bonds of the acquired company inherently riskier. As a result, investors

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