

January, 2007

My ten month old daughter surprised me this past holiday season with a framed crayon drawing, connected lines flowing ubiquitously up and down. My wife & I erroneously declared this as Ava's artwork, until Bill Haas recognized the real genius in her drawing adorning my office wall. "Ah, a budding technical analyst he announced. Her prediction of the 2007 market is amazing for her age." Upon re-inspection of Ava's "charts" I found his comments to be most insightful. They can be summarized in one word, describing the markets of 2006, and predicting our thoughts for the markets of 2007, "volatile".

For the year ending December 31, 2006, client portfolios generally experienced low double digit advances. By completing the year with diversified portfolios representing both fixed dollar and equity we generally had performance not quite up to that produced by wholly equity accounts but much in excess of where the fixed dollar indices completed the year. Our focus looked to reduce risk and protect our client's accumulations during a period laden with concerns, all while retaining significant exposure to the stock markets to capitalize on total returns.

It is said that the stock market climbs a wall of worry. Our concerns were abundant. In May the market fell. A new inexperienced chief was at the reins of the Federal Reserve Bank. The dollar seemed to be ready for a precipitate fall. The yield curve was inverted and remained inverted for much of the year. This is often thought to be an early warning of a recession to come. Headlines told of the difficulties faced abroad as this country became more and more isolated from those who were once friends. North Korea played experiment with their nuclear capability; Iran announced its increased nuclear potential. We expended significantly from our national treasury for protection at home and abroad. The death tolls of our service men and women rose in Iraq and Afghanistan. Yet for a world wide war of global proportions and five year duration the figures may have been the lowest in history. At home the housing bubble was perceived to have burst. Repeated incidents of corporate greed and corruption were regularly reported. Our national leaders were involved. And the national debt grew.

Like a number of others our market outlook became conservative, looking to additional principal protection measures and risk adjusted return portfolio strategies. High dividend achieving stocks and closed end funds were recommended in the areas of consumer staples and utilities. These investments saw significant appreciation throughout the remainder of the year while still providing a defensive posture. In the areas of fixed income, CD's and short term notes were found at some of the best rates available nationally. Our cherry picked "model portfolios" were used to provide greater diversification and access to some of the best managers on Wall Street where management has consistently provided above average risk adjusted returns. Technology

related investments were sought that focused on communications and information from management in which we had particular confidence.

Many of the highlighted issues in last quarter's newsletter (reduced energy costs, inflationary concerns, real estate's impact on consumer spending, goldilocks economic opportunities, US dollar softening and global trade imbalances, congressional and presidential election ramifications, and continued geopolitical pressures) have played out with varying impact over the period.

During the last half of 2006 the economy along with major stock indices and, during the last three months of the year, the American dollar, all moved forward. The mild weather of the Northeast fall and early winter permitted stocks of oil and gas to accumulate. The prices of those and other basic commodities fell. The result was as if a significant restraint on the economy was removed. What's more, from an historical perspective interest rates and tax rates are quite low. There was (and is) significant liquidity in the economy. Unemployment is below 5%. Our gross domestic product and our trade gap fell—but only as they related to the recent past.

For now, Wall Street has placed its bets on 2007 Federal Reserve rate cuts and decreases in energy costs to provide the counterbalance to economic softness elsewhere. We continue to think the market is weighing a delicate balance of risks and opportunities and could quickly move in either direction, considerably up or considerably down with volatility. Our portfolios may have contained too much risk aversion to achieve the highest market returns for 2006. But what we did achieve for the year was most often a low double digit advance with reduced risk. We will be most pleased to continue this in the New Year. Managing tax implications and psychological expectations should not be underestimated for the coming year.

As we enter 2007, the domestic economy, once again, appears to be weathering the storm, though sluggish US growth appears highly probable regardless of whether or not recession occurs. Recession risk continues to be forecast in the range of 25-35%. However should inflation, interest rates and oil prices rise in 2007; these probabilities are likely to increase significantly. Regions outside the US such as the Eurozone are also expected to see GDP growth slow in light of the excellent second half economic numbers recently reported. While fiscal policy will likely tighten in key countries such as Germany and Italy, China and India are expected to continue to experience significant growth. Both have continued to show few signs of excessive overheating according to many relied upon economic sources.

To a large extent, slowing GDP projections have done little to slow the market momentum. Wall Street continues to bank on additional liquidity supplied through reduced energy and commodity costs and monetary and fiscal policy infusion to provide supportive stimulus. Certain areas within healthcare, consumer staples and financials should all do well in such a market climate. In part, this is due to their defensive posture and in part due to narrow credit spreads and free cash flow occasioned by many stocks within the sectors.

Though oil prices have come down more than 25% from their market highs, we anticipate long term demand issues should continue to apply upward pressure on oil prices long term. OPEC continues to indicate that they will cut production should crude fall below the \$55-\$60 range. Energy, consumer discretionary and residential real estate will likely suffer bumpy rides and selling pressure in 2007. However, some energy stocks should provide buying opportunities and should be viewed as important diversification tools within your portfolio. "Where you are" in these sectors continues to be of utmost importance.

The dollar has increased in value recently when contrasted with the Euro and a number of other currencies. The price of gold and other commodities is down. In November the U.S. trade deficit fell for the third straight month as exports of commercial airplanes and other products hit an all-time high. The Commerce Department reported that the deficit narrowed by 1% to \$58.2 billion, the lowest monthly total since July, 2005. At the same time, the U.S. government's trade deficit with China rose to \$213.5 billion, the United States consumer was not helping matters as, in the first week of 2007, consumer debt rose another 6%. Does anyone doubt that if China and other countries acted on the threat to stop investing in United States debt instruments, a financial crisis might occur? Does anyone doubt that if Middle Eastern oil and gas were cut off from the American economy the result would be dire?

Of equal import to the markets will be upcoming tax legislation. Raymond James Economist Scott Brown recently indicated in his economic outlook that "A lot will ride on who wins the White House in 2008- but between now and then (and perhaps even after) tax policy uncertainty could matter to the markets."

For those running American companies, the corporate tax future is hard to predict. Major sections of our tax code are obviously just temporary. Perhaps the best publicized of these "temporary pieces of legislation" is found in the estate tax. This section of the law will pass out of existence in 2010 only to return in 2011 when its incidence will involve many more estates than it does presently. The present administration is on record as wanting the entire code of income and estate taxation rewritten. Their plans are dramatically at odds with most from members of the legislative majority. With such widely disparate views as those represented by the new Ways and Means Chairman Charles Rangel and the Republican senior member Jim McCrery, how can business make long range tax plans? They do not know what tax law will govern their decisions for the future. In a somewhat analogous situation in the period 1984-1986, business was dramatically slowed. When the business of America slows, the market of America is apt to stumble.

A careful perhaps precarious balance is evident between the positive and negative indications for the American economy and world markets. As if to emphasize this fact significant volatility continues to be displayed by the various market indicators. For the first five trading days of the New Year, the intraday trading range of the Dow was never less than 97 points. On January 3rd, shortly after the day began with triple digit gains the Federal Reserve released its December 12th minutes. Thereafter, the market retreated into the red due to the hint of stronger inflation and a weaker than expected housing market. Fear and greed are often credited with the movement of these markets; both will continue to be showcased in their glory throughout 2007. We expect this volatility to continue and for this reason continue to emphasize the presence of significant diversification and risk aversion for our portfolios.

William Haas & Mike Kertyzak

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