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Market Commentary and Review

January 2, 2008

"If you take a starving dog and make him sleek and prosperous,
he will not bite you;
This is the principal difference between man and dog."

SUMMARY:

2007 was the 5th consecutive year of gains in the stock market. It was a year for large cap growth, international, and commodities, not for small caps or REITs.

The expected economic slowdown is finally here. Now we'll see how slow and for how long.

We made another 5% reduction in equity targets in November.

We got most of our 2007 predictions right, except missing one big one. How will we do in 2008?

Dear Clients and Friends,

As far as the financial markets were concerned, 2007 ended with a whimper, or even a downright sob. Stocks tumbled almost 5% in the last two months to finish with modest gains for the year. Foreign and technology stocks, and commodities did much better.

The following table summarizes returns for 2007 and the last few years:

	2007	Last 3 Years Annualized	Last 5 Years Annualized
Large Cap (S&P 500)	5.5%	8.5%	12.7%
Large Cap (Dow Jones Industrials)	8.8%	9.6%	12.1%
Mid Cap (S&P 400)	7.2%	9.9%	15.8%
Small Cap (S&P 600)	-0.5%	7.2%	15.9%
Nasdaq 100	19.0%	9.0%	16.5%
Foreign Stocks (EAFE)	9.9%	16.2%	21.2%
Bonds (Lehman Aggregate)	6.9%	4.3%	4.3%
REIT's (Vanguard REIT Index)	-16.5%	8.1%	17.5%
High Yield Bonds (Vang. High Yield)	1.4%	4.1%	7.5%
Commodities (AIG Index)	16.2%	13.0%	14.1%
Alternative Assets Group (AAG) (11 Fund Avg)	10.0%	9.7%	13.3%

In This Letter

Market & Economic Commentary....................1
Strategy...........................2
Performance....................3
Asset Class Recap..........3
Model Equity....................4
Company News...............4

As you can see, the last 5 years have been remarkably good. Of course, they came on the heels of 3 negative years, so for the 8 years of this century we have had only a 1.7% annual return.

The market was underpinned for most of the year by good economic data, rising corporate earnings, and despite high oil prices, inflation remained low. During the 4th quarter however, several of these underpinnings were challenged. Fourth quarter economic growth fell close to zero, and massive write-offs from banks and brokerage firms wiped out earnings growth. Further, oil prices set records, the housing debacle finally slowed consumer spending, and the falling dollar spooked both foreign and U.S. investors.

A year ago, we forecast six primary issues for the year ahead.

1. Oil prices would remain high, but stabilize. We were right on the first part, but wrong on the second. They went higher than we expected.
2. The Fed quit raising rates in June 2006. Some predicted they would raise rates again. We disputed that and were correct. In fact, the Fed has lowered rates by 1%.
3. We forecasted a soft landing – no recession. Correct… so far.
4. There were signs the housing slump was ending. A risk we said we would monitor. In fact, it has continued to deteriorate.
5. The trade deficit could lead to a sharply falling dollar or an increase in inflation. We were right on both counts.
6. We expected no major initiatives from Washington and we got none.

There were other major stories from 2007. Most of the political news was bad: Scooter Libby was found guilty but then pardoned; Attorney General Gonzales resigned as did Karl Rove; deaths in Iraq reached an all-time high, but the situation did seem to improve toward the end of the year. There were the Virginia Tech shootings that killed 32, the wildfires in San Diego, Al Gore won a Nobel peace prize, the introduction of the iPhone, the baseball doping scandal, and last but not least, the Colorado Rockies made it to the World Series.

By far, the story we did not anticipate that had the biggest impact on financial markets was the total meltdown in sub-prime debt that led to billions of dollars of write-downs, the resignations of some of the nations top CEOs, and a crisis in the credit markets. As we enter the new year, this story is still unfolding and will have a significant impact on whether the economy and markets stabilize.

Looking ahead, we suggest the following list will be the important determinants for the financial market performance in 2008:

1. Politics. Unfortunately, it is an election year, and for the first time in many years, an incumbent is not running. There will be changes expected both domestically and internationally regardless of which candidate wins. Several tax laws are set to expire in 2010 and may get attention this year. Historically, election years have been good for the stock market, but we would not suggest taking that to the bank.
2. Federal Reserve policy. The Fed is almost certainly going to continue lowering interest rates. The question is how far and how fast, and is it too late?
3. High oil prices. At $100 a barrel it seems inevitable there will be a drop, but many (including us) have said this before. With oil and gas prices this high it makes it even more difficult for consumers to continue spending. A drop in oil prices would be an unexpected piece of good news.
4. The credit crisis. This will probably subside during the first part of the year as the banks and regulators get their arms around the extent of the problem, but there will be more write offs, capital infusions, dividend cuts, etc.
5. Slow economic growth, rising inflation, rising unemployment. There will be a lot of headlines and worry over these numbers. The fears are valid, and we expect the data to get worse for a few months. But we believe we will muddle through with a slowdown for a couple of quarters, and a modest uptick in inflation and unemployment.
6. Slower earnings growth. After write offs, 2007 is likely to show a 0% growth in earnings for the S&P 500. If we avoid recession, 2008 will likely be better, but growth will be only in the mid-single digits. This makes stock picking even more important as there will be a wide divergence between winners and losers.
7. Housing. The worst period of the housing market decline is likely to be seen in 2008. From there, it will not improve quickly or dramatically, but it should stop being as much of a drag on the economy.
8. Foreign trade and the Beijing Olympics. Exports have been one of the brightest spots of the economy lately. Continued progress will be key to avoiding a recession. With the spotlight on China this summer, many analysts predict continued strong growth from the Chinese economy.

Strategic Allocation Decisions

In our September letter we announced we had reduced equity targets by 5% and increased our Alternative Assets Group allocation by the same amount. In November, we made another 5% reduction in equity targets with a corresponding increase in cash. This is our first cash allocation in 4 or 5 years. We took the 5% from small & mid-cap targets, reducing them to their lowest possible weights. In many cases, cash balances will be higher as we sold underperforming positions or took tax losses at year end and have not yet re-invested the proceeds. At this point, we believe the market is in a sideways consolidation period, so we do not expect to increase cash allocations further, but we will continue

to monitor events and adjust accordingly.

Our underweighting of bonds finally proved wrong in the 4th quarter as investors fled the stock market and bid up the price of Treasury bonds. As shown on page 1, bonds outperformed stocks for the year. We continue to find little value in bonds, which yield only about 4%, so we don't expect to increase allocation targets unless economic prospects become dire. International investments have remained at the upper end of allocation targets for some time, and this is expected to continue as long as the dollar remains weak.

Performance

Our accounts had a very good year on a relative basis, and a decent year on an absolute basis. A sampling of balanced accounts showed an average gain of 6%-8% (every account is different, so your portfolio may be higher or lower than these averages), and the equities were up 9% - 11% on average. These returns compare quite favorably to the 5.5% from the S&P 500. Our individual stocks outperformed the market averages, and some of our mutual funds did exceedingly well. Funds with international exposure did the best, especially emerging markets, and small cap funds did the worst. Bucking that trend, the Turner Emerging Growth Fund increased 17% last year. There was a significant split last year between growth and value returns. For example, our average large cap growth fund was up 13% and the average large cap value fund was down 0.5%.

Asset Class Recap

U.S. Stocks:

According to our multi-factor model the market is now 13% undervalued. The P/E on 2008 estimated operating earnings is only 14.5; however, we think the earnings estimate is probably too high. Using a more conservative estimate we think the PE is 15 or 15.5 on 2008 earnings. This is still attractive and provides downside protection to the market. Relative to bonds, stocks look very attractive. Put another way, the earnings yield is currently 6.5%. Add to that the dividend yield of 2% and you get 8.5% compared to only 3% - 4% from bonds.

Earnings were terrible in the 3rd quarter due to significant write downs from the financial sector. Financial earnings were down 37% in 3Q07 versus the previous year, and are predicted to fall 60% in the 4th quarter. Excluding financials and the consumer discretionary sector, which includes housing, earnings increased over 7%. The 4th quarter is expected to be similar with an overall decline of 8%, with losses exclusively due to financials. Since financials make up 20% of the S&P 500, it will be difficult for the market to get traction until this important sector stabilizes.

Investment-Grade Bonds:

As previously noted, there was a rush to quality over the quarter that brought interest rates on Treasury bonds down to 4% for 10 year maturities and 3% for 5 year maturities. This increase in price brought the total return on the Lehman Brothers Aggregate Bond Index to 7.0% for the year.

Does this mean our strategy of underweighting bonds was wrong? Maybe. The return was higher than we expected. However, since the assets were allocated to our Alternative Assets Group, which performed even better, we came out all right. Over the next few years, we are even less enthusiastic about bonds compared with other asset classes. But, over the near term they will provide a sanctuary against the volatility of equity markets.

Dividend / Defensive Group:

Our Dividend / Defensive group struggled last year due to the emphasis on financial stocks and REITs. The two portfolios we manage to monitor this strategy had an average return of 2.4%, below the total returns of bonds but higher than the Dow Jones Dividend Index Fund (DVY), which declined -5.7% last year. Looking forward, we are optimistic this might be another excellent period for this strategy, especially compared to bonds. With 5 year bonds only yielding 3.3%, and with many dividend oriented stocks down significantly, there is a high probability this strategy will shine again. As a reminder, we first began this strategy back in 2004 when yields were last 2.5% to 3%. The objective then was to achieve a yield similar to bonds with a basket of high yielding stocks, with the expectation that the total return would be much higher. Through 2006 this strategy worked exceptionally well, averaging nearly 15% for three years from 2004 – 2006. The average yield on our list is currently 3.6%, slightly higher than bonds. So, while we do not expect a return to the '04 – '06 period, we do expect the strategy to outperform bonds.

Alternative Assets Group:

Once again, this strategy performed at or better than expectations. For reporting purposes, we are using the average of the firm's top holdings. At year end, we had $89 million invested in this strategy, and the

top holdings totaled $77 million. As shown on page 1, the performance has averaged 8% - 10% for the last 5 years, but more impressive is the downside protection. During the last three stock market corrections (May '06, July '07, and Nov '07), which averaged drops of 8.5%, this group fell only 2%.

For the 4th quarter, the best performing funds were TFS Market Neutral Fund and the Commodities Index Fund. The worst performers were the Merger Fund and Franklin Income Fund. For the year, the Leuthold Fund was the best performer with a 19% return and commodities came in second with 14.9%. The TFS Market Neutral Fund has replaced the Schwab Market Neutral Fund in most accounts, and should be done in all accounts soon now that we are in a new tax year.

Model Equity: *Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.*

The model equity account had its best year of outperformance since inception in 2003. The portfolio returned 14.9%, beating the S&P 500 by 9.4%. Since inception on 1/1/03, the cumulative return is now +98.9%, again outperforming the S&P 500 by over 16% (and outperforming in 4 of 5 years).

Like most investors, or anyone trying to improve, we try to evaluate what we did right or wrong the previous year. Fortunately, this year it was analyzing what we did right. Last year we avoided major pitfalls both by under-weighting financials and by eliminating almost all banks. We also took profits several times by trimming stocks that had run up significantly. We were much more deliberate in our decision making, and we were on the right side of several important themes. In addition to underweighting financials, we underweighted consumer discretionary stocks and overweighted industrial and energy stocks. We increased the technology sector from a significant underweight at the beginning of the year to a market weight (20%).

Foreign Equities and Fixed Income:

There isn't much new to report for this sector. It continued to outperform in 2007, but as we reported in September, most, if not all the outperformance came from currency translation. While the dollar fell for the year (-7.4%), it recovered a little in December gaining 1.8%. Whether the dollar continues to fall will determine whether foreign investments continue their outperformance. It is not coming from stronger economic growth. Europe is expected to grow at 2% next year, and Japan even a little slower. It is only the emerging market countries that are experiencing strong growth. China, for example, grew in 2007 at 11.5% and is expected to grow by 10% in 2008. At this point it is important for investors to keep their heads on straight because speculation is getting rampant. When investors ignore valuation and buy just because things have gone up, it always ends badly. It is just a matter of time.

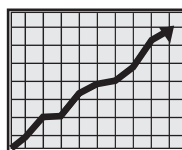
Company News:

We are happy to have Dick Stebbins joining our investment committee and sharing office space with us effective the beginning of the year. Dick brings over 40 years of investment management, investment banking, and financial analysis experience with him. He is retaining his investment management firm as a separate entity, but we will share ideas, research, and some resources.

We were proud to be honored by the Denver Business Journal as one of Colorado's Top 20 Independent Wealth Advisors for 2007, listed 9th. We are not exactly sure how they made their selection, but believe it was based on experience, clients and assets under management, and profitability.

As we previously announced, 2008 is our 20th anniversary. We anticipate several celebrations this year including some client gatherings. We would like to thank you for your confidence and trust, and remind you that if you know of anyone who might be interested in our services, or simply receive our newsletter, please have them give us a call or check us out at www.sargentbickham.com. We have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses it is important for us to continue to grow. Soon you will be receiving a letter from us that will make it easy to suggest someone appropriate for us to contact.

Many happy returns,



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