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Market Commentary and Review

June 30, 2007

"Those who have few things to attend to are great babblers; for the less men think, the more they talk."
- Montesquieu

Summary:

2007 has started out on a good note. After a lackluster 1st quarter, the 2nd quarter has produced equity returns of 7% or better.

Our previous conclusions of a slow but growing economy, slower but growing corporate profits, reasonable valuations, continued takeovers and corporate share repurchases, and modest inflation remain intact.

No changes to our strategic allocation decisions.

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Dear Clients and Friends,

Excellent returns for the second quarter have brought year to date results to attractive levels. All major equity indices have returned 5% or better in the last three months, bringing 2007 returns to about 7%. International equities continue to lead the way, with emerging markets particularly strong. Negative returns came from bonds (both investment grade and high yield), and especially REITs, which were down over 9% for the quarter, 5% for the year.

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

	2007 thru 6/30/07	Last 3 Years Annualized	Last 5 Years Annualized
Large Cap (S&P 500)	7.1%	11.8%	10.7%
Large Cap (Dow Jones Industrials)	8.9%	11.2%	10.1%
Mid Cap (S&P 400)	12.1%	15.2%	13.9%
Small Cap (S&P 600)	8.3%	14.4%	14.2%
Nasdaq 100	10.4%	9.0%	13.2%
Foreign Stocks (EAFE)	10.3%	21.7%	17.4%
Bonds (Lehman Aggregate)	0.6%	4.0%	4.1%
REIT's (Vang. REIT Index)	-5.5%	14.4%	14.2%
High Yield Bonds (Vang. High Yield)	1.2%	6.8%	7.9%
Commodities (AIG Commodity Index since 4/03)	4.5%	9.9%	13.1%
Alternative Assets Group (AAG) (13 Fund Avg)	4.4%	9.5%	12.1%
AAG without Gold	6.1%	8.3%	11.4%

As we entered 2007 we listed the following issues as the main focus for the markets: oil prices, the Fed and interest rates, a slowing economy but no recession, housing, risks due to the trade deficit, and Washington D.C. So far, things have developed the way we expected. Oil prices have remained high, housing is weak and slowing the economy (GDP grew only .7% in the first quarter) but there is no recession looming, and there has been a lot of noise from Washington but no action. Interest rates and the trade deficit have been the wild cards but not exactly for the reasons we anticipated.

For several years we have been pointing to the trade deficit as a risk, but have had to concede that it just hasn't seemed to effect anything. Recently,

we may have seen that change. From May to June we witnessed short and intermediate term interest rates increase by ½ % -- from 4.6% to 5.1%, 10-year yields went even higher to 5 ¼ %. Part of the reason for the change was due to changed perceptions in the U.S., but part of it was also due to rising rates overseas. As a large debtor nation, our bonds compete with foreign bonds for capital. This is one of the risks we face due to the trade and budget deficits, and it is likely to only get worse in the future.

Oil prices have jumped over concerns about summer supplies following the release of a U.S. government report that showed gasoline inventories dropped unexpectedly as the driving season neared its peak. The weekly petroleum supply snapshot has been watched closely during a spring and early summer that has had an unusually high number of refinery outages. This has led to record high gasoline prices at the pump. We claim no ability to forecast oil prices, but as we've commented before most of the world's oil is in places not very friendly to the U.S. We have research projects ongoing looking for companies or mutual funds involved in alternative energy, or that benefit from global warming, but these are longer term opportunities. Currently, we believe energy needs to be an important part of an investor's portfolio, but we are not so enamored that we're willing to bet the ranch. Energy represents 10% of the S&P 500, and we target an equity allocation of that amount or more.

Housing activity and prices have not hit bottom nationwide, and consumption growth has and will continue to weaken. Higher borrowing costs, high gasoline and food prices, and slowing job growth will all diminish the consumer's ability to spend. But never underestimate the American consumer. We find money to spend. For example, according to Business Week, household financial assets increased by $1.5 trillion in the second quarter due to the increase in the stock market. This far surpasses any decline in home values. Most economists now expect second quarter economic growth to rebound to the 3% - 4% range, so we're sticking with our forecast of a slower growth rate but no recession.

Due to the economic weakness from housing, high gas prices, and slower consumer spending we think the Fed is unlikely to raise interest rates. On the other hand, because there are some inflation pressures from energy costs, a weak dollar, and tight labor markets we also expect no decrease in rates. Interest rates will probably stay within a narrow range of 4.5% to 5.5%.

We've had a lot of questions about our view on the private equity boom. In our opinion, there are positive and negative implications. Generally, we don't view the taking private of a public company as bad. In fact, some companies are probably better managed when they aren't focused on short term quarterly earnings. Also, additional buyers in the market improves valuations and forces managers to work harder for shareholders to maximize returns. The downside comes from too much leverage, and there is a huge mountain of leverage out there. Combined with the billions of dollars of derivatives, there is potential for a nasty correction if something negative surprises the financial markets. Currently, greed is driving Wall Street, but investor fear can replace greed incredibly fast. The final positive and negative from the buyout binge is increased demand for stocks. Much of the demand for equities this year has come from buyouts and corporate share re-purchases. There's nothing wrong with this, but more balanced demand between the public, institutional investors, and these groups would be better.

Strategic Allocation Decisions:
We've made no changes to our allocation models this year, and most of our tactical moves have proved correct. As previously reported, we began reducing small and mid cap allocations in the middle of 2006. Returns over the last year have been about equal between large, mid, and small caps. We've correctly under-weighted bonds for a few years, and we've maintained an over-weight to international equities. Our Alternative Assets Group has outperformed bonds as expected, and REITs have finally had the correction we anticipated.

Performance:
Our accounts have a good start to the year with balanced accounts up 5% to 6% and equities up 9% or more (everyone's account is different, so your portfolio may be higher or lower than these averages). After struggling against equity benchmarks last year, we're finding most accounts out-performing this year. Our individual stocks are outperforming the S&P 500 on average with few significant negative surprises and more than a few positive ones. Complacency and over confidence are the enemy though so we will remain diligent for the balance of 2007.

Asset Class Recap

U.S. Stocks:
According to our multi-factor model the market is currently 6½ % undervalued. The P/E on 2007 estimated operating earnings is 16.3, and based on 2008 estimated earnings is only 14.5. However, the consensus estimated growth in earnings for 2008 is over 12%. This seems too high. Regardless, despite the increase in the Dow Jones to 13,500 and the S&P 500 to 1,500, it is not overpriced. Stock prices have only increased in line with earnings.

Earnings outperformed expectations again in the first quarter increasing 8%. For the year, S&P earnings are projected to increase 7%. As we've stated before, we would not be surprised to see this estimate outperformed again. U.S. corporations remain in solid financial condition with strong balance sheets.

Investment-Grade Bonds:
Last year, we predicted a peak in rates at 5.25% (10 Year Treasury bond) in May and got it about right. This year may look similar with rates peaking at 5.25% (June this time) and meandering sideways for the rest of the year. We expect a range of 4.5% to 5.5%. Total returns (includes price changes) will probably improve, but are still likely to remain below the returns from other asset classes, possibly including cash.

Dividend / Defensive Group:
Generally, this strategy has not performed as well this year. There are a few reasons but the main one is what has happened to the bond market. Many of these stocks such as utilities, are sensitive to changes in interest rates. When rates rise, bond prices and income stocks decline. There also tends to be a lot of banks and other financials in this group, and they have underperformed this year as their profit margins get squeezed from high short term rates. And finally, some big defensive companies such as Johnson & Johnson, Procter & Gamble, and General Electric have simply had a flat to negative year in their stock prices. On the other hand, the group has still outperformed the bond market with an average return of 2% to 4% while bonds have been flat.

Alternative Assets Group:

You may remember this sector is our alternative to hedge funds, private equity, and other investments that don't fit into the traditional asset classes of stocks and bonds. We joke at our investment committee meetings each week that the returns continue to do exactly what they are supposed to do, each week, boring but predictable. The return continues to be 60% to 75% of the return on stocks with less than half the volatility. It has been an excellent alternative to bonds or stocks as shown in the following table:

	AAG (13 funds)	AAG w/o Gold	Bonds	S&P 500
YTD Thru 6/30	4.4%	6.1%	0.1%	7.1%
1 Year	10.6%	10.6%	6.3%	22.8%
3 Years	9.5%	8.3%	4.0%	11.9%
5 Years	12.1%	11.4%	4.0%	10.7%

These returns are an average of the mutual funds we select from. Actual results will vary.

Hedge funds and private equity get a lot of attention in the financial press partly because they are the fastest growing sector of the asset management business. While there are some great funds out there, we will continue to look for mutual funds or other alternatives that have better visibility, lower fees, better regulation, less risk of fraud, and we think attractive results.

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.

After eating crow last year, we have had a very good start to 2007. Our model equity account is up over 12% giving us a 5% advantage over the S&P 500, our benchmark. We've had excellent performance from a number of companies such as Oshkosh Truck (+30%), Toro (+26%), Schlumberger (+34%), Express Scripts (+40%), and Apple (+44%). We've had a few losers but even those are down only slightly. We sold a couple of our bank stocks, had one company taken private (Harman), and sold Scotts due to a restructuring strategy we didn't agree with. The only real mistake we made was to sell Valero, which has had a great year due to the spike in gasoline prices.

We remain underweighted in technology but did move to increase our allocation to this sector. Like in many of our other portfolios, we've used a technology mutual fund and an exchange traded fund to increase our allocation. We subscribe to the Warren Buffet philosophy that if we can't understand it don't invest in it, but we think the sector is too important to ignore and may perform well for the balance of the year.

Foreign Equities and Fixed Income:

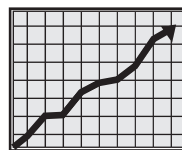
No changes to our views expressed previously: "we continue to have over weighted positions in foreign equities and fixed income in our model portfolios, but we would not be surprised to see some moderation in relative performance. For the last several years foreign investments have significantly outperformed – emerging markets by a large margin. Some speculative characteristics are clearly forming, which usually leads to a nasty correction. However, with the U.S. dollar likely to be weak for some time to come, we believe international investments have attractive benefits."

Company News:

2007 has already seen its share of changes. Dale Dumaw left and will be pursuing a new career in real estate. Andrew Drummond joined us in February only to leave in June. He had an opportunity to work with some former colleagues as they launched several new mutual funds. We were sad to see both of them go but wish them both success. We have a great group of interns (some for only the summer and some for longer): Christian, Dylan, Sheldon, Lindsey, and Tyler. Steve Stein joined us as an Administrative Assistant; and we're very proud of Meagan D'Angelo who became a Certified Financial Planner last month. For those of you unfamiliar with the CFP, it takes 2-3 years of study followed by a 10 hour exam over two days. Meagan will be working more and more on financial planning projects for clients in the future. Robin Catlin will be sitting for the CFP exam this fall.

2007 marks the 19th year the company has been in business – originally started in Mike Sargent's basement. We'd 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.

Many happy returns,



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