



Trustees and Investment Advisors

Market Review

June 30, 2007

Dear Clients & Friends,

U.S. and global equity markets ended the mid-way point of the year with solid gains following strong performances in the second quarter. The S&P 500 increased 5.8% for the quarter, the Dow 8.5% and international stocks, as measured by the MSCI EAFE Index, rose 5.3%. These results left most averages with healthy appreciation levels on a year-to-date basis, as shown in the table below. Higher interest rates at quarter end, meanwhile, created better buying opportunities for bonds.

Major Market Averages & Yields June 30, 2007

| | Level | YTD% |
|-----------------------|-------------|-------|
| Dow Jones | 13,408 | +7.6% |
| S&P 500 | 1,503 | +6.0% |
| NASDAQ | 2,603 | +7.8% |
| MSCI EAFE | 2,262 | +9.1% |
| Oil | \$70.68/bbl | |
| Lehman Agg Bond Index | +0.6% | |
| Federal Funds Rate | 5.25% | |
| 6 Mos Treasury Bill | 4.94% | |
| 2 Year Treasury Note | 4.87% | |
| 5 Year Treasury Note | 4.93% | |
| 10 Year Treasury Note | 5.03% | |

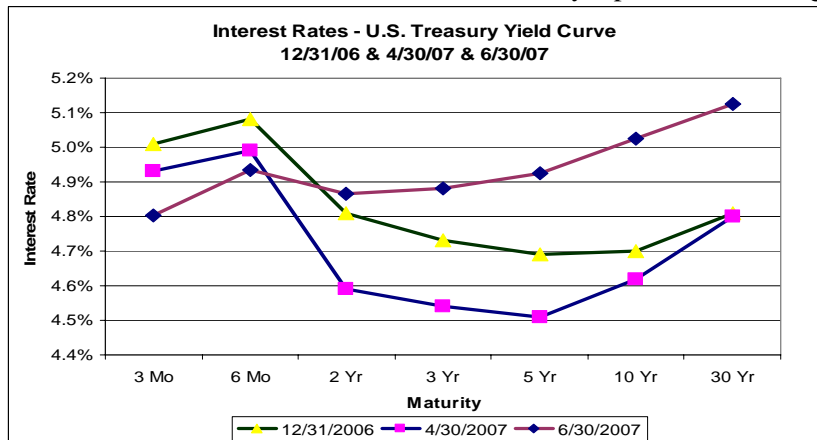
Equities Move Higher, But Rising Interest Rates May Be A Bigger Story

Former Fed Chairman Alan Greenspan stated several years ago that the bond markets presented a “conundrum,” with longer-term interest rates remaining surprisingly low despite factors that usually push rates up: strong economic growth and rising short-term interest rates from Fed rate hikes. What Mr. Greenspan was mindful of at the time was how stimulative low interest rates were on economic and market activity. Specifically, low long-term interest rates provided a proverbial “punch bowl” to many types of financial and investment activities, including the housing and stock markets. Therefore, a significant story for the quarter was that intermediate and longer-term interest rates took a major step higher after April 30th.

Often an increase in inflation expectations is to blame when long-term rates rise, but that was not the case in May and June. The lack of change in interest rates on TIPS (Treasury Inflation Protected Securities) and inflation predictors such as gold confirmed this. Other factors were also involved. Global investors, including foreign governments, bought fewer U.S. Treasury bonds than before, turning to other assets including commodities, buyout firms, or other countries’ equity or bond markets.

The surge in interest rates, as seen in the chart below, is an important development for the markets and the economy going forward. In essence, the “punch bowl” is being taken away and the cost of borrowing is going up.

The stock market seemed mostly unaffected by this increase in rates, however, and rose throughout the quarter. One catalyst for equities in the quarter was companies’ first quarter earnings beating expectations. Earnings were up 7.9% on a year-over-year basis as measured by S&P compared to early estimates in the 3-4% range. An additional factor behind stocks’ advance was the continued takeover and buyout activity, particularly affecting mid-cap stocks. But along with the higher interest rates came a renewed sense of risk in the stock market (and other assets) as seen in the volatility chart on the next page. Meanwhile, the U.S. dollar staged a modest rally near quarter-end. We and most investors view the dollar’s increase as only a pause from a longer-term downtrend.





Note the trend higher in volatility

U.S. Economy: Slower First Quarter; Stronger Second Quarter is Inventory-Related; Housing Worsens

First quarter U.S. economic growth came in at a surprisingly tepid 0.7% annualized increase. However, consensus estimates for the second quarter are between 2.5%-3.5% because of a rebound in business inventories (to replace that which was liquidated in the first quarter) as well as sustained levels of consumer spending and a smaller trade deficit. The important question relative to the inventory building by businesses is will consumers and businesses buy all that is now in the pipeline? Recent consumer confidence and business surveys are mixed.

Meanwhile, some, including the Fed, believe that “core” inflation as measured by the Federal Reserve should trend lower throughout the summer and remainder of the year. The disparity between core inflation, which excludes volatile food and energy components such as gasoline and “headline” numbers, which include them, have rarely been as wide as now. In the latest reading by the Bureau of Labor Statistics, “core” inflation increased at only a 2.0% rate year-over-year and a rate of 1.6% on a three month annualized basis while the “headline” rate increased at a 7.0% annualized basis over the last three months. We believe that the disparity between “core” and “headline” inflation makes a Fed rate cut unlikely unless the U.S. economy weakens significantly.

There appears to be a long road ahead for a recovery in the housing market. Data released at quarter end showed further declines in new and existing home sales, particularly on a year-over-year basis. The National Association of Homebuilders’ index fell in June to the lowest level since 1991. Contrary to predictions of a rebound by the summer, inventories of unsold existing homes swelled to a capacity equal to nine months of supply, up from more than six months at the start of the year. The decline in home prices has led to a drop in the pace of home-equity withdrawals while higher interest rates have led to an increase in loan delinquencies and defaults.

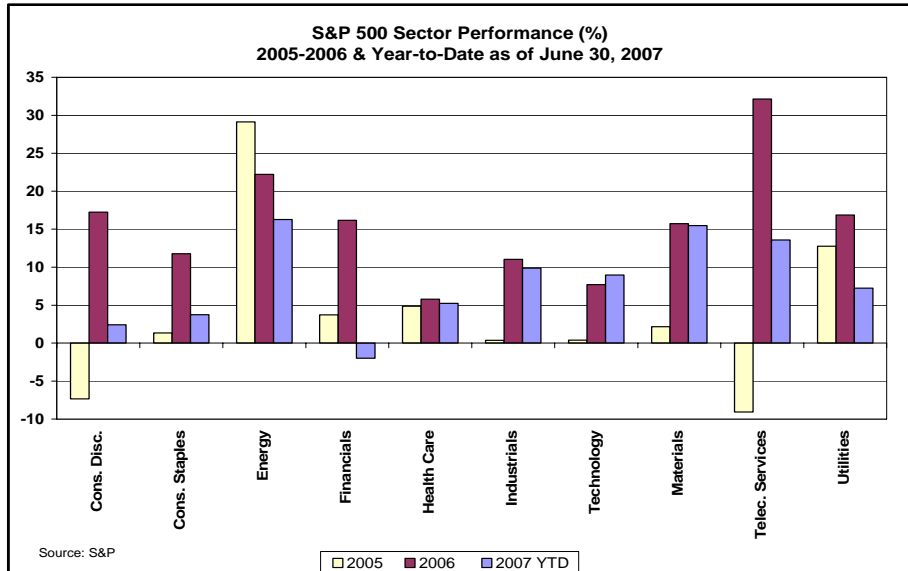
One’s view of the health of the economy going forward hinges on U.S. consumers, who account for more than two-thirds of economic activity. Despite the slide in housing and higher prices for gasoline and food, consumers continue to be resilient, enabled by a stable labor market with unemployment at a relatively low 4.5% level and modest gains in payrolls. Additional buying power has come from credit card spending. Federal Reserve data show a surge in such “revolving” debt levels, mitigating the effect of lower mortgage equity withdrawals.

Many point to signs that stronger second quarter economic growth represents a turning point in the economy after a slower first quarter, with business spending on the rise and global economic growth still on firm ground. Data indicate that second quarter growth is largely inventory related and that a reduction in the trade deficit may be as much from a decline in consumer demand for imports as a rise in exports.

Higher interest rates should start to pinch consumer spending and further damage housing related businesses while posing stiffer competition for financial and utility stocks, as we discuss further in the next section.

Equity Markets: Energy, Technology and Industrials Lead in the Second Quarter

Energy stocks led the quarter in the S&P 500, gaining 14.3%. Technology and Industrial stocks were second and third best, rising 10.2% and 9.2%, respectively. On a year-to-date basis Energy, Materials and Telecom are the best performers. June's decline of 1.6% for the S&P marks only the third drop in the last eighteen months. In the past 12 months returns of many market indexes are above 20%. The chart below shows the gains in the sectors of the S&P 500 for 2007 on a year-to-date basis along with the full year returns for 2005 and 2006.



Full year earnings growth estimates for companies in the S&P 500 are unchanged from levels predicted in March, despite stronger than expected first quarter numbers and increasing estimates for the second quarter. Because of the advance so far this year in stocks without any change in full-year earnings estimates, S&P now predicts a 2007 return of 6.5% for the market. On a year-to-date basis the S&P 500 is up 7.1%, leaving little room for gains by their numbers. The fact that markets have moved close to full year return estimates without any lift in the earnings outlook is significant. The U.S. stock market is more fully valued now than three months ago.

Popular financial publications point to “mega” cap companies selling at relatively low valuation levels compared to small and mid-cap. We have agreed with this assessment but now find many large cap stocks to be expensive too. On a prior-year basis, the S&P 500 is currently trading at an average of 17 times earnings, which is close to historical levels rather than being cheap. Moreover, adjusted for average levels of earnings and profit margins, the market is trading at a P/E closer to the mid-20s. By our analysis, earnings and profit margins are near peak levels and P/E multiples applied to future earnings are already elevated for numerous sectors. Share buybacks by companies remain a vital component of the growth in earnings per share, enabling companies to meet their guidance levels. The declining dollar was also a major factor in first quarter earnings coming in above targets.

We continue to be active with existing holdings when targets are met and expect to find better value opportunities from the higher levels of volatility, elevated valuations and lowered earnings expectations.

For example, near quarter end several retailing stocks declined after warning that their earnings estimates were going to be difficult to meet with slowing consumer activity. We look at these instances as possible opportunities to buy quality companies that have experienced price declines greater than warranted.

Financial stocks, notably banks, and utility stocks face challenges from higher rates compared to more defensive sectors such as Health Care and Industrials. Our portfolio weights in these sectors, along with Energy and Technology, and our value discipline worked well in the first half of the year. Foreign stock additions to the portfolio via ADRs have provided incremental returns. By contrast, underweight positions in Financials, Utilities and Consumer Discretionary stocks based on valuation levels and earnings outlooks proved to be timely results of our process as these have been weaker performing sectors.

Fixed Income – Yields Move Back to Attractive Levels Relative to Cash

The chart below shows the rise in the 10-year U.S. Treasury bond yield, from 4.64% at the end of March to 5.03% at the end of June. The move higher in intermediate and longer-term yields made additions to existing bond ladders attractive for client portfolios relative to cash. Government Agency bond yields topped money market rates for the first time since last year. As such, we moved a portion of cash reserves into bonds and extended duration modestly in some accounts in the last few weeks of the quarter after yields rose. Municipal bonds continue to be useful for taxable clients given the favorable after-tax yields.

We have moved more money into intermediate government agency bonds at current levels, reflecting their relative attractiveness over money market rates – particularly for taxable clients who benefit from the Maine state tax-exempt status of Agency bonds. Corporate bonds remain relatively less attractive.



Speculation about potential cuts in short-term interest rates by the Federal Reserve all but disappeared in the second quarter, with the probability of a Fed cut by year-end now standing at only 15%. Some believe that given moderate but not low inflation levels, a growing economy and the possibility of an ever tighter labor market, the Fed may not be able to lower rates throughout 2008 unless substantial economic weakness unfolds.

Summary – U.S. Equity Market More Fully Valued; Patience and Discipline Will Identify Opportunities

Current valuation levels without tangible signs of full-year earnings improvement lead us to be patient on the buying side and active in taking gains in stocks above target levels. Despite equity turnover at or below average levels, healthy appreciation from past years has resulted in higher levels of realized gains at this point in the year. We will continue to review gains with clients and balance tax budgets with our active management.

Our disciplined, bottom-up research process and team approach maintains a steady course for equity and bond portfolios alike. As always, we look forward to our next opportunity to visit with you.

Christopher H. Lyford, CFA
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