



Trustees and Investment Advisors

Market Review

June 30, 2008

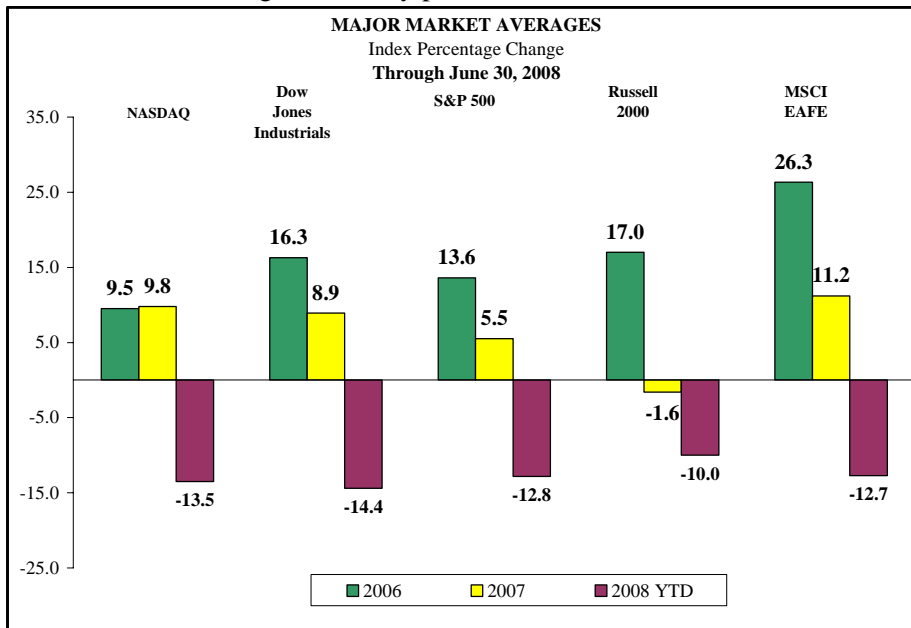
Dear Clients & Friends,

The second quarter of 2008 saw equity markets rebound from their March lows until the end of May, and then head back down sharply in June as rising oil prices, weak housing markets, and related troubles for U.S. financial companies eroded investor confidence. Continued volatility in the U.S. dollar, generally weak economic data and ambiguous comments by the Federal Reserve about inflation and interest rates also affected market sentiment.

The S&P 500 ended the second quarter with a decline of 2.7% on a total return basis, while the Dow Jones Industrial Average declined 6.9%. Year-to-date the S&P 500 is down 11.9%, while the Dow is down 13.4%. Global markets rose and fell similarly in the quarter. Excluding the positive effect of the weak dollar on foreign returns in the past twelve months, non-U.S. markets have declined more than 22% as measured by the EAFE index. The chart below reflects the returns of the major markets (in dollars) in the first and second quarters as well as the annual returns for 2006 and 2007.

Soaring energy prices were a major concern for consumers and investors in the quarter. Crude oil surpassed \$143 per barrel at the high point and has risen more than 45% in 2008 alone. Gasoline prices have risen in tandem. Consumers are fretting about their summer travel plans, with talk of “staycations” now in the press, but also many are looking ahead to the coming winter’s heating bills. We discuss the supply and demand dynamics of the energy markets along with other factors affecting commodity prices further in this letter.

<i>Market Statistics</i>		
<i>June 30, 2008</i>		
	Level	YTD%
Dow Jones	11,350	-14.4%
S&P 500	1,280	-12.8%
NASDAQ	2,293	-13.5%
MSCI EAFE	1,967	-12.7%
Oil (WTI)	\$140.00/bl	
Lehman Agg Bond Index	+1.1%	
Federal Funds Rate	2.00%	
6 Mos Treasury Bill	2.21%	
2 Year Treasury Note	2.80%	
5 Year Treasury Note	3.50%	
10 Year Treasury Note	4.09%	



U.S. Economy – Employment, Manufacturing & Housing Weaken; Inflation Concerns Continue

Part of the challenge for the stock market at the end of the quarter was related to the disappointing economic data and its ultimate effect on the outlook for corporate earnings. As we have written previously, a centerpiece of the economic outlook in 2008 related to the employment situation. According to the May payroll and unemployment figures, job growth continued to decline for a fifth straight month. Unemployment surged 0.5% to 5.5% from the prior month. Related levels of consumer confidence, which are a barometer for potential consumer spending, fell to 15 year lows. Meanwhile, manufacturing activity, as measured by the May industrial production data, showed the first year-over-year decline since 2003. With higher input costs, slowing job growth and headlines of declining demand for high fuel consumption vehicles, the manufacturing and consumer data is not surprising.

U.S. housing data remain quite weak and show no sign of bottoming. Reports still show lower prices in many markets. Homebuilder sentiment is at an all-time low, new home construction continues to contract at a double digit year-over-year pace and inventory levels remain nearly twice the average levels. Moreover, house prices nationally are falling. The Case-Schiller home price data for May saw a year-over-year decline of more than 15%. Lower prices may eventually lead to improving sales, but given the tepid employment situation, high consumer debt levels and mortgage rates that are higher than a year ago, a full recovery in housing is not nearby.

Inflation data in recent months have renewed investor concern. In the U.S., the annual rate of inflation hit 4.2% in May, according to the Bureau of Labor Statistics. Excluding food and energy, “core” prices have risen just 2.3% by contrast, highlighting the impact of those two major categories. However, other prices are also rising, and even within the “core” rate, for example, health care expenses rose 4.1% in the last 12 months.

Globally, inflation fears are on the rise too. Germany has seen producer prices increase at 26 year highs, and China is experiencing inflation levels closer to 10%. Monetary authorities in those countries are discussing the need to raise interest rates and tighten lending standards to stem the inflation tide. The silver lining on inflation for most countries, including the U.S., is that employment costs have not risen in the same manner. Historically, inflation becomes a runaway problem more from wage pressures than commodity costs. With a slowing U.S. economy, inflation should generally be contained, although still frustrating at the grocery stores and gas stations.

The implication of the continued soft economic data is that corporate earnings are likely to slow. We have been anticipating this for some time and are now seeing Wall Street’s estimates lowered too. Standard & Poors, for example, lowered its 2008 earnings estimates for the S&P 500 from a 16% growth rate at the start of the year to 8% now. We expect other companies and brokerage analysts to reduce estimates further.

Energy Prices – What’s Behind the Big Increases and What Will It Take to Slow them Down or Reverse?

For consumers, the sharp rise in energy prices, both directly at the pump, or indirectly in prices of commodity intensive consumer goods or services, has presented challenges to already tight consumer budgets. Indeed, oil prices have more than doubled in the past year, from \$67 per barrel to \$140 on June 30th.

Why have energy prices risen so steeply in the past year? First, supply and demand data indicate that rapid growth in emerging market countries such as China and India is beginning to put a dent in global supplies. Although these countries still account for only one-eighth the amount of oil consumed by the U.S., their rate of growth is in double digits compared to almost no change in U.S. demand. Current worldwide consumption is estimated to be 88 million barrels a day compared to 87 million barrels of supply according to the International Energy Agency. As the growth of new supplies has slowed there are increasing calls for more drilling activity.

Second, the lower U.S. dollar is having a major impact on the increase in the price of oil and gasoline. Oil is priced globally in dollars, so producers want to be compensated with more of the U.S. currency if its value is falling relative to other currencies. A related tie to the price of oil is that the dollar’s decline picked up pace this past year with the aggressive action by the Federal Reserve to lower interest rates, as seen in the chart below:



Third, in the financial markets, there has been a growing demand for nearly all commodities including oil, rice, copper and iron ore by institutional investors. This includes investors such as large pension funds and endowments, which have increased allocations, likely permanently, to commodities. Such investments have increased to over \$250 billion in the past five years from next to nothing by comparison before 2000. A fourth effect has been from pure speculation trades by investors chasing the recent higher returns of commodity markets.

Our view is that the supply and demand data will continue to result in sharply higher prices in the longer term barring any major energy saving technologies and global (not just in the U.S.) demand changes. Near-term volatility in commodity markets could continue to mean sharp upward and downward swings in prices. A case could be made for both higher or lower prices near term, based on the factors mentioned above. On the stock side and the economic front, a fall in the price of oil could provide much welcomed relief and stronger results.

Equity Markets – Financial Stocks Drag Down the Overall Indexes, Again.

As the table below shows, the financial sector of the S&P 500 ended June as the worst performing category in the index in terms of the quarter and year-to-date returns. Financial stocks renewed their downward trend after a brief rally from early March to the end of May. Stocks including commercial banks, brokers and insurance companies were particularly affected depending on their exposure to problems from sub-prime debt. In addition to financial and consumer weakness, technology and industrial stocks were also weak late in the quarter.

The troubles of financial companies have forced some to raise or preserve capital either through selling new stock to foreigners (e.g. Citigroup and Lehman Brothers) or to lower their dividend rates (e.g. Wachovia and Key Bank). For the year-to-date, financial sector stocks are down over 30%. On a year-over-year basis they are down over 44%. The drop in financial stocks has had a disproportionate effect on S&P 500 earnings and the major indexes since last summer. **Our research leads us to conclude that a bottom is not yet in for financial companies, especially those with low-quality debts, or stocks particularly exposed to strapped consumers. That said, significant value opportunities are likely to arise now as new lows are reached in expectations.**

Energy and materials stocks benefited from the spike in prices for basic commodities. The most important facet of the current equity market is that the slowing employment picture and rising commodity costs mean earnings expectations are still too high, despite notable estimate reductions by many analysts. Our process continues to weed out the stocks most affected by the fundamental issues they face and identify new opportunities to invest in quality companies that have been unfairly beaten down because of the general malaise in the financial markets.

Active investment management and data-based analysis rather than macro observations or indexing remain critical steps in our disciplined stock selection process.

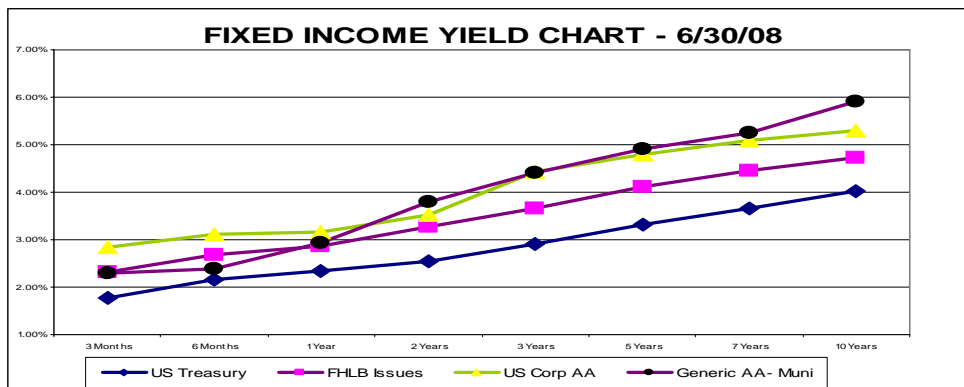
S&P 500 Sectors			
	% of Index	2nd Quarter 2008	Year-to-Date 2008
S&P 500 Index		-3.2%	-12.8%
Total Return (with dividends)		-2.7%	-11.9%
Energy	16.2%	16.9%	8.1%
Materials	3.9%	3.9%	0.2%
Utilities	4.0%	7.1%	-4.3%
Consumer Staples	10.8%	-5.9%	-8.5%
Information Technology	16.4%	2.3%	-13.4%
Health Care	11.9%	-1.7%	-13.5%
Consumer Discretionary	8.1%	-8.1%	-13.9%
Industrials	11.1%	-10.6%	-14.6%
Telecommunications Services	3.3%	-5.1%	-18.9%
Financials	14.2%	-19.0%	-30.9%

Fixed Income and Interest Rates – Why are Mortgage Rates Rising?

Unlike the first quarter, the second quarter saw rates for maturities beyond one year rising rather than falling. While the Fed did lower short term rates one additional time, to 2% for the Federal Funds rate, they also signaled a certainty, for now, that they would not need to lower rates any further. In fact, as recently as their June 25th meeting, the Fed reiterated a concern that rising inflation expectations are very important, because of higher food and gas prices, particularly. Because of their comments, the possibility of a rate increase is not out of the question. However, it is hard to see how rising interest rates would slow the surge in energy and food prices.

Expectations have swung back and forth on whether the Fed will raise rates as soon as this fall. On the “yes” side, the inflation numbers do appear to be stubbornly high because of the increase in commodity costs. If anything, the official statistics understate how much consumers need to increase their budgets for basic goods and services. In addition, fighting inflation is a primary mandate of the Fed. On the “no” side of whether the Fed will raise rates is that historically the Fed rarely pushes up interest rates while employment is declining, which is exactly the case at the moment. Unless employer sentiment improves and hiring begins to pick up, the usual case for rate hikes is not in place. Indeed, the Fed continues to be caught between a rock and a hard place in balancing a slowing economy, higher than desired inflation and the low dollar. Interestingly, for the first time in decades Fed Chairman Ben Bernanke commented that the Fed should indeed have a role in supporting a strong currency. This comment, along with the recent inflation data, caused rates across the yield curve to rise over 0.5%.

For investors, the result has been slightly better yields for fixed income portions of portfolios. The chart below shows the most recent rates available for different types of bonds. Of note, high quality corporate bonds offer better yields at present compared to government agency bonds or tax-equivalent municipal rates. Because of continued problems in the financial sector, however, we favor industrial bonds in most cases.



Summary

The market and economic environment contains more pessimism now than at the end of the first quarter, as measured both by investor sentiment, consumer confidence data and quarter end index levels. There is ample justification in the data for consumers and investors to be cautious. Market pundits who cite historically low valuations and a great buying environment may be premature. Their optimism in early March proved wrong.

This year, price to earnings ratios based on forecasts of future results have proven to be an unreliable measure of valuation. As the economy slowed analysts have cut their growth forecasts in half for some companies. Based on the reduced estimates, the overall market averages are just beginning to present more attractive levels and the number of individual stocks at reasonable prices is increasing. We continue to believe that better opportunities for quality new investments lie ahead, but patience and care in managing existing holdings is paramount.

As always, we look forward to our next opportunity to visit with you and appreciate your continued support.

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Senior Vice President, Chief Investment Officer