INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

MARKET SNAPSHOT: MARCH 30, 2007	DJIA: 12,354.35	NASDAQ: 2,421.64	S&P 500: 1,420.86	10 YEAR TREASURY NOTE: 4.64%F

RECENT MARKET VOLATILITY

The recent one-day 500 point decline in the DJIA sent jitters through the investment community, needlessly we believe. Nonetheless, it does provide the opportunity for us to help explain things a little more than we all get from the daily media coverage. First of all, remember this drop simply gave back a small portion of the great gains investors made only recently, and that most of the declines are already in the process of being restored by the markets.

Secondly, please know that most of that one-day loss happened that afternoon in just two minutes—repeat, two minutes—of trading that day. We have often written about the huge derivative trading that goes on today, noting the concerns that we and other investors should have regarding the massive leveraged market trading that takes place daily, largely by hedge funds and their ilk. Remember that these are transactions by speculators seeking short term profits by buying and selling "non-securities" that only represent the actual stocks or bonds that are behind each derivative or option. Investors typically buy and hold securities over some period of time, but these traders borrow heavily each day to finance the purchase of contracts backed by the actual share or bond prices, at a fraction of what you and I would pay to buy and own such securities.

Our concern, as we express fairly regularly now, is that these transactions are so huge now as to be totally outside the ability of worldwide regulatory bodies to comprehend. Most regulators regularly and freely admit that the size of this trading is beyond their ability to calculate, regulate, or even to know how big it actually is in total. Last month's large and sudden price decline is perhaps the first wake-up call to regulators that such trading may now be beyond the world's major clearing systems to handle. When the sharp two-minute drop in prices happened, almost everyone stood silently, some even aghast, that the volume of shares so suddenly entered for clearing or settling sales orders could not be matched by the clearing systems to buyers willing to purchase. Accordingly, prices were momentarily marked down to match the last transaction price.

The purpose of this Letter is not to address what happens next in this modern day challenge, but rather to let investors know that in actuality nothing happened to share valuations other than for those playing these giant leveraged day trade games. Once this jolt happened and share trading got back to some semblance of normalcy, investors saw bargains at the lower price level and stepped up their buying. Remember that almost all professionals today use computer models to provide them with every major security's "warranted" price level based on each issuing company's last reported financials. Once quotes fell below those warranted values, buyers were again eager to buy and own stocks and bonds. Of course, many still held back waiting for the other "shoe to drop" in case the traders were not yet done with their shenanigans. After a pause, buyers once again chose to begin accumulating securities that now seemed undervalued according to the models they used.

We, of course, immediately took another look at the basics, like the economic outlook, the inflationary picture, and any probable fiscal changes coming out of Washington. Our read on these issues was that nothing had really changed. All that was known before the market drop was still the same afterward. This should not come as any surprise to our regular readers or to our clients. Much of our focus is always on the big picture, after which we make investment decisions based on these macro issues in tandem with the specific financial fundamentals of the companies in which we want to invest client monies.

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With this as an explanation of this one-time occurrence, the opportunity is now opened for us to further explain a much more important change in the investment management industry that we have alluded to in past Letters. This major change has to do with the daily continuing marketing and media onslaught that tries to convince people with money to invest that the secret to success is to try to out-pick the markets regarding specific stocks or bonds.

We said last month that such an idea is not only absurd on the face of it, but that it is also futile today. We won't repeat here all the reasons why modern market factors are not only widely known instantly, but also known by everyone who cares to receive key financials. However, there is now ample evidence to make us confident of the fact that such an approach is no longer statistically able to yield any extra rewards for taking the added risks. It is our considered opinion that today it is plain outright wrong that investment managers are still allowed to aggressively solicit persons of wealth on that basis except for the purpose of raising capital for new, untested enterprises that have little or no financial history. Such new companies are of little interest to fiduciaries charged with protecting and conserving client assets. We are certain that after this recent market episode there will be more regulatory attention forthcoming regarding the massive speculation that seems to be turning capital markets everywhere into little more than casinos where bets are placed in large volume on price changes in near total disregard of legitimate free market capital purposes.

It is also becoming increasingly obvious that the sideways markets for the three or four years prior to 2006 are linked in some way with the simultaneous surge in derivative usage and with the dramatic rise in hedge fund investing that employs perhaps dangerously heavy borrowing practices. Markets during that period suddenly, and without any clearly related financial reasons, departed from the historical pattern of share price movements closely correlated to corporate profitability. It is only over the past year or so that evidence is reappearing that the historical correlation is restoring the connection of prices to earnings for major public companies, as should be so.

CONCLUSION: Media attention to the recent rise in the default rate on what is referred to as "sub-prime" lending on real estate has been given as a major reason for stock market price volatility. History provides some support for such concerns. Nonetheless, it is correct to say that today, things involving real estate lending are 180 degrees different than during past periods when lenders became over-extended when real estate prices rose sharply, as happened in the U.S. a year or so ago. Today, most banks are flush with cash, have strong capital ratios, and make sound mortgage loans to qualified home owners, by and large. The Feds have little concern that the lending by some on speculative real estate investing will impact our banking system. Fed Chairman Bernanke, Treasury Secretary Paulson and others have said as much in testimony to Congress and in public comments. When the real estate speculative bubble burst there should have been no question that once again speculative lenders and borrowers would suffer damage, as always happens in a free market. This is now happening and the quite normal correction is underway. It is also manageable by our financial markets and should be of little concern to long term investors in solid public company shares. Once again, our advice is: gradually move away from fixed investments and stay invested in shares of soundly financed and managed public companies with most of one's assets. And, above all, spread risks over a package of stocks *(i.e., index)* rather than be in just a few stocks or the stock of a single company. Believing that today one can out-pick the professionals who have enormous research capabilities at their command to determine warranted stock prices, is unworthy of pursuit by any thinking person.

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