INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

MARKET SNAPSHOT: AUGUST 31, 2007 DJIA: 13,357.74 NASDAQ: 2,596.36 S&P 500: 1,473.99 10 YEAR TREASURY NOTE: 4.54%

S.N.A.F.U.

Situation Normal, All Fouled Up. It's a term the military coined during WWII to notify authorities of battlefield conditions. Today, investors might consider it an apt description of current financial market conditions.

After the Dow Jones Industrial Average had languished in the 10,000 range for several years, stock prices suddenly took off. A heady 4,000 plus point rise was followed by a precipitous decline of over 1,000 points in a matter of a week or so. True, these market gyrations are a bit unusual by historical standards in that for the three or four years after 2000, stocks failed to move higher in tandem with corporate profits which were steadily rising in favorable U.S. and world economies. However, our point is that these days stockholders should not view such moves as abnormal or a source of worry. The difference between now and times past is simply the speed at which prices can change in today's highly electronic world.

Before the advent of hedge funds and massive derivative usage around the world, stock buyers and sellers had time to deliberate on an advisable action to take, if any, on a daily basis. Today, there is little or no time for such deliberations. Once the herd instinct kicks in, traders push buttons for these kinds of investment funds and the trading volume generated is staggering both in size and in the speed at which it is completed.

This reality makes it imperative that conventional investors and their managers hold on to a longer term perspective and take these sudden market moves into consideration before making decisions. If we can all accept the fact that there is enormous liquidity everywhere now, and it is always itchy to find another way to grab quick profits using leverage and rapid trading—which can be and is being done—then it may become a little easier to tolerate the recent stock selling madness. This is the price to be paid for those who want to participate in the ongoing economic growth both here in the U.S. and abroad by investing in the stock market.

In brief, the key issues over the past month that triggered trader reactions were:

1. Subprime mortgage lending failures; and
2. Fears of the potential for a looming banking problem.

Quick rebuttals to these issues are:

1. Subprime lending was ill-conceived from the start and is not a precursor of anything even remotely like the S&L lending crisis of the past; and
2. Today's well-capitalized banks are fully in control of their lending practices with the Fed is right there to add liquidity if needed.

Indeed, many Wall Street firms had a feast creating new types of securities to sell to large investment pools when they gathered together a lot of mortgage paper, broke it into pieces, and then sold the pieces off to those looking for higher risk securities in hopes of garnering high returns. Now that it is time to pay the piper, a lot of these creative types are scrambling to try to minimize the damage and their losses. The upset this has caused in some marginal credit markets is most certainly unpleasant for the players who engaged in these activities. But, it has little to do with investors who have stayed with the more conventional ap-

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proach of buying and holding solid investment securities, both bonds and stocks.

The worry was that such activities could spill over into the broader markets and cause a free-fall in prices. However, recent support for stock prices in the face of a lot of bad news around the "Street" offers plenty of reassurance that so far, most of these problems are relatively insignificant to the mainstream economy and financial markets.

Considering the way market trading works now, another factor worth noting is that "indexing" portfolios makes more sense than ever. We have often mentioned that few active traders and managers are able to consistently outperform the returns that the 30 stocks in the Dow Jones Industrial Average deliver over any reasonable time period. Many try, but few deliver. Parenthetically, we cannot resist passing along that a major financial publication recently calculated, and reported in print, the return results for one of today's most popular TV stock gurus. Seems he has likewise failed to match the returns that investors earned who simply bought and held the 30 Dow stocks. So much for media-type investment advice.

CONCLUSION:

Perspective is a contribution we try to provide our readers of this newsletter each month, so consider this … We are pleased to report that there is little that is fundamentally unsound in the factors that genuinely impact the share "value" of stocks issued and outstanding for most major public companies. As readers know by now, we monitor the economic outlook closely, evaluate forecasted company profitability on a quarterly basis, seek any evidence of inflation's resurgence, and make our best determination as to present and future tax rates at the federal level. These four big factors are the ones that can and will change the outlook for share prices on a fundamental basis ahead.

Our advice continues to be: Stay the course even though it sometimes seems "*all fouled up*," because probably "*the situation is actually normal*."

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