# 2Q08

# THE FSAG ADVISOR

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## Market and Economic Update

It has been a wild one as of late for the financial markets, including such high-profile events as the failure of Bear Stearns, the opening of the borrowing window by the Federal Reserve to non-bank institutions, the Fed's interest rate cuts of 75 basis points, a reduction in capital holding requirements for Fannie Mae and Freddie Mac, the Bush Administration indicating its willingness to deal with Democrats on housing relief, the largest daily gain by the U.S. stock market in five years, a sharp correction in commodity prices and the lowest 90-day Treasury bill rates in 50 years.

Amid all of these events, the Dow Jones Industrial Average jumped 3.4% to 12,361, the S&P 500 advanced 3.2% to 1,329 and the Nasdaq Composite climbed 2.0% to 2,258. Financials led the way, and were up 10% for the week, and on the downside, basic materials and energy stocks were off around 5% as commodity prices experienced a (perhaps long overdue) correction.

Relying on both conventional and unconventional policy mechanisms, the Fed has been attempting to break the impasse occurring in credit and mortgage markets and is trying to prevent the negative feedback loop between financial sector and broader economic weakness from spiraling. While the fundamental pressures on the U.S. economy stemming from the decline in housing prices persist, and while credit markets are still under strain, policy reaction has become increasingly aggressive. The Fed has cut rates significantly over the past six months and has been using more creative means to provide stimulus (including the Fed's role in helping to negotiate the terms of JPMorgan's purchase of Bear Stearns, where, for the first time in its history, the central bank used its own balance sheet as a tool to combat a credit crisis). In addition to the Fed's actions, the Bush Administration has reversed course and is now negotiating with Democrats in Congress regarding housing legislation. We believe this indicates that something will, in fact, get accomplished on the legislative front to help the housing market.

To us, all of these positive signals indicate the likelihood that more of the ongoing credit crisis is behind us than is ahead of us. That does not imply, however, that we are out of the woods and that the economy is going to surprise on the positive side. Rather, this means that policymakers are diligently working to reduce the odds of a downward spiral and to rekindle some risk-taking in the financial system. This remains a major challenge since market sentiment has been crushed and will remain fickle for some time.

Regarding the broader economy, growth continues to bump along at a slow pace. In our opinion, the burden of proof in calling a recession remains on the bears. Fourth-quarter U.S. gross domestic product was positive, and the data released so far suggest to us that first-quarter GDP growth will be around 1%. Looking ahead, we would also note that second-quarter growth will be helped by the pending tax rebate checks.

These positive signals also support our view that stocks are in the process of establishing a cyclical low and are in a bottoming process. Recently, the major averages dropped to levels that were close to the significant lows established in mid-January. As is typical in secondary market lows, however, technical factors were stronger. Additionally, we would point to the fact that failures of major financial institutions (such as what recently occurred with Bear Stearns) are often coincident with market bottoms.

*Continued on page 4*

**2008 YTD Returns**

| | |
|---|---|
| *DOW* | *-3.95%* |
| *S&P 500* | *-9.47%* |
| *NASDAQ* | *-13.90%* |
| *Russell 2000* | *-9.90%* |
| *Russell Mid Cap* | *-9.98%* |
| *MSCI EAFE* | *-8.91%* |
| *Lehman US Agg.* | *2.34%* |
| *Lehman Muni.* | *-0.71%* |
| *10 Year Treasury Yield* | *3.45%* |

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## Investment Returns - Setting Reasonable Expectations

*"...any long-term average must be tempered by one's investment time horizon and what is achievable in today's market environment."*

Some investors continue to expect eye-popping portfolio returns year after year – even after the market's 2000-2002 downturn. Bringing such expectations down to earth means investors resetting their sites on more reasonable returns.

But what is "reasonable"? What return should investors look for in today's market? The best way to answer this is to look at performance over a long period – one that spans different business and market cycles. Stocks, as measured by the S&P 500 Index, have recorded an average annual return of 12.4% since 1931. This compares with an average annual return of 5.8% for bonds over the same period. But there have been many periods when stocks and bonds have significantly outperformed or underperformed these averages. Moreover, any long-term average must be tempered by one's investment time horizon and what is achievable in today's market environment.

**Return Expectations Should Reflect Risk**

It is important for investors to temper their expectations with their appetite for risk – beginning with their asset allocation. Those with more conservative asset allocations should not expect to reap the full rewards of a burgeoning stock market, no more than they should expect to suffer the full impact of a falling market. Likewise, those with highly aggressive allocations should expect significant year-to-year volatility. For these investors, it is especially important to keep a long-term perspective.

Return expectations should also factor into an investor's sub-allocations or fund investment styles. A client with a portfolio whose equity allocation is made up primarily of small-cap tech stocks should expect entirely different results than a client with a portfolio composed primarily of large-cap, dividend-paying defensive stocks. Again, risk should be the key consideration when setting expectations.

**Points to Remember**

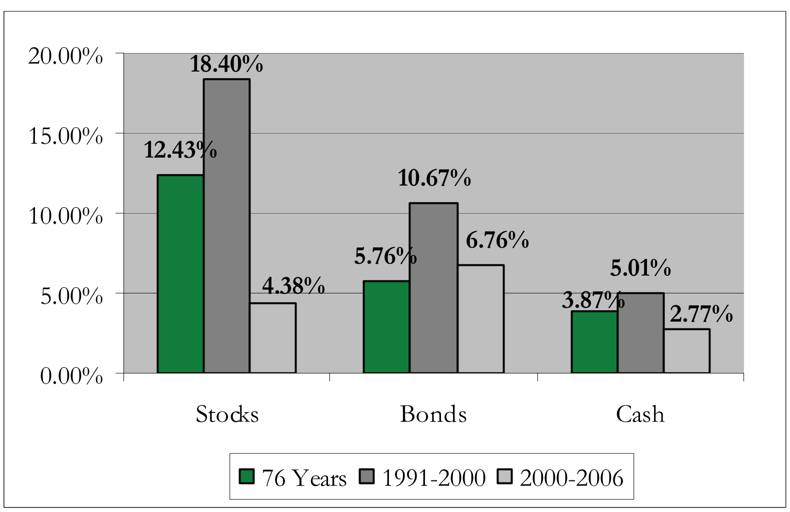
▶ Focus on stocks average performance over the past 10 years or longer, versus their out performance of the late 1990s and their underperformance from 2000 through 2002.

▶ The double-digit returns of stocks in the late 1990s were the exception, not the rule. In the past 76 years, there were only three periods when stocks returned over 15% for more than three years in a row, and only one period (the late 1990s) when stocks returned over 20% for three consecutive years.

▶ Focus on the relationship between investment risk and return. Investors rightly have high hopes for high-risk investments. But these expectations must be tempered by the higher risk of loss of these investments.

▶ Make sure you are comparing apples to apples when setting performance expectations. For instance, make sure you are not weighing growth stock performance against bonds.

*Source: BlackRock*



## The U.S. Dollar and Your Portfolio

The U.S. dollar has struggled over the last few years. The Canadian dollar recently reached parity with the greenback for the first time in three decades. In October 2000, the euro was worth 82 cents. Last year it hit a record $1.45 and kept going, while the British pound sterling was at a 25-year high. (All statistics are from the Federal Reserve system.) According to the Federal Reserve Board of Governors, as of last August the dollar had dropped 26% (adjusted for inflation) against the major industrialized nations' currencies, and 7% against key emerging-market currencies, since early 2002.

If you have no plans to travel abroad, don't eat imported out-of-season fruit, and buy only domestic cars, a weaker dollar may not worry you. However, a falling dollar can lead to rising inflation. Not only can it affect the price of commodities such as oil, but with the higher cost of overseas products, domestic manufacturers may feel more comfortable raising prices. And inflation can lead to higher interest rates, which could affect everything from credit cards to mortgage rates.

A diluted dollar also can affect your portfolio. If you've held international investments in the last few years, you may have caught a tailwind. Past performance is no guarantee of future results, of course, and there are special risks to global investments, including not only currency risks but also political risks and different accounting standards. Risk factors vary considerably by country and region, and as with any investment, you can lose some or all of the funds you invest.

However, returns produced in part by the dollar's decline are one reason investing globally has become popular. According to the Investment Company Institute, more than 90% of the $160 billion of net new money added to stock mutual funds in 2006 went into funds investing in foreign companies.

**Looking over the hedge**
A mutual fund that invests overseas may or may not try to hedge against currency fluctuations. Some are managed to try to minimize the impact of exchange rates; others deliberately do not hedge their currency exposure. Your preferred approach will depend on your view of the dollar's future and how much currency exposure you want in your portfolio. A weaker dollar may boost an unhedged fund's performance because the fund holds securities denominated in other currencies. However, an unhedged fund would suffer more from any dollar recovery. Obtain and read a fund's prospectus carefully before investing.

**Domestic can also be global**
A weak dollar makes U.S. companies' products cheaper abroad, which has benefited many large multinational corporations that are headquartered here but have substantial overseas sales. According to Standard & Poor's, roughly 44% of the 2006 revenues of companies in the S&P 500 Stock Index came from international sources; in 2001, that figure was 32%. Even companies without overseas operations may benefit. For example, with higher prices for overseas goods, some distributors and retailers have begun to find less expensive U.S. suppliers. Also, a weak dollar in the past has made some U.S. companies targets for foreign acquisition.

**What goes down can come up**
The dollar goes through cycles, of course. A stronger economy, higher U.S. interest rates or lower rates abroad, foreign currency crises, market turbulence, or lower federal deficits could help boost the dollar's value. When determining your overall asset allocation, consider both your currency exposure and your level of international investments.

*"...returns produced in part by the dollar's decline are one reason investing globally has become popular."*

| Change in Value of U.S. Dollar Jan 1 to Nov 30, 2007 | |
|---|---|
| Euro | -10.8% |
| Yen | -7.7% |
| Canadian Dollar | -15.1% |
| Pound | -5.4% |
| Source: OANDA Corporation | |

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## Stocks in the News: Chesapeake Energy Corp. (CHK)

Chesapeake Energy Corp. (CHK) is engaged in exploratory and developmental drilling, as well as corporate and property acquisitions in the Mid-Continent, FortWorth Barnett Shale, Appalachian Basin, Fayetteville Shale, South Texas, Permian Basin, Delaware Basin, Ark-La-Tex and Texas Gulf Coast regions of the U.S. The company estimates it is the third largest independent producer of natural gas in the U.S. and seventh largest overall, as of year-end 2006.

CHK believes one of its most distinctive characteristics is its ability to increase its reserves and production through the drill bit. As of year-end 2006, CHK utilized about 132 operated drilling rigs and about 90 non-operated drilling rigs to conduct what the company believed was the most active drilling program in the U.S. The company characterizes its drilling activity by one of four play types: Conventional gas resource, unconventional gas resource, emerging unconventional gas resource, and Appalachian Basin gas resource.

CHK's CEO, Aubrey McClendon, was one of its co-founders; he has served as the company's chairman and CEO since 1989. Mr. McClendon is heavily invested in the company and now owns more than 30 million shares, or 6% of the company's shares outstanding. He has continued to add shares in the midst of the company's strong recent run, acquiring approximately 500,000 shares near the end of February. These transactions push his total open-market purchases since late November to more than one million shares. He has steadily increased his holdings since 2003, when he held approximately 11 million shares. CHK's management provides more commentary than any of its peers, offering additional insights into its operations.

**Bulls Say**

- Management is making a huge bet on high natural-gas prices; if it's right, returns should be phenomenal.
- Chesapeake's ownership interest in drilling rigs and drilling companies has helped the firm hedge the recent rise in daily rig rates.
- Although liquefied natural-gas imports are inevitable, domestic reserves should maintain a cost advantage for the foreseeable future.
- The executive team has been purchasing significant amounts of stock on the open market during the last few years.
- CEO McClendon has an uncanny grasp on the natural-gas industry. Management commentary is second to none.

**Bears Say**

- Chesapeake employs more leverage than most of its competitors.
- The conversion of the firm's numerous convertible issues will dilute common shareholders' ownership interests.
- The firm announced a secondary offering in December 2006. As a result, outstanding shares will increase by 30 million shares, or roughly 7%.
- McClendon's personal accountants were paid $579,000 in 2006.

Key Statistics: CHK

| | |
|---|---|
| *Price* | *$45.01* |
| *Trailing EPS* | *$2.62* |
| *Estimated EPS* | *$3.66* |
| *Forecast P/E Ratio* | *12.1x* |
| *PEG Ratio* | *1.00x* |
| *Dividend* | *$0.27* |
| *Market Cap* | *$23B* |
| *52 Week High* | *$49.87* |
| *52 Week Low* | *$30.74* |
| *Beta* | *0.72* |
| *Expected Annual Growth Rate* | *12.0%* |
| *ROE* | *16.0%* |

*Sources: Standard & Poor's, Morningstar*

## Market and Economic Update *Continued from page 1*

Looking back at history, such events as the failures of Continental Illinois, Drexel Burnham Lambert, Kidder, Peabody & Co. and Long Term Capital Management helped mark important bottoms in the U.S. stock market and were followed by periods in which stocks climbed noticeably. Although financial market volatility remains high and concerns about the health of the economy remains acute, our view regarding stocks is still a cautiously optimistic one. We continue to believe that stock prices will be higher in one year than they are today. Over the longer term, we are even more positive about the prospects for equities, believing that valuations are attractive, that non-financial corporate profits will remain strong and that policymakers will remain committed to combating credit issues and economic weakness.

*Source: BlackRock (Bob Dell, Vice President and Director)*

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