



MAY 2008

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***From the desk of Eric Barden – Chief Investment Strategist***

After enduring the worst quarter in five years, investors are straining to see the light at the end of the tunnel. Stocks fell more than 10%, bottoming out in early March. Since then, the market has recovered much of its losses, but concerns about high oil prices and weakened financial institutions continue to create investor anxiety.

As is typically the case during market downturns, international stocks suffered more than U.S. stocks. Chinese stocks were down more than thirty percent, India was off almost twenty percent and France and Germany were down more than fifteen percent. Fortunately, our client portfolios held up quite a bit better than the rest of the market. Timely increases in the allocation to bonds and a substantial overweight in energy stocks helped to insulate our clients from the worst of the downturn.

As we have previously discussed, current investor anxiety results from uncertainty about the size of losses that banks will take due to the crash in securities relating to U.S. mortgages. As of this writing, financial institutions have announced \$300 billion in losses. Worst case estimates range from \$600 billion to over a \$1 trillion. Nothing could make the seriousness of the current situation clearer than the almost instantaneous collapse of Bear Stearns, the fifth largest investment bank on Wall Street.

Financial “celebrities” such as George Soros and Alan Greenspan are making headlines by claiming that this current financial panic is the most threatening since WWII. Perhaps they would be more convincing if they hadn’t been claiming the exact same thing during the hedge fund panic of 1998. You may recall that after the sharp sell-off in the fall of 1998, the market responded to the Fed’s rapid reduction of interest rates by exploding higher over the next twelve months.

There is no disputing the substance of the difficulties. Many large, global institutions aggressively leveraged their balance sheets to invest in securities of questionable worth. Beginning in early spring of 2007, large hedge funds from firms like Bear & UBS began to announce write-downs in these funds. As it became clear that loans financed by sub-prime mortgages were much more likely to default, the value of sub-prime debt crashed. Bear Stearns overall leverage ratio of 30-1 left it most vulnerable to a collapse in asset values.

Essentially insolvent, Bear Stearns was bailed out by JP Morgan. JP Morgan is one of the few banks left with a sturdy enough balance sheet to absorb the liabilities of Bear Stearns. Even still, the Federal Reserve guaranteed on behalf of JP Morgan, \$30 billion of Bear Stearns most problematic assets, reducing the risk to JP Morgan. Chairman Bernanke asserts that the collapse of Bear Stearns would have wreaked chaos on the economy and the markets.

Opponents of the Bear Stearns “bailout” claim that the Fed is socializing risk. This charge is probably true. Regulators will try to limit bailouts to the most dire of circumstances, but there is no denying that the Fed intervened to stabilize the market. Presumably, future Federal Reserve policy will continue to lean towards intervening in the event of panics. Whether this is right or wrong is difficult to say, but we should not underestimate the impact of aggressive fiscal and monetary stimulus.

On average during the bull markets since World War II, stocks have risen more than 30% in the first twelve months following the bottom of the bear market. Priming the economy through lower interest rates and higher government spending has helped create economic growth. Economic philosophers debate whether this intervention is necessary to stabilize the economy, but no one disputes the impact of this intervention.

Bear Stearns was the weakest link in the banking system. That link has been strengthened by JP Morgan’s acquisition of Bear’s liabilities. But, we are still suffering from a contraction in banks’ willingness to lend money. The credit contraction will likely cause a recession, if it hasn’t started already. This could take a little longer to turn around. Housing prices will continue to suffer as long as mortgages are hard to get. Companies with heavily leveraged balance sheets may have to downsize or even go out of business. Under these circumstances, companies with little debt and strong cash-flows are much more capable of internally generating earnings growth.

We have been anticipating a reduction in the availability of credit for some time. As a result, your stock portfolios consist generally of high quality, low-debt companies. We continue to see upward revisions to earnings expectations for many parts of the economy, most obviously energy and basic materials. Companies with a large international business are benefiting tremendously from the decline in the value of the dollar. Generic pharmaceuticals continue to take market share from large research oriented pharmaceuticals. Much of Latin America is prospering, leading to an increase in the quantities of Coca-Cola consumption. Though we can’t avoid losses in times like this, we have been able to substantially protect your portfolios from the full severity of the decline.

Periods of intense market volatility are the best time to purchase excellent companies at very attractive prices. Taking advantage of the mistakes of others who are forced to liquidate their positions is one of the most effective ways to build strong long-term performance. Though the economy may take a while to get back on its feet, the best performance for stocks occurs well before the new economic strength is apparent. The latest banking crisis began in the spring of 2007. Historically, these periods take about twelve to eighteen months to work through. Given the complexity and severity of the current crisis, cautious optimism is prudent, but the longer stocks can go without falling to new lows, the more likely it is that the worst is over.

Thank you for your continued business and trust. We hope to continue to reward the confidence you have in us.

Sincerely,



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President & Chief Executive Officer



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Enclosures