

June 30, 2007 Market Commentary

Money, Time, and Risk

Remember that time is money.

Benjamin Franklin

Advice to a Young Tradesman (1748)

Ben Franklin's observation that "time is money" doesn't just apply to earned wages—it also applies to interest rates and investments. In fact, the relationship between time and money is so critical that it can affect the market value of virtually every investment you own.

The reason interest rates are so central to investment value is that investments aren't priced in a vacuum—they are priced **relative to each other**. And, in many cases, interest rates are the primary measuring stick against which investments are valued. For example, a stock may appear attractive when a competitive interest-bearing security, such as a bank certificate of deposit, yields only 2.5%. However, if the bank CD were to yield 5.5%, the stock might be viewed as unattractive on a comparative basis, causing its valuation to decline.

This is why recent news relating to the value of time and risk is important to all investors, even those who hold few or no interest-bearing securities.

Revaluing Risk

The second quarter began with upbeat reports of rising economic growth, share buybacks, and corporate merger activity. However, as the weeks passed, several developments caused investors to reconsider their risk exposures.

Subprime mortgage woes. Rising interest rates squeezed homebuyers; home sales and prices sagged, mortgage delinquencies and foreclosures rose, and the "home equity ATM" effectively shut down. Regulators, concerned that lax lending standards had contributed to the surge in subprime defaults, issued tougher lending guidelines for subprime loans.

Real estate trends are often self-reinforcing. Weakness in residential housing activity, now entrenched, may not subside until 2008, as stricter lending standards threaten to prolong the chill in the national housing market.

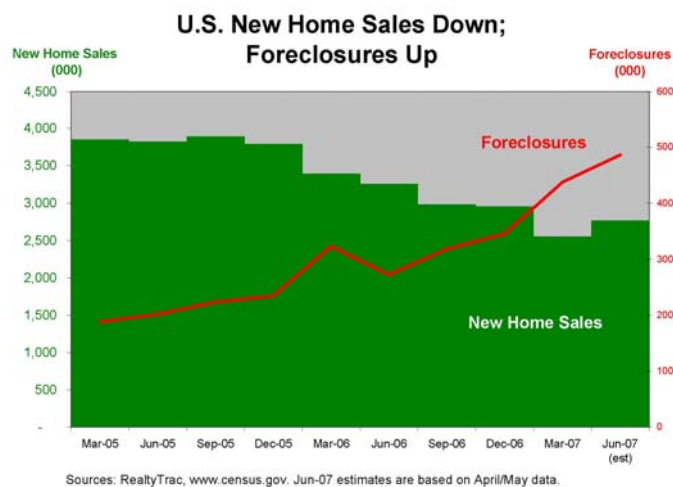
Collateralized debt obligations (CDOs) come under scrutiny. In an attempt to minimize mortgage default risk, Wall Street cut its lines of credit to two Bear Stearns hedge funds that were heavily invested in CDOs¹ which were backed by subprime mortgages. This move raised the prospect of a forced liquidation of subprime CDOs that could cause a general write-down of similar securities.

¹ A CDO is a securitized pool of fixed income assets such as loan or debt obligations that is sliced into parts or tranches that carry different risks. CDOs vary widely in composition and are difficult to value.

When market conditions change rapidly, model-based prices for illiquid securities such as CDOs are sometimes discovered to be inaccurate. It is for this reason that daily-valued mutual funds generally restrict or prohibit illiquid securities.

By the end of the quarter the premium demanded for taking on additional risk, or committing for longer periods of time in the case of fixed income securities, had clearly risen. U.S. Treasury note yields had climbed by +0.4%. Stock prices began to falter in June as rising bond yields competed for investors' dollars and put pressure on corporate earnings and acquisitions.

If bond yields continue to rise, it could have a negative effect on the stock market.



Stock Outlook

While this past quarter's higher interest rates and tighter credit conditions have acted to discourage stock market risk-taking, there are still several powerful factors that could drive equity prices higher:

- **Strong global growth.** The world economy is projected to grow at a 4.9% annual clip in 2007-2008, more than a percent faster than it has over the past two decades, providing abundant investment opportunities worldwide.
- **A weak dollar.** As the dollar's exchange value approaches a 10-year low, U.S. goods and service providers become more competitive in the global marketplace. An inexpensive dollar also makes the stock of U.S. companies appear attractive to foreign investors, thus raising the prospect of further acquisition activity.
- **Expanding manufacturing.** The Institute for Supply Management manufacturing index is at the highest

level in over a year, providing evidence of a resilient economy and industrial sector.

- **Mergers, acquisitions, and private equity buyouts.** Domestic and international players continue to acquire U.S. companies at a rapid clip, driving up equity valuations, and creating new opportunities and efficiencies.

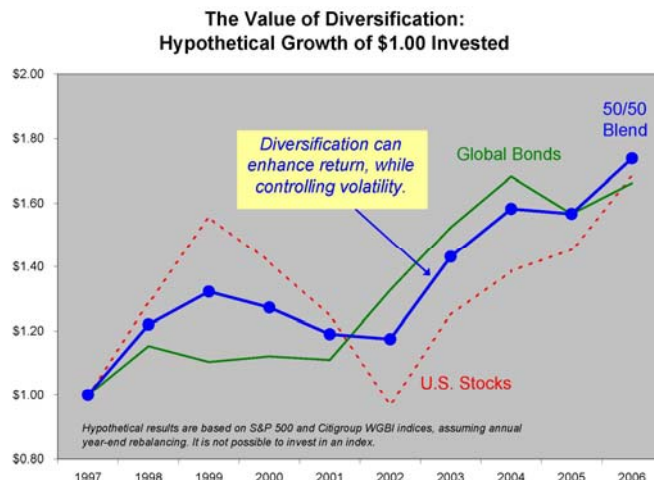
Managed Portfolio Perspective

In the past few years, the U.S. economy and capital markets have fallen slightly out of sync with their global counterparts, due to a variety of factors such as the Iraq War, the rise of emerging markets, and a sharp boom-and-bust housing cycle. During such topsy-turvy periods, geographical and asset class diversification are of great benefit to investors. Our tactical strategy seeks to geographically diversify both equities and fixed income. We are maintaining an overall defensive posture while the Federal Reserve attempts to pilot our economy to a “soft landing”. Our current strategy by asset class:

- Domestic Large Cap: Near-neutral allocation, with an emphasis on value.
- Domestic Mid- and Small-Cap: Underweight small- and mid-cap stocks to protect capital in the event of an economic downturn or recession.
- International Stock: Maintain near-neutral allocation, with an emphasis on value.
- Bonds and Cash: Overweight, tilted towards shorter-term investments, while using global bonds to improve diversification.
- Investment Manager Selection: Seek investment managers that have a demonstrated ability to preserve capital during adverse conditions.

Why Diversify?

During a bull market, such as the one we’ve experienced lately, it is possible to overlook the value of diversification. Before you put all of your investment eggs in a single basket, consider the following investment modeling results.



This example demonstrates that by blending dissimilar investments, it is possible to enhance overall performance, while controlling volatility. While the benefits of diversification can be modest at times, they should never be overlooked, for as Ben Franklin observed, “a penny saved is a penny earned.”

Investment Committee
Northwest Capital Management, Inc.
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