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TO: All clients and interested parties
FROM: Bob Kargenian

Compared to June and July, August was a calm month in regards to a majority of markets, though there was some wide disparity. Equity performance was led by the Russell 2000 (small stocks), up 3.6% for the month, followed by the S&P 400 (mid caps), up 1.7% and the Russell 3000 (broad market), up 1.6% and the S&P 500 (large stocks), up 1.4%. On the downside, the EAFE (foreign stocks) was slammed with a -4.3% loss. Thanks in part to strength in the U.S. Dollar along with the typical performance chasing of the crowd last year in which over 90% of all new dollars went into foreign equities, foreign stocks as measured by the Vanguard Total International Index Fund are down twice as much in 2008 as U.S. domestic stocks.

In fixed income, yields fell modestly, with the 10-year T-note dropping from 3.98% to 3.81%, and the 30-year bond sliding from 4.6% to 4.41%. For the month, the Lipper Intermediate Govt Index gained 0.7% and the Lipper High Yield Fund Index gained 0.2%. With oil and other commodities dropping like a rock, the Lipper Gold Fund Index fell 11.8% for the month.

The Evidence--A Bullish Divergence is in Place

Thus far, the month of September is proving to be wicked and living up to its seasonal tendencies. In the first six trading days of the month, the S&P 500 has dropped 4.54%, the EAFE is off 7.5%, energy stocks as measured by the IYE are down 14% and the XAU Gold Index is down 24.5% (that is no misprint). As I've written before, the stock market is much more volatile than many investors realize, and we've all been reminded of that this year.

Without sounding pollyannish, I want to state that in my view, we are beginning to see signs of a major stock market bottom. Since mid-July, I've repeated that the market likely made an internal momentum low on July 15, at S&P 500 1214 with 1304 stocks making new lows that day. Most bear markets do not end at the internal low--the odds favored a rally of several weeks, then another decline undercutting the low, with a higher momentum low as measured by market breadth statistics.

So far, that is exactly what has transpired. Look at the statistics below:

	July 15	Sept. 9
S&P 500	1214.91	1224.51
S&P Midcap	772.80	765.22
NY Composite	8157.80	7871.15
NY Bullish %	24.2	40.33
# New Lows	1304	391

Two indexes, the NY Composite and the S&P Midcap Index, have already breached their July 15 low, and the S&P 500 is less than 1% away. Yet, with these new price lows, the NY Bullish % has increased from 24% to 40% and the number of stocks making new lows has shrunk from 1304 to 391. This means that as the market indexes are going lower, the internal condition of the market is getting stronger. In dealing with probabilities, it is certainly possible that stocks will go substantially lower and set up multiple positive divergences. But, given the widespread pessimism towards stocks, with consumer confidence at 16-year lows, one must be open-minded to believe that the bear market may be ending right now. To get some confirmation, we need to

see the action of the market itself confirm this divergence, first by displaying at least one 9-1 up/down volume day, and second, by crossing above 50-day and 200-day moving averages.

Remember--the stock market is about the only place on earth where investors want to buy what is expensive and sell what is cheap. Stocks are not dirt cheap here, but they are a much better value than one year ago, and are currently priced for moderate future returns. It is very hard to turn your emotions inside out--we know--we are right there with you--our personal accounts are down for the year, exactly like all of you, but this is temporary, and we trust our research and our indicators, even though the ride has been more bumpy than we care for. But it does happen. Stock market declines are a fact of life--the only thing we can do is attempt to minimize the downside and put the odds in our favor. Giving in to one's fears and giving up on stocks is in most cases the wrong thing to do--it means you'll have no chance of keeping up.

Where We Stand

In the past four weeks, one of our stock market risk models has flipped flopped more than a fish at Seattle's Pike Market. Equity allocations since late January had been mostly steady around 50%. The last four weeks have seen this change to 75%, 50%, 75% and again back to around 50%. This has never happened before, but its turned out to be more of a nuisance than anything. At 50% with some hedges in place, we remain neutral but hopeful. There's been no change in fixed income--we are overweight intermediate bond funds and underweight high yield, and have been since June 25. This has been helpful thus far, as yields on the 10-year note have fallen from 4.1% to 3.63%. However, our core fund, Loomis Sayles Bond, has recently gone through a 7% drawdown, its first since 2004, and this has temporarily hurt the bottom line. In addition, our sector strategy and gold stock exposure, with one of our two gold models positive, have been an albatross the last two months after being a difference maker the prior 18 months.

In terms of risk tolerance (in English, that translates to "how much pain can you handle"), some of you may be finding that its not what you thought it was. That is OK--we understand, because we are there with you. We are already planning to implement some changes to the allocations in all three risk categories--Conservative, Moderate and Aggressive, sometime after mid-October. Our intent is to lower the volatility without giving up too much on the upside. If this is something that is on your mind, feel free to contact us.

Tomorrow is the seventh anniversary of September 11, 2001, perhaps the darkest day in U.S. history. Let us remember those who were lost that day, and pray for their families and friends. Our country certainly has its flaws, and could be better, but in the end, would you rather live anywhere else?

Best regards,



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