



Fourth Quarter 2007

The storm clouds got darker over the American economy in the fourth quarter of 2007. The housing market continued to deteriorate as home prices and sales declined, and the number of mortgage defaults significantly increased. Most financial companies (especially mortgage companies) took very large losses as the mortgage bonds which they hold, lost much of their value. As it turns out, we were very fortunate to have taken our profits in Bear Stearns in the second quarter. Furthermore, the price of crude oil went to roughly \$100 / barrel during the quarter, from about \$60 / barrel, a year ago. Thus, the economic climate during the fourth quarter was consistent with a market decline.

Enclosed you will find the results for your portfolio in the most recent quarter and for the full year. During the fourth quarter of 2007, the average of all portfolios I manage declined by 6.6 percent (after transaction costs but before advisory fees). Over the same period, the S&P 500 and the Value Line indices declined by 3.2 and 6.7 percent respectively. For all of 2007 my average portfolios declined by 1.5 percent (after transaction costs). For the year, the S&P 500 index increased by 4.2 percent and the Value Line index declined by 3.3 percent. Thus, by blending the two indices we can say that the market increased by 0.5 percent during 2007. As always, I will update and present our ten year performance results in the next quarterly report.

Over the past five years, the market has essentially recovered the loss generated by the most recent crash. During this period, we have done well on a relative and absolute basis. For example, over the last five years the blended market (S&P 500 increased by 64.1% and the Value Line Composite increased by 66.0%) increased by 65.0 percent. During that same five year period, the average of all my accounts has appreciated by 91.4 percent after transaction costs but before advisory fees.

There were no major stock trades during the fourth quarter (unless an account had a larger than desired cash position). When the opportunity presented itself, I tried to sell some calls and thereby generate some cash in a declining market. The opportunities were fleeting, since one needs to negotiate these options without giving away too much upside potential. Our cash position remains at roughly 10 to 15 percent.

TIMING MODEL

The Timing Model was neutral to slightly bullish for most of 2007. At the present

time, it has fallen back to a neutral reading of 50%. It means that the market is equally likely to move up or down over the next 3 – 6 months.

2008 OUTLOOK

The US economy grew at an annual rate of about 2.5 percent during 2007. This produced average corporate earnings growth of about 6 percent. Since the market was essentially flat, the price – to – earnings ratio of the overall market declined to about 17. Thus, the market is reasonably priced given present Treasury rates.

I discussed earlier, the two major negative concerns affecting the market at the present time (i.e. mortgage defaults and the high price of energy). These negative forces are being counter – balanced by the Federal Reserve lowering interest rates, and federal agencies and banks working to prevent as many defaults as possible. No one is smart enough to know how these forces will translate to GDP growth and corporate earnings over the next few quarters. This uncertainty is producing the fear that is presently driving the market lower.

What we do know, with a high probability, is that these countervailing forces will begin to resolve themselves over a matter of months rather than years. In addition, while the market was flat last year, many stocks, particularly small and midcap stocks, have been sold indiscriminately and some of these stocks in our portfolios are now extremely cheap. Experience teaches me that the probability is high for these undervalued stocks to become fairly valued in the future – and represent an opportunity for me to sell at a significant profit for you. As an example, my fair valuation of Helen of Troy is \$26 a share. It is now trading at \$14. Historically, my portfolios outperform the market in eight out of every ten years. Having just had two subpar years in a row, I am optimistic that 2008 will be a turning point and we can resume the market outperformance to which I am accustomed.

The main reason that the stock market provides higher (long term) rates of return than bonds or CDs is that at times it tests our courage, patience and resolve.

I wish you all a healthy and prosperous New Year, and thank you for your continued confidence. Please call either me or John Vaccaro if you have any questions.

Sincerely yours,

Ray Hofshi

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