



Third Quarter 2007 Performance Report

During the third quarter of 2007, the market finally had a significant correction of about ten percent. The correction was stimulated by a near panic associated with the housing related credit markets. The situation was sufficiently serious, that it prompted the Federal Reserve Board (Fed) to reduce short-term interest rates by one half of one percent. By the end of the quarter, much of the decline had been erased.

During the third quarter, the S&P 500 index increased by 1.6 percent and the Value Line Geometric index declined by 3.8 percent. That divergence in performance represents a major “flight to quality”. Thus, we can say that the “market” declined by 1.1 percent over the quarter (average of S&P 500 and Value Line indices).

On a year – to – date basis, the market increased by 5.7 percent, while our accounts appreciated by 5.5 percent (after commissions). Since January 1, 2004, the market has increased by 31.0 percent.

The primary portfolio actions taken during the third quarter was the sale of Alpha Natural Resources, and the purchase of Manitowoc. Alpha was sold at roughly break-even. Coal prices have declined; and the prospect for future profit growth for coal companies has diminished. An effort was also made to re-balance the positions in each account, with the objective of reducing our nominal cash position to roughly ten percent.

TIMING MODEL

The Timing model strengthened significantly during the third quarter. It went from a neutral reading of 50% to a bullish reading of 60%. The improvement reflects the correction, which held at the appropriate level, and the Feds cutting of interest rates. The model presently predicts a 60% chance of a market rise and a 40% chance of the market moving lower, over the next 3-6 months. The improvement in the Timing Model is the primary motivator for reducing our cash position.

MARKET OUTLOOK

The most important event which took place during the third quarter was the Fed’s reduction of the Fed’s Fund Rate to 4.75 percent. As you know, this important interest rate has been held constant at 5.25 percent for more than a year. Historically, the stock market has done well during periods of Fed easing.

Unfortunately, there are two countervailing economic forces underway. The most important is the deterioration of the housing market. Housing prices have declined by about ten percent over the past year. This “negative wealth affect” is expected to reduce future retail spending by individuals. Furthermore, declining house prices have increased

the number of mortgage defaults, which in turn has hurt the liquidity of the fixed income markets mentioned earlier. The bottom line is that the current state of the housing market is producing a significant drag on the US economy. The second negative force, on the economy, is the price of crude oil. Crude oil prices have gone back to last year's peak levels of about \$80 per barrel. Thus, energy prices remain a moderate drag on the US economy.

The US Gross Domestic product (GDP) increased at an annual rate of 2.2 percent during the first half of 2007. Consistent with my discussion above; a consensus of economists project that GDP growth should slow a bit to 1.5 – 2 percent over the second half of the year. This should allow the average corporation to maintain modest to normal profit growth (i.e. 5-10%) over the second half. Our portfolio of stocks is designed to grow earnings at a more rapid rate. At existing price levels, and particularly in an easing interest rate environment, the market continues to be undervalued.

Sincerely yours,

Ray Hofshi

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